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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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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. GM PULLS THE PLUG ON OLDS... AND LIFO TAX RESERVES GO <u>DOWN THE DRAIN</u>. As the shock from the news that GM is abandoning its Oldsmobile dealers is sinking in, more tax ramifications of this news are becoming evident. The enormous loss to any dealer holding an Olds franchise cannot really be measured purely in monetary terms. However, as with just about every major event in life you can think of, the IRS always is a partner. Sometimes silent. At other times, not so.

Several years ago after GM started it all with Project 2000, we had several articles in the *DTW* addressing tax issues faced by dealers and their advisors. You can look them up in the June 1996 and December 1996 issues. Now, GM's "transition assistance package" has dealers scrambling to come out with the best overall deal. This will leave interesting tax issues to be faced by their advisors down the road (i.e., when their tax returns have to be filed).

One special problem area relates to the recapture of LIFO reserves by Olds dealers facing the prospect of rapidly declining levels of inventory. Yes, Virginia...there will be recapture.

Apparently, there may be some opportunity for Olds dealers to try to seek reimbursement to some extent from GM for the unexpectedly soon repayment of their LIFO reserves. How successful they might be could depend in part on the actual results when LIFO layer penetrations are computed.

How much and how quickly can only be determined on a dealer-by-dealer basis. Single franchise Olds entities will face recapture consequences more drastically than dual or multiple franchise operations. Another variable, not surprisingly, is the method of LIFO being used. The potential recapture consequences will be different for dealers using the Alternative LIFO Method, than for dealers not using it.

WATCHING OUT FOR

Under the Alternative LIFO method, dealers who have Olds ***and*** other franchises as well may be able to offset a decrease in the new autos pool caused by a drop in Olds inventory. This can be done by increasing, to some extent, the other make new vehicles which are included in the new autos pool. After all, Rev. Procs. 92-79 & 97-36 provide that all new automobiles, regardless of manufacturer, *must* be included in the same single pool. This is mandatory.

Interestingly, the IRS on several occasions has attempted to recapture the LIFO reserve attributable to a specific franchise by using a vertical-slice approach when it (the IRS) thought recapture was appropriate in order to clearly reflect income.

Might the Service argue that Rev. Proc. 97-36 is not applicable to prevent LIFO reserve recapture where the dealership no longer continues to hold the franchise? The Service has traditionally looked at the disposition of a franchise of a particular make of vehicles as an event requiring the recapture of the

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associated LIFO reserve. It has even said this in its recently updated *Audit Guide.*

#2. IRS UPDATES ITS AUDIT GUIDE FOR AUTO DEALERSHIPS. The IRS MSSP (Market Segment Specialization Program) recently released its *Audit Guide for Auto Dealerships.* With the recent decline in IRS audit enforcement activity, taxpayers and/or their advisors may be tempted to become more bold or take more aggressive positions hoping that playing the IRS "audit lottery" may pay off.

A review of this *Audit Guide* (see page 6) suggests that although we might debate whether the Service has become "kinder and gentler," no one would debate that any ambitious agent intelligently using the materials and suggestions contained in this *Guide* could easily make life very miserable. Calls to mind what Little Red Riding Hood said (when it was too late): "My, what sharp teeth you have, Grandma!"

One of the most effective ways you can use the information in the *Audit Guide* in serving your clients is to construct from it your own "pre-audit evaluation" data which can be used in analyzing a dealer's potential exposure to IRS audit issues. Clearly, the IRS has to walk a fine line between obtaining as much information as possible about dealerships, related entities and their owners while avoiding running afoul of the limitation on intrusive activities Congress enacted in 1998.

The emphasis that the *Audit Guide* places on the use of entity flowcharts should not be underestimated by practitioners. In fact, these charts can be very useful tools in assisting dealers in proactive planning activities.

#3. SERVICE TECHNICIAN TOOL RENTAL & REIMBURSEMENT PLANS. No dealer tax issue has gotten more coverage than this in the last few years. It's been on every IRS speaker's list of "hot topics." It was so significant that the IRS devoted a special Coordinated Issue Paper to it this summer.

...So what does the newly issued *IRS Audit Guide* say about it: Absolutely nothing ...That's strange!

#4. USED VEHICLE LIFO...IRS APPROVES SIMPLIFIED METHOD. I recently had the opportunity to attend the IRS Motor Vehicle and Inventory Technical Adviser Conference held in Dallas in November. The IRS allowed a limited number of non-IRS industry people to attend a portion, but not all, of the proceedings. At this Conference, two IRS speakers said they expected a Revenue Procedure to be issued soon that would provide a standardized methodology for an automobile dealer's USED vehicle LIFO computations.

(Continued from page 1)

It was expected that a safe harbor procedure for used vehicle LIFO would be patterned after the favorable and liberal methodology in Rev. Proc. 97-36 for new vehicles. What seemed to be encouraging in the discussion was that the so-called "52-week" method described in TAM 9853003 would not be required...nor would the use of separate data bases to determine prices for used vehicles acquired at auction vs. those acquired by trade-in from customers.

GOOD NEWS: the IRS unveiled its Alternative Used Vehicle LIFO Inventory Method in Revenue Procedure 2001-23. The IRS approved method hinges on the selection and consistent use of an "official" used car industry guide such as *Black Book, NADA, Kelley* or *Edmund's* as the basis for repricing comparable vehicles at the beginning and end of the year.

One major advantage: Dealers who voluntarily change to the simplified method are guaranteed that the IRS will not challenge their previous used vehicle computations. Many of the special rules applicable under the IRS approved method for new vehicles also apply to used vehicles: (1) vehicles which are not comparable and can't be repriced are treated as new vehicles and given a 1.000 index so that all used vehicles end up being considered in the index calculation; (2) options and accessories do not have to be repriced; (3) two pools are required—one for autos, the other for light-duty trucks; (4) all invoices for vehicles in inventory must be retained; (5) the cut-off method is applied and (6) the LIFO index at the beginning of the year of change is converted to 1.0000, and all indexes for prior years are rebased accordingly.

#5. SERVICE CONTRACT "OVERPAYMENT" PROGRAMS MAY IMPROPERLY DIVERT DEALERSHIP INCOME. A recent IRS Motor Vehicle Technical Adviser (MVTA) Automotive Alert dated October, 2000 said that certain vehicle service contract overpayment arrangements could be illegal.

The Alert indicated that the MVTA had received information from examination teams about a possible "area of abuse and significant non-compliance." The programs may vary slightly in operation and may be identified by names such as oversubmits or dealer override agreements. Also, they may be found in non-dealer-obligor as well as dealer-obligor programs for new and/or for used vehicles.

The Alert illustrates several types of plans and discusses some of the arguments the IRS may make when it believes there is improper reporting of the overpayments. The Alert concludes: "The overpayment program is just one option in the variety of vehicle service contract programs that are (is) avail- →

able. The lack of uniformity in the overpayment program makes it difficult to formulate a 'one size fits all' approach to the proper tax treatment....(These) programs present an opportunity to divert income and for wide-spread non-compliance with the tax laws." Agents are requested to gather information on similar programs for further evaluation by the MVTA.

#6. GIFT REPORTING UPDATE. Recent articles in the *Dealer Tax Watch* (March 2000 among others) have dealt with the importance of properly preparing gift tax returns where the valuation of a closely-held (dealership) entity is involved. This was intensified by the issuance of final Regulations spelling out what the IRS will accept as adequate disclosure to prevent previous gifts from being revalued.

Revenue Procedure 2000-34 now provides guidance for submitting information and amending gift tax returns to adequately disclose a gift if full information was not initially submitted with a gift tax return when it was filed.

The period of limitations with respect to such a gift will run when the taxpayer adequately discloses the gift on an amended gift tax return filed pursuant to the Revenue Procedure. The statute of limitations will generally expire three (3) years after the date such an amended return is filed. The top of the first page of the amended return, Form 709, must have the words "Amended Form 709 for gift(s) made in [insert the calendar year that the gift was made]–In accordance with Rev. Proc. 2000-34, 2000-34, I.R.B. 186."

This Revenue Procedure is effective for amended returns filed after August 21, 2000 which are filed to comply with the new adequate disclosure Regulations. Several other special rules apply. If no gift tax return had been filed to report the gift in the first instance, it appears that a taxpayer cannot use the safe harbor filing opportunity offered in Rev. Proc. 2000-34 to make its initial filing.

#7. INDIRECT GIFTS. An interesting gift tax case was recently decided in the Tax Court. It involved a taxpayer–not an auto dealer–who tried to benefit from additional annual gift exclusions. The case is *Estate of Marie Bies v. Comm.* (T.C. Memo 2000-338, November 2000). It shows how the IRS, in reviewing an estate tax return (Form 706), can upset prior gift tax activity where the decedent made indirect transfers to family members.

In prior years, the decedent had gifted stock to certain relatives who were inactive in the business. These recipients then transferred the stock that they had received to their spouses who were actively involved in the business.

The Tax Court said, "It is...clear from the record that the (donee daughters-in-law) had pre-existing agreements to transfer the shares to their husbands." It concluded, "Viewed as a whole, the evidence shows the daughters-in-law were merely intermediate recipients, and the decedent intended to transfer the stock to her lineal descendants who were committed to continuing the operation of the...business." This case is worth your reading.

#8. DISGUISED PAYMENTS FOR DEALER'S BENEFIT AFTER DEALERSHIP RESTRUCTURING WERE REALLY TAXABLE INCOME TO HIM FROM A SALE. Another recent Tax Court decision, *Henry Misle v. Comm.* (T.C. Memo 2000-322, October 2000) involved the taxation of payments made after a complicated series of restructurings by the Misle Family members who owned and operated car dealerships in Nebraska. After being affected by certain family disharmony, payments made by the newly created holding company for the benefit of one of the exiting dealers were held to be taxable to him as ordinary income...and deductible by the payer.

This case includes references to the seller's CPA tax opinion letter and it also involves the imposition of various penalties on the taxpayer. Warning: the fact pattern is rather complex and unique. However, this case clearly demonstrates the ability of the IRS to get to the bottom of things even in the most complicated of situations.

#9. SAMPLE DEMO AGREEMENT. If your dealers still can't be persuaded to drop demos entirely, see the agreement on pages 4-5. It is reprinted with permission from Woodward & Associates, Bloomington, Illinois.

#10. INDEPENDENT CONTRACTOR PAYMENTS. Each year dealers are required to report payments of more than $600 to unincorporated independent contractors on Form 1099-MISC. Obviously, payments to incorporated independent contractors are not required to be reported.

Here's some advice several attorneys have passed along: Businesses should request Certificates of Good Standing from independent contractors on a yearly basis to make sure that the independent contractors they are dealing with are, in fact, incorporated.

#11. HOW IS THE INTERNET REALLY AFFECTING AUTO DEALERS? Two recent articles shed interesting light on this question. If you're curious, take a look at *Fortune*, Nov. 27, 2000 "Revenge of the Car Salesmen: The Internet is a Lemon." Similarly, try *Barron's*, Dec. 11, 2000 "Stuck in Reverse: Why Selling Cars Online Just Doesn't Work."

SAMPLE AGREEMENT FOR DEMONSTRATOR VEHICLES

(DEALERSHIP LETTERHEAD)

DEALERSHIP ______________________________

USER'S NAME ______________________________

1. The demonstrator vehicle is provided to the User primarily for the purpose of facilitating the User's performance of services, where and if appropriate, for the Dealership. The use of the vehicle is also intended to provide and enhance high visibility and exposure for the Dealership and its products.

   Use of the demonstrator vehicle for personal purposes and personal use mileage is to be kept to a minimum and the User agrees to do so.

   (Alternate language: Personal use mileage, which includes commuting, is to be minimized and the vehicle is not to be used for vacations.)

2. The demonstrator vehicle is required to be available at all times to be shown to potential customers.

3. The demonstrator must be available at all times to be loaned to Dealership customers upon approval of Dealership management.

4. User is not allowed to store personal possessions in the vehicle. User is responsible for all parking tickets. In addition, User agrees to use seat belts and to engage other safety restraints at all times and to refrain from smoking and to prevent others from smoking while in the vehicle.

5. If the demonstrator is used for any unauthorized use, including vacation use, then the User agrees to pay the Dealership 35 cents ($.35) per mile for any and all non-business usage. This mileage (if any) must be reported to the Dealership and paid for no less frequently than annually.

6. The demonstrator vehicle is not to be loaned to, nor used by, friends, relatives or the User's spouse. Use of vehicle outside of normal working hours is to be limited.

7. The User agrees to pay for all gasoline costs allocable to non-business use and to see that regular maintenance is performed on the vehicle.

8. The Dealership will __ / will not__ provide insurance on the vehicle, and the User is responsible for the insurance deductible in the amount of $_____ and is responsible for any unreimbursed costs incurred by the dealership for the vehicle.

9. Upon termination of the use of the demonstrator, the User agrees to immediately return the demonstrator. The User agrees that the Dealership may report the demonstrator vehicle as stolen if it is not returned to the Dealership within one day after being notified by the Dealership that this agreement has been terminated.

10. Dealership elects ***NOT TO WITHHOLD*** income taxes and/or Social Security/FICA taxes until and unless written notice to the contrary is given to the User.

11. Parts, service, business and other managers may be supplied demonstrator vehicles. These demonstrators are supplied for the benefit of the Dealership and are required to be used as a condition of employment by the employees to whom they are provided subject to all the terms and conditions of this agreement. User agrees and understands that these vehicles are to be available to be loaned to customers, and/or parts pickup, dealer trades, emergency service calls, bank deposits, post office, customer pickup, after-hour calls for the Dealership, security and fire protection, sales presentations and for other purposes.

(Continued)

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SAMPLE AGREEMENT FOR DEMONSTRATOR VEHICLES

12. The demonstrator vehicle is subject to sale by the Dealership at any time and without regard to any inconvenience such sale may present to the User.

13. The User must accept the make and model of demonstrator vehicle selected by the management of the Dealership. The User is responsible for all costs to return the vehicle to the Dealership and to restore the demonstrator to "new" condition when it is returned.

14. The User assumes responsibility for paying all income taxes and any other taxes that may be imposed as a result of User's personal use of the demonstrator vehicle.

15. The User agrees to pay the Dealership $____ per month for the personal use of the vehicle. The User agrees that the annual taxable value is $____. The average value of the vehicle to be used is $_____.

    If the amount charged for personal use is less than an amount determined by the Internal Revenue Service to be appropriate, the user agrees to reimburse the Dealership for any and all payroll tax and/or personal income tax assessed against the Dealership by the IRS and collected from the Dealership attributable to such use of the vehicle.

16. The vehicle must remain within the Dealership's marketing area, which is generally no more than 50 miles from the dealership.

17. User acknowledges having a current valid drivers license and that his/her driving record has no recorded use of alcohol or illegal drugs in the last 7 years. User agrees that he/she will never drive the vehicle while under the influence of alcohol or drugs. User agrees to give two day's notice if his/her drivers license is suspended.

18. The User agrees to keep a mileage record of personal use of the vehicle where it is used for other than commuting purposes: Yes___ No____.

19. *METHOD OF VALUATION* ... check appropriate box(es):

    ___ No charge needed since demonstrator vehicle will be used by full-time salesman or equivalent.
    ___ Fair market value of lease (based on local third party lease) $________.
    ___ Annual Lease Value Table (from IRS table) $________.
    ___ Fleet Average Valuation $________.
    ___ Vehicle Cents-Per Mile Valuation ______ Personal Miles ________.
    ___ Commuting Valuation Rule ($90 per month/$3.00 per day round trip commute) ________.
    ___ *Personal* miles driven in the year 200__ were _____
    ___ *Total* miles driven in the year 200__ were _____. Value $_____.
    ___ Expected average value of the vehicle is $_____. Expected annual taxable use value is $_____.

________________________________ ________________________________
Authorized Signature for Dealership *Title*

(Date) ________________________

________________________________ ________________________________
User's Signature *Print User's Name*

(Date) ________________________

(This agreement should be completed when the vehicle is first supplied and every January thereafter.)

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IRS UPDATES ITS AUDIT TECHNIQUE GUIDE FOR AUTOMOBILE DEALERSHIPS

IRS AUDIT GUIDE

In December, the IRS released its MSSP (Market Segment Specialization Program) *IRS Audit Guide for Auto Dealerships.* This updated *Audit Guide* contains examination techniques for automobile dealerships and is Training Document 3147-120, dated September 2000. The *Guide* contains this usual IRS disclaimer: "Under no circumstances should the contents be used or cited as authority for settling or sustaining a technical position." Go figure.

When the IRS MSSP issued its *Audit Technique Guide for Independent Used Car Dealers,* we reviewed that manual in both its preliminary form (see September 1995, *DTW*) and in its final form about a year later (see September 1996 *DTW*). This article follows in the style and approach of those overview articles.

The *Audit Guide* contains 19 Chapters and is divided into 4 Parts. A separate group of Appendices is included as the 5th Part. The Chapter breakdown appears on the facing page.

Each chapter of the *Audit Guide* is summarized with some of the IRS coverage selected for further discussion or amplification. This should enable you to decide which areas you may want to study further on your own. Certain information presented in the *Audit Guide* has been regrouped for clarity. This article is not intended to be a critical analysis of the IRS technical discussions of each topic in the *Audit Guide.*

Because of the variation in formats available in downloading the document, we have referred to the paragraph numbers that appear in brackets throughout the text of the *Guide*, rather than to specific page numbers. This should make it easier to find specific paragraphs or citations in the *Audit Guide.* For more information on the *Audit Guide,* see the IRS web site at www.irs.ustreas.gov or we can send you the full-text PDF version via e-mail if you contact us at cpawjd@aol.com.

FINANCIAL STATUS

Chapter 1 is most thought-provoking. It sets forth the idea that financial status analysis applied to auto dealership examinations, though possibly more complex, is in reality, the same analysis that agents were previously exposed to in classes which concentrated on the tracing of cash through "T" accounts.

The previous training classes referred to were the controversial "lifestyle/economic reality" audit classes which provoked a firestorm reaction from the AICPA and other organizations in late 1995 and 1996. These courses and the resulting "lifestyle questions" culminated in the AICPA's successful lobbying to get the IRS to stop what taxpayers' representatives considered to be "invasive probes" for possible unreported income or fraud.

In case you've forgotten about this, see the June 1995 *DTW* which lists the 27 questions that IRS agents were asking to get an idea of a taxpayer's lifestyle and economic status. Also, see the March 1996 *DTW* which summarizes the AICPA's recommendations to practitioners for dealing with the lifestyle audits. The AICPA's recommendations are just as important today as they were in their 1996 context.

The definition in the *Guide*'s Appendix given for ***financial status*** analysis is "a determination of whether what is represented on tax returns as true actually has economic merit and substance." This seems to be the current working definition, and the *Audit Guide* indicates that "the scope of the audit would focus in this direction" by concentrating on cash as it affected the ultimate earner and end user of that cash.

Chapter 1 simply notes that the IRS Restructuring and Reform Act of 1998 "prohibits the use of financial status examination techniques to determine the existence of unreported income unless the IRS has a reasonable indication that there is the likelihood of unreported income." Without getting into the legalese, it seems to be like the idea of "probable cause"...or which came first: the chicken or the egg?

As part of the so-called Taxpayer's Bill of Rights in 1998, Congress imposed a number of limitations on the Internal Revenue Service, one of which was an Amendment to Section 7602. Code Section 7602(e) is entitled "Limitation on Examination on Unreported Income." It reads in its entirety: "The Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income."

One might expect that a really enterprising revenue agent will do everything possible to walk a fine line here. In interpreting Section 7602(e), the Service just recently concluded that a revenue agent may drive by an individual's house or conduct a Lexis search to determine if the individual purchased real

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AT A GLANCE	IRS/MSSP AUDIT GUIDE FOR AUTO DEALERSHIPS
PART I **GENERAL FOCUS & PROCEDURE**	Chapter 1 Financial Status 2 Getting Started (Incl. Appendix A - *Initial Interview*) 3 Standard Audit Index Numbers (SAIN) 4 Books and Records (Including Appendix E - *Glossary*) 5 Balance Sheet (Incl. Appendix B - *Balance Sheet Examination Specifics*)
PART II **INVENTORY**	6 General - Non LIFO 7 LIFO Background 8 Computing LIFO: Pre-Revenue Procedure 97-36 (Incl. Appendix C - *Definition of an* Item *Coordinated Issue Paper*) 9 Alternative LIFO for Auto Dealers
PART III **AFTERSALE FINANCIAL PRODUCTS**	10 Automobile Dealership Aftersale Financial Products 11 Extended Service Contracts (Including SWIM Method) 12 Extended Service Contracts - "Dealer Reserve Accounts" 13 The Producer Owned Reinsurance Company (PORC) (Including Appendix D - *Analysis of the* William Wright *Case*)
PART IV **STAND ALONE ISSUES**	14 Advertising Associations 15 Covenants Not to Compete 16 Related Finance Companies 17 Passive / Non-Passive Considerations 18 Voluntary Employees Benefit Associations (VEBAs) 19 Other Prevalent Auto Practices • Holdback Charges • Warranty Advances • Finance Reserves • Use of Demonstrator Vehicles & Other Fringe Benefits • Officer (Reasonable) Compensation • Sub-Prime Issues re: Sales vs. Loan Arrangements with Unrelated Finance Companies
PART V	Appendices: A - E ... Referenced to related chapters above.
WHAT'S REALLY GOOD/ INTERESTING	• *Financial Status* determination: How it relates to audit process and dancing around Section 7602(e) limitations on IRS activity. • Use of entity flowcharts. • Discussions of extended service contracts, PORCs and sub-prime issues involving sales to, and/or loan arrangements with, unrelated finance companies.
WHAT'S "NEW"	• Discussions on VEBAs and Advertising Associations.
WHAT'S DISAPPOINTING	• Absence in most discussions of reference to specific citations based upon Letter Rulings, Technical Advice Memoranda and Field Service Advice. • No discussion concerning service technician tool rental and reimbursement arrangements (the subject of a recent IRS Coordinated Issue Paper). • Discussion of inadequate recordkeeping practices and noncompliance with Rev. Proc. 98-25.

estate before having a reasonable indication that there is a likelihood of unreported income. This was in Field Service Advice 200101030.

After commenting that agents should relate their current financial status analysis techniques to their previous cash-flow orientation training, the *Audit Guide* adds, "Complexities in this analysis arise when multiple related entities, common in the auto dealership context, are discovered."

To help agents cope with variations they may encounter, the *Guide* classifies dealerships into three categories for purposes of determining financial status: (1) Type A: Schedule C Used Cars; (2) Type B: Single/Smaller Dealers of New Cars; and (3) Type C: Large Multi-entity Concerns. It also suggests that financial status analysis should be applied to "large holders," indicating that an ownership holding of 50% or more would be the cut-off. The *Audit Guide* gives illustrations of an analysis for each type (A, B, C).

RELATED ENTITY FLOWCHART. In its analysis for Type B, the *Audit Guide* first introduces what may be a new concept to many taxpayer representatives. It suggests, ***"An entity chart is helpful in getting the big picture."***

The use of an entity chart is a recurring theme throughout the *Audit Guide,* and agents are encouraged to request taxpayers (representatives) to provide them. The *Guide* contains one example of an entity chart which attempts to portray an overall financial consolidation of related entities. Another example—taken from a previous *Dealer Tax Watch* article—appears on the facing page. This chart reflects perhaps a more useful way to "view" the ownership and relationship of related entities without necessarily getting bogged down in the numbers.

The *Guide* makes two observations. The warning given to agents at [12] is that "these additional entities can give some taxpayers flexibility to devise improper tax avoidance schemes that would not be possible without the additional entity layer and are difficult to detect because of it." At [14], the *Guide* states that it is important that all related returns are gathered because "the one the agent may miss may be the one that sheds a great deal of light on the *reality* represented in these tax returns."

The *Audit Guide* gives agents other suggestions for ways that they can see the "big picture" and determine material areas to pursue further. It adds that this type of analysis will steer the agent away from "verification audits" and more quickly result in the determination of the probability of material adjustments.

SIX PRESSING QUESTIONS

The concept and use of an entity flowchart showing all related dealerships and all other related entities and the principal shareholders is helpful in understanding how:

1. Losses incurred by the entities are being financed,
2. Loans and other inter-company transfers are financed,
3. The acquisition of assets can be justified,
4. The "financial maintenance of particular business philosophies" can be justified,
5. Debt service obligations are being satisfied, and
6. "Business and personal lifestyles" can be maintained. (What does this last one really mean?)

We would add that the use of entity flowcharts is even more powerful if a chart is prepared for each year under scrutiny since changes in structure and ownership percentages will jump right out at you.

GETTING STARTED

This chapter identifies some of the key documents that agents should request. It also addresses in detail the concept or process of the initial interview. Appendix A (see pages 19-23) lists questions and concepts which agents should consider for inclusion during their initial interview with the taxpayer.

The four documents forming the cornerstone of any dealership examination are said to be (1) the unadjusted trial balance, (2) adjusting journal entries, (3) tax classification workpapers and (4) the Manufacturer's statement. The latter (i.e., Manufacturer's statements) "can be utilized to establish confidence in the taxpayer's books early and quickly in the examination process." The *Audit Guide* adds that any differences between the Factory statements and the tax return that are large or unusual should be questioned.

In discussing the initial interview process, the *Audit Guide* observes that it is not uncommon for a representative to recommend that the dealer stay visible to discourage compensation-related issues, but out of direct access of the agent. Another observation is that some representatives may wish to test the examiner early on in the audit process to determine not only the technical aptitude of a particular agent, but also his or her resolve to do the job.

At [41], it is stated that the Information Document Request should ask the dealership to prepare a flowchart laying out all related entities and their purpose

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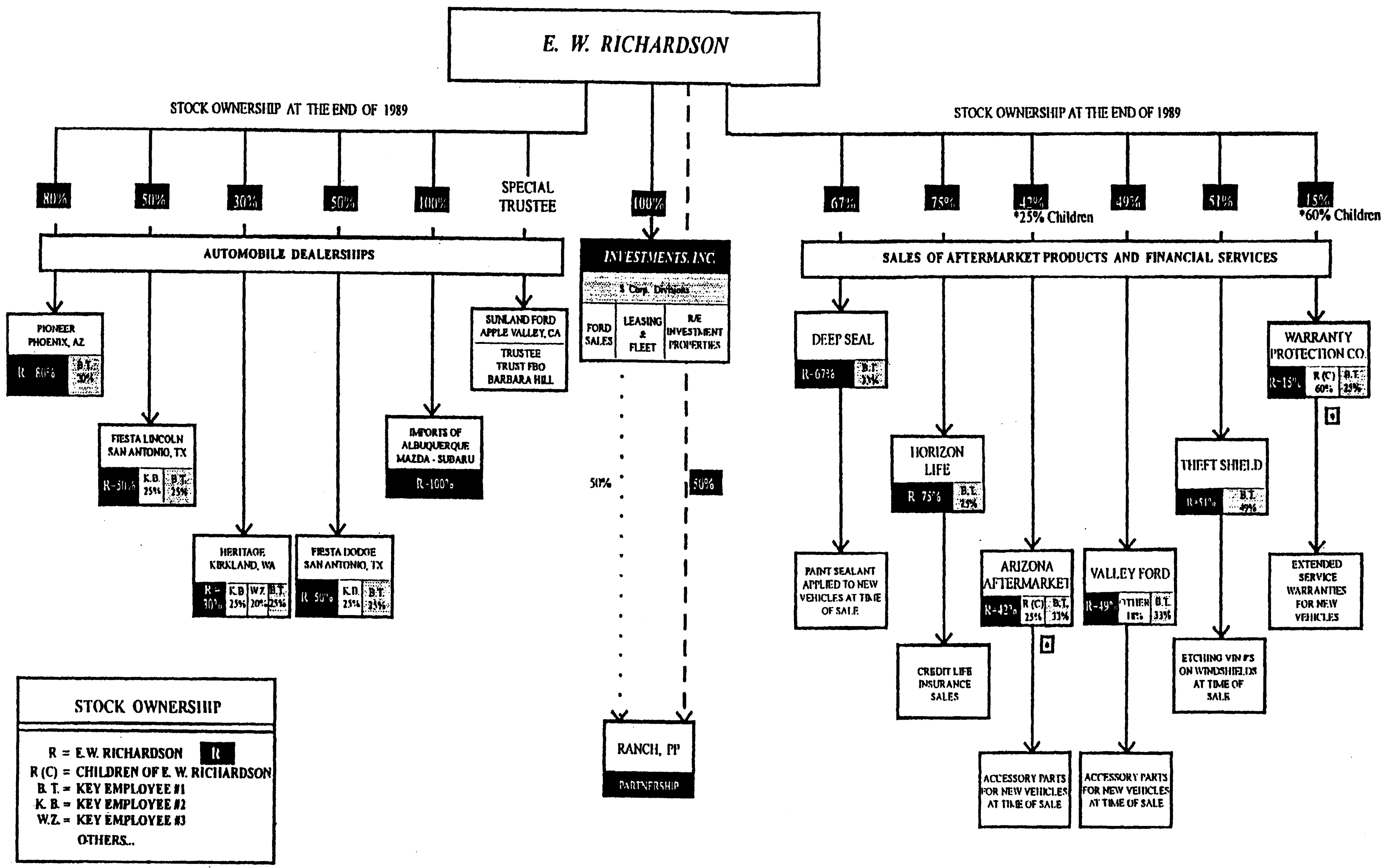
E. W. RICHARDSON
STOCK OWNERSHIP AT THE END OF 1989
80%
50%
30%
50%
100%
SPECIAL TRUSTEE
AUTOMOBILE DEALERSHIPS
PIONEER PHOENIX, AZ
R 80%
B.T. 20%
FIESTA LINCOLN SAN ANTONIO, TX
R-50%
K.B. 25%
B.T. 25%
HERITAGE KIRKLAND, WA
R - 30%
K.B 25%
W.Z 20%
B.T. 25%
FIESTA DODGE SAN ANTONIO, TX
R 50%
K.B. 25%
B.T. 25%
IMPORTS OF ALBUQUERQUE MAZDA - SUBARU
R-100%
SUNLAND FORD APPLE VALLEY, CA
TRUSTEE TRUST FBO BARBARA HILL
100%
INVESTMENTS, INC.
FORD SALES
LEASING & FLEET
R/E INVESTMENT PROPERTIES
50%
50%
RANCH, PP
PARTNERSHIP
STOCK OWNERSHIP AT THE END OF 1989
67%
75%
42%
*25% Children
49%
51%
15%
*60% Children
SALES OF AFTERMARKET PRODUCTS AND FINANCIAL SERVICES
DEEP SEAL
R-67%
B.T. 33%
PAINT SEALANT APPLIED TO NEW VEHICLES AT TIME OF SALE
HORIZON LIFE
R 75%
B.T. 25%
CREDIT LIFE INSURANCE SALES
ARIZONA AFTERMARKET
R-42%
R (C) 25%
B.T. 33%
ACCESSORY PARTS FOR NEW VEHICLES AT TIME OF SALE
VALLEY FORD
R-49%
OTHER 18%
B.T. 33%
ACCESSORY PARTS FOR NEW VEHICLES AT TIME OF SALE
THEFT SHIELD
R-51%
B.T. 49%
ETCHING VIN #S ON WINDSHIELDS AT TIME OF SALE
WARRANTY PROTECTION CO.
R-15%
R (C) 60%
B.T. 25%
EXTENDED SERVICE WARRANTIES FOR NEW VEHICLES
STOCK OWNERSHIP
R = E.W. RICHARDSON
R (C) = CHILDREN OF E. W. RICHARDSON
B. T. = KEY EMPLOYEE #1
K. B. = KEY EMPLOYEE #2
W.Z. = KEY EMPLOYEE #3
OTHERS...

and relationship to the principal shareholder. Agents are encouraged to be persistent and repeatedly ask for this information if they are not satisfied that full disclosure has been made. Photocopies of all related returns ***for all years of relevance*** should be requested. "When the agent has this information in hand, a determination of whether there is ***financial status*** can be made [47]."

Another critical reminder (at [60]) is that "It is not one year of one entity that is under audit...This one year, one entity look is the beginning point of the examination and merely provides ***a window for the agent to see into the taxpayer's operations***. The overall picture of how the taxpayer is handling the whole concern for all relevant periods is at issue with the examination."

Here again, an enterprising agent encouraged by this statement could significantly expand what initially was expected to be a "simple audit." This could readily be done by applying the considerable leverage that the Courts have recently given to the IRS in dealing with change in accounting method (CAM) issues and precedents. As many articles in the *Dealer Tax Watch* have amply illustrated, change in accounting method issues are no respecters of the traditional three-year statute of limitations.

The *Audit Guide* states that if the initial analysis does not result in indications of unreported income, the scope of the examination may be limited to technical issues such as compliance with Revenue Procedures dealing with applicable changes in accounting method and Package Audit (see September 1995 *DTW*, page 15) requirement compliance.

This chapter concludes with the statement, "If ***financial status*** does not exist...then the scope of the examination should be expanded as circumstances warrant." It is important to keep in mind that where the term "financial status" is used in the *Audit Guide*, this term refers to congruity between the tax returns and the substance and economic activity of the taxpayer. In short, if ***financial status*** exists, limit the scope of the audit. If ***financial status*** does not exist, then expand the scope of the audit.

STANDARD AUDIT INDEX NUMBERS (SAIN)

This chapter simply deals with the IRS preferred system that agents should...but are not required to... use in organizing their workpapers.

BOOKS AND RECORDS

This chapter restates the importance of (1) the financial statement the dealer is required to send to the Factory or Manufacturer and (2) the underlying Factory accounting manual as tools to be used by the agent throughout the examination.

Agents are encouraged to start with the accountant's or return preparer's workpapers and the General Ledger "to determine focus" and become familiar with the specifics of the taxpayer's books and records. The common practice of using 13th month journal entries is given a special section in this chapter.

Agents who are less experienced with auto dealerships may encounter unfamiliar terms for certain transactions and/or activities as they go through the books and records and financial statements. Appendix E of the *Audit Guide* is a Glossary of Terms which defines many of these terms.

BALANCE SHEET

This chapter and a related appendix ("Balance Sheet Examination Specifics") guide agents through the specifics of conducting Balance Sheet examinations in order to save time and ensure that a thorough job is done.

The *Guide* states that the reason a ***three-year comparative analysis*** is done at the beginning of a dealership examination is to allow the Service to identify changes and fluctuations that may require further examination while the audit is still in the planning stage. "This (three-year comparative) analysis, coupled with financial status concerns will aid in determining the scope of the examination."

The chapter itself is very brief, but it is supplemented by Appendix B, which is a "compendium" of specific audit techniques relative to dealership Balance Sheet accounts. Not surprisingly, loans to and from shareholders are given special attention. Emphasis is given to (1) the need to inquire during the initial interview as to the existence of loans and the taxpayer's policies with respect to repayments, interest rates and collateral; and (2) the special rules concerning demand loans.

After discussing the complex demand loan rules in Section 7872, the *Guide* concludes, "Despite the fact the computation may seem somewhat tedious at first, adjustments can be substantial and are required by law." Also, in discussing loans from shareholders and potential thin capitalization issues, emphasis is given to the fact that if a portion of the loans from the shareholder is converted to capital stock, then interest paid by the Corporation will be disallowed and classified as a dividend to the shareholder to the extent of earnings and profits.

The building and equipment Balance Sheet accounts also receive special comment since "the main issue should be the arm's-length nature of the rent paid by the dealership to the related entity for the property. The examiner may wish to determine Fair

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Rental Value to disallow excessive rent and expand on a constructive dividend issue."

On the liability side of the Balance Sheet, agents are encouraged to verify that any accounts payable and other liabilities expensed in the tax return satisfy all of the requirements of Section 461(h), including determining that: (1) economic performance has occurred, (2) the expense is ordinary and necessary and (3) the expense is directly related to the business.

In discussing capital stock and capital accounts, the point is made that "The economic-reality analysis for capital is useful as it gives a full picture of who owns what and how much. Possible issue areas include the transfer of ownership from one family member to another. These transfers should be examined to ensure that there is no unreported gift tax or capital gain tax."

Another glance at the entity flowchart on page 9 readily shows how useful a chart of this nature can be...especially if similar charts for prior and/or subsequent year-ends are updated to highlight changes in ownership percentages resulting from sales and/or gifts.

Similarly, consider how useful a chart like this is in helping to understand factual complexities, such as those present in the recent *Henry Misle* case (T.C. Memo 2000-322). In this case, payments made in connection with an option and stock purchase agreement were held to be taxable to the dealer as ordinary income.

PART II: INVENTORY

This Part of the *Audit Guide* consists of four chapters, three of which exclusively involve LIFO matters. Chapter 6 deals with Non-LIFO considerations. Chapter 7 provides general background on LIFO. Chapter 8 addresses LIFO computations before the Alternative LIFO Method for New Vehicles came along as well as situations where the taxpayer is not using the Alternative LIFO Method. Chapter 9 deals exclusively with the Alternative LIFO Method. In the aforementioned Glossary of Terms (Appendix E), roughly 60% of these terms relate to LIFO inventories.

GENERAL: NON-LIFO. Chapter 6, dealing with Non-LIFO considerations, is relatively short and absent of any meaningful information other than its references to the application of Section 263A inventory cost capitalization rules to auto dealers.

LIFO BACKGROUND. The LIFO background in Chapter 7 discusses origins of the LIFO method and a short history of auto dealership LIFO applications and early IRS audit activities and concerns.

The point is made in this chapter, as well as elsewhere, that an agent considering LIFO computations for dealers who have not elected to use the Alternative LIFO Method should be familiar with the IRS Coordinated Issue Paper on dollar-value LIFO definition of an item. This Coordinated Issue Paper dated July 1989 holds that appropriate adjustments should be made in repricing the cost of vehicles on hand at the beginning and end of a year to reflect differences in make, year, model, body style, standard equipment, options and other factors. The full text of this CIP is included as Appendix C.

COMPUTING LIFO: PRE-REV. PROC. 97-36. This chapter is more than twice as long as any other chapter in the *Audit Guide*. It probably could stand alone as a separate IRS reference guide for agents who have need to look into the rather limited application of the information in this chapter. The application is rather limited because (1) many dealers have not elected, or are no longer on, LIFO; and (2) many dealers electing LIFO for their new vehicles apply either the IPIC method or the Alternative LIFO Method, thus considerably narrowing the universe of application for the material in this chapter. The LIFO Method of Inventory Valuation: A IRS Self-Instructional Program–Student Guide (Training 3127-01, revised December 1987) contains much of the same material, with more elaboration.

This chapter does include an interesting discussion on the use of the earliest acquisitions method, and one result thereunder which the IRS refers to at [208] as the creation of a so-called "hidden reserve." LIFO connoisseurs, with spare time on their hands, might want to look into this (or read about it in a subsequent issue of the *LIFO Lookout*!).

The important LIFO conformity requirements for financial statement purposes are discussed in this chapter (beginning at [252]). Although the *Audit Guide* discusses Revenue Procedure 97-44 which provides relief for auto dealers under certain circumstances, the companion Revenue Ruling 97-42 is not discussed at all. Note that Rev. Proc. 97-42 discusses and illustrates disclosures by an auto dealer that will or will not be treated as violating the LIFO conformity requirements in financial statements issued to the credit subsidiary of an automobile Manufacturer.

The *Audit Guide* indicates that revenue agents should, at a minimum, inquire if the dealer elected to accept relief for the violation of a conformity requirement offered by Rev. Proc. 97-44. If the dealer did so elect, then the agent should follow-up on whether or not the required three payments were made. Alternatively (at [252]), ***if the dealer did not elect relief under Rev. Proc. 97-44, "The agent must check to see if the taxpayer is in violation of the LIFO conformity requirements under IRC Section 472."***

see **IRS ISSUES NEW AUDIT GUIDE FOR AUTO DEALERSHIPS**, page 12

Agents are further reminded that (1) Rev. Proc. 98-46 extended similar relief for conformity violations to medium and heavy truck dealers, and (2) even if dealers did elect relief, they are still required to continue to comply with the financial statement conformity requirements in ***all*** subsequent years.

There is not much to be found in the discussion on LIFO recordkeeping requirements and only the *Boecking* decision (T.C. Memo 1993-497) is cited.

Many illustrative link-chain computations are presented in this chapter. It is interesting to note that under the caption "BLS Sanity Check," agents are told at [207] that one simple way to "ballpark" the taxpayer's LIFO reserve without a great deal of time is to compare the indexes computed by the taxpayer to the relevant BLS indexes. The result of this short-cut test of reasonableness may suggest to the agent either that (1) the taxpayer's results seem to be unreasonable and further investigation is warranted, or (2) the taxpayer's results may be regarded as coming reasonably close to a BLS result, and therefore, no further detail review of the computations seems to be warranted.

Appendix C contains the text of the Coordinated Issue Paper entitled: Definition of an Item for Dollar-Value LIFO Purposes. As noted previously, this CIP is very important because if a dealer has not elected to use the Alternative LIFO Method for new vehicles, then strict comparability adjustments are required in order for the dealer's LIFO calculations to be accepted as clearly reflecting income.

ALTERNATIVE LIFO FOR AUTO DEALERS. Chapter 9 deals exclusively with this topic. It emphasizes just how little guidance there is on what constitutes a "separate trade or business." It also states that, in order to properly determine an *item category,* the taxpayer must use the most detailed description of the base vehicle's characteristics. It is not correct to broadly interpret the term "model code number" used in the Revenue Procedure to mean only an alphanumeric vehicle identifier such as the three-digit model code number used by some manufacturers. "Because the intent is to measure inflation, an interpretation that focuses merely on the model code and ignores the most detailed description is improper and a misapplication of the Revenue Procedure [294]."

The *Audit Guide* confirms that the Revenue Procedure does not distinguish an item category by model year. Therefore, if a dealer's inventory contains two model years of a single vehicle, all those vehicles will be included as comprising one item category in determining the average cost for that item category. This section also contains a simple example illustrating the mechanics of restating the base year when a change to the Alternative LIFO Method is made.

Finally, the chapter concludes with a list of Information to Request When Examining the Alternative LIFO Method. This proforma Information Document Request (IDR) includes "invoices for all items in current-year's ending inventory,"..."invoices for all items in prior-year's ending inventory,"...and "applicable price lists for items in existence in the prior year, but not stocked in current-year's ending inventory."

AUTOMOBILE DEALERSHIP AFTERSALE FINANCIAL PRODUCTS

Part III contains three chapters dealing with aftersale financial products. Chapter 10 introduces discussions of extended service contracts (dealt with more fully in Chapter 11) and credit life insurance, credit accident and health insurance (dealt with more fully in Chapter 12).

Chapter 10 indicates that the terms aftersale and aftermarket essentially are synonymous. The Service is careful to note that these products are not referred to "insurance" products because such characterization denotes a legal conclusion that may be adverse to IRS interests. It warns agents that some of the products discussed are disguised and sold as "insurance," but in reality, they are not "insurance." It is the non-insurance aspect of these products that provides a basis for adjustments which the Service usually seeks to make. The remainder of the chapter presents a few general paragraphs on each topic.

EXTENDED SERVICE CONTRACTS

Chapter 11 provides considerable detail on agent vs. principal/obligor issues in building up to its discussion of the Service Warranty Income Method (SWIM). The section entitled "Contract Construction" points out that it is important for the IRS to try to find out whether the dealer entered into his contract free of mistake or duress of the insurance company. Absent such a finding (of mistake or duress), the dealership should not be allowed to use parole evidence to interpret the contract having it conform to the dealership's immediate needs. It warns at [362], "Some dealers may claim they are not principals, even though the contract explicitly states they are."

This chapter also includes discussions of the change in accounting method (CAM–Section 446) issues and corresponding Section 481(a) issues that agents are likely to encounter in requiring dealers to change from expensing insurance premiums to amortizing them.

EXTENDED SERVICE CONTRACTS –"DEALER RESERVE ACCOUNTS"

This very brief chapter simply takes the facts and issues presented in the Tax Court case of *Rameau*

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Johnson, et.al. (108 T.C. No. 22) and presents them to illustrate how a dealer should not be handling extended service contracts which are tied-up with an administrator in an escrow or trust account.

THE PRODUCER OWNED REINSURANCE COMPANY (PORC)

Chapter 13 is probably the best chapter in the *Audit Guide* in terms of the technical discussion of its subject matter. It includes the following sections: (1) Introduction, (2) Introduction to Reinsurance, (3) Considerations for Forming a PORC, (4) The Reinsurance Transaction, (5) PORC Issues, (6) The Captive Transaction, (7) Reinsurance and Auto Dealership Aftersale Financial Products, and (8) The Future.

At [407], the *Audit Guide* says, without qualification, "In situations where the owner of the dealership also owns the reinsurance company and personally uses the funds of the reinsurance company, the income of the reinsurance company is taxed to the owner." The *William T. Wright v. Comm. Case* (T.C. Memo 1993-328) is cited in support of this statement. Appendix D includes an analysis of this case which the IRS considers a significant precedent for challenging questionable PORC activities as sham transactions.

At [411], agents are told that if they follow the flow of the funds, they may find that the funds have never left the dealership's hometown. They are also told, "It is important to remember that most producer owned reinsurance companies often do not reinsure any risk other than that of contracts written by dealerships owned by the sole shareholder of the reinsurance company." The Service's concern is that many reinsurance companies are not regulated and funds may be held in any form by the dealer and/or used for investment, dividend payments or as loans to the dealer.

If a Form 1120-PC is filed, reserves (incorrectly) calculated by representatives of the promoter may be used to reduce the income of the reinsurance company under Section 832. The premium income earned by a non-life insurance company may be exempt from tax if it remains below $350,000. With overstated reserves and paid out claims, a reinsurance company may never pay taxes, thus effectively sheltering all income. The *William T. Wright* case, mentioned above, is cited as a classic abuse situation [414]. Another case cited in connection with potential PORC abuse is *William L. McCurley v. Comm.* (T.C. Memo 1997-371). This case was written up in the September 1997 *DTW*.

In addition to reminding agents that if they encounter unfamiliar insurance arrangements, they should be coordinated with the Captive Issue Specialist, the chapter lists many issues that could be developed in certain situations. These issues are summarized on page 14.

ADVERTISING ASSOCIATIONS

Advertising associations are the subject of the first chapter of Part IV which contains several "stand-alone" issues. In addition to key questions relating to the advertising entity, Chapter 14 discusses potential association tax return issues (diversion of income, double deductions, timing of deductions, all events test and segregation into member and non-member categories) and related audit techniques.

COVENANTS NOT TO COMPETE

Chapter 15 is essentially a case study to illustrate the four primary arguments that an agent can raise in connection with covenants not to compete. The four tests set forth are:

1. Whether the compensation for the covenant is separable from the price paid for the goodwill,

2. Whether either party is trying to repudiate an amount fixed by both parties as allocated to the covenant,

3. Whether, in the absence of a precise allocation in the agreement, both parties nevertheless intended that some portion of the price should be allocated to the non-compete covenant, and

4. Whether there was economic reality behind the convenant.

RELATED FINANCE COMPANIES (RFCs)

Chapter 16 addresses issues concerning related finance companies set up by dealers. The *Audit Guide* points out that not all RFC arrangements require an audit adjustment; only those that lack economic substance warrant such an adjustment. Where economic substance is lacking, losses on the sale of receivables to the RFC will be disallowed to the dealership. The IRS Checklist on RFC validity is on page 15.

Section 482 also permits the IRS to reallocate income and expenses between related taxpayers in order to clearly reflect income.

This chapter contains (at [502]), a very interesting discussion illustrating just how broad an argument might be used to challenge certain RFCs. The issue has been raised as to whether there has been a change in accounting method where a related finance company is used to defer dealership income. The *Audit Guide* indicates that the National Office is actively considering two different points of view on this issue.

Those who believe that a dealership's use of an RFC to defer income results in a change in accounting

see **IRS ISSUES NEW AUDIT GUIDE FOR AUTO DEALERSHIPS**, page 16

PORCs & CAPTIVE TRANSACTIONS EXPOSURE			PORCs
	N/A	YES	FOLLOW-UP WARRANTED
PRODUCER OWNED REINSURANCE COMPANIES - Issues to Consider			
1. Substance vs. form (*Gregory v. Helvering*).			
2. Assignment of income doctrine/Section 61 (*Lucas v. Earl*): "to hang the fruit on the tree from which it came.")			
3. Section 845 tax avoidance.			
4. Recharacterization of a portion of ceded premiums as commission contracts - circumvention of statutory commission caps (credit insurance).			
5. "Cash Cow" - constructive dividend treatment for poorly documented and non-performing loans.			
6. Self-insurance arrangement (100% dealer obligor VSCs).			
7. Oversubmits (funds in excess of a stated or required amount) - dealership treatment and ultimate flow of funds.			
8. Undercapitalization (*Malone & Hyde, Inc.*).			
9. Indemnification agreements (*Malone & Hyde, Inc.*) and any other form of contractual arrangement negating insurance risk.			
10. Section 481(a) and Section 446 change in method of accounting implications.			
11. Violations to Section 806 small life insurance deduction.			
12. Validity of Section 953(d) election of foreign insurance company to be treated as domestic corporation.			
13. Inadequate reserves.			
RETROSPECTIVE COMPENSATION AGREEMENTS - Questions to Ask			
1. Is the underlying reason behind a retrospective compensation arrangement ("retro") to circumvent a state-imposed cap on commissions generated from the sale of credit life & disability insurance? If yes, consider reclassifying the arrangement as a commission contract.			
2. Is the retrospective payment diverted from the dealership and not reported as income by the dealership or the dealer? (In one situation, the "retro" was negotiated separately by the dealer. No one at the dealership was aware of the arrangement. All payments were sent individually to the dealer at his place of residence.)			
3. Is the timing of the retrospective payment properly accrued by the dealership, considering the all events test?			
4. Is there an "oversubmitted" aspect of the origin premium that is held in a related escrow or reserve account? How did the dealership treat this "oversubmit" and who ultimately receives it?			
5. What access does the dealer have to the reserve? If any, is there corporate separateness between the insurance company and the dealership? (See *Moline Properties)*			
6. Is the "retro" arrangement a disguised form of self-insurance?			
OTHER SELECTED CASES			
1. *William T. Wright*			
2. *William F. McCurley*			

Source: *IRS MSSP Audit Guide for Auto Dealerships*, Chapter 13, Paragraphs 452-453. (Training 3147-120 ... 9/2000)

RELATED FINANCE COMPANY CHECKLIST				RFC
		YES	NO	PURSUE
	ORGANIZATION			
1.	Is the RFC a separate legal entity from the dealership?			
2.	Does the RFC meet all state licensing requirement?			
3.	Does the RFC maintain all required local business licenses?			
4.	Does the RFC comply with title and lien holder laws in its area?			
5.	Does the RFC have adequate capital to pay for the contracts?			
6.	Does the RFC have its own address and operate from separate facilities?			
7.	Does the RFC have its own telephone number?			
8.	Does the RFC maintain its own books, separate from the dealership(s)?			
9.	Does the RFC have its own employees?			
10.	Does the RFC compensate the employees directly?			
11.	Does the RFC pay its own expenses?			
12.	Does the RFC maintain its own bank accounts, separate from the related dealership(s)?			
	OPERATION			
13.	Does the lien holder on the finance contract change from the dealership to the finance company?			
14.	Does the dealership notify customers that the contracts were sold?			
15.	Does the RFC pay the dealership for the contracts at the time of purchase?			
16.	Does the RFC purchase any contracts from unrelated companies?			
17.	Does the RFC have written agreements with the dealership(s)?			
18.	If so, does the agreement state how the discount rate was determined?			
19.	Does the discount rate approximate the actual loss experience?			
20.	Are the finance contracts non-recourse?			
21.	Does the RFC handle repossessions?			
22.	Does the dealership sell any finance contracts to unrelated finance companies?			
23.	Does the RFC report income on a pro-rata basis?			
24.	Did the profit reported on the initial sale of the vehicle exceed the loss on the sale of the finance contract?			
25.	Does the RFC have a business purpose?			
26.	Prior to determining fair market value of the note, did the RFC investigate items such as the borrower's credit history, length of the note, age of the vehicle and payment history?			
	CONCLUSION			
	An adjustment is appropriate where the note is not discounted at fair market value to a "controlled financier" or where the Related Finance Company arrangement is an economic sham. If such is the case, then adjustments should be made to assign income to the proper year in which it was incurred.			

Source: *IRS MSSP Audit Guide for Auto Dealerships*, Chapter 16, Paragraph 509. (Training 3147-120 ... 9/2000) method suggest that the aggregate income for the owner of both the dealership and the related finance company is the same. Therefore, because only the *timing of income* is effected as to the owner, the use of the RFC results in a change in method of accounting.

On the other hand, those who believe that the use of an RFC to defer income does not result in a change in accounting method argue that income earned by the dealership that is shifted to the RFC will never be reported by the dealership. Therefore, because the shift of income as to the dealership is *permanent rather than temporary,* there are no change in method of accounting implications.

In citing possible legal assertions against RFCs at [502], the *Audit Guide* includes Section 9722 which it describes by stating, "If a principal purpose of any transaction is to evade or avoid liability under the IRC, tax may be computed without regard to that transaction." Frankly, few have heard of this Code Section. Checking a little further indicates that Section 9722 (Sham Transactions) was added to Subchapter J, Chapter 99: Coal Industry Health Benefits; Subchapter D: Other Provisions; by Congress effective October 24, 1992. This Section would appear to have no legitimate bearing as a challenge to RFCs given its narrow placement in the Internal Revenue Code.

Nevertheless, other arguments available to the IRS under Section 446 regarding changes in accounting method and under Sections 267, 453 and 482 are formidable enough without one more spurious addition.

This chapter also reminds agents that there is much useful material available to them for combating RFC arrangements in the *MSSP Independent Used Car Audit Technique Guide.* And that is very true.

PASSIVE / NON-PASSIVE CONSIDERATIONS

Chapter 17 raises several interesting considerations for challenging rental arrangements between dealerships and related parties. The potential application/abuse which concerns the IRS is not unique to dealerships, although it may be present in some. Once again, the benefit of using an entity flowchart to see the "big picture" is evident here. This chapter's discussion on passive activities limitations (PALs) is summarized on the facing page.

One thought prompted by this discussion is simply that if a dealer does not have an arrangement like the one described, maybe he or she should!...only just treat the passive activity losses properly...and tolerate them with patience until they can be used.

VOLUNTARY EMPLOYEES BENEFIT ASSOCIATIONS (VEBAs)

Chapter 18 is said to be included "for agent awareness only." VEBAs are not a subject that, heretofore, have been included in IRS presentations of "hot topics" or troublesome audit issues. In other words, until now, VEBAs have not really been on a generalized IRS-practitioner radar screen. Suffice it to say that within the Service there is a VEBA Issue Specialist, and the Service sees audit potential in looking into Section 419/419A plans.

OTHER PREVALENT AUTO PRACTICES

This chapter includes 6 separate discussions, each of which merits special attention in its own right.

HOLDBACK CHARGES. Apparently, many dealerships are not properly treating holdback as an item that should be excluded from inventory cost. Note: If you weren't aware of it, you can obtain a listing of all of the manufacturers' holdback amounts from www.edmunds.com (click on "dealer holdback" for the information there.)

WARRANTY ADVANCES. The *Audit Guide* discusses the proper treatment for warranty advances; apparently another often mistreated item.

FINANCE RESERVES. Similarly, agents are directed to be sure that dealers are properly recording finance charge income at the time when they arrange financing for the buyer with a specific financial institution. (Debit finance charge receivable [a Balance Sheet asset account] and credit finance income [an income account].) Agents are reminded to look into the possible existence of related corporations set up to handle installment notes.

USE OF DEMONSTRATOR VEHICLES. This section of Chapter 19 discusses fringe benefits including demonstrator vehicles. It is clear from the discussion that the business use of automobiles (in the opinion of the IRS) must be substantiated by adequate records under the substantiation requirement of Section 274(d). This would appear to be the case even where the value of the use of a demo is being excluded from gross income as a working condition fringe benefit.

OFFICER (REASONABLE) COMPENSATION. The discussion on this subject contains little that is new or interesting. The *Audit Guide* does alert agents that the existence of multiple corporations may create a situation in which compensation may be split between two or more related corporations, and which in the aggregate, may be considered excessive.

One argument is often raised by dealers (and other taxpayers) in defense of compensation which the IRS is challenging as "unreasonable" in a given

see **IRS ISSUES NEW AUDIT GUIDE FOR AUTO DEALERSHIPS,** page 18

WHEN PALs AREN'T FRIENDLY
SEC. 469 PASSIVE vs. NON-PASSIVE ACTIVITY LIMITATION ISSUES

In general, Section 469 provides that only passive income can be offset by passive losses. This means that taxpayers will have losses from passive activities that are not deductible in a particular year unless income from other sources is properly characterized as passive income.

It is paramount that the agent look at the individual and related entity returns and see the "big picture" to determine if the taxpayer may be manipulating passive characterization rules. Please also see the chapter on Financial Status in this Guide. Simply see if any of the individuals are securing a benefit by using flow-through entities. [513]

THE TYPICAL SCENARIO

The taxpayer, who is also a shareholder in a large C Corporation auto dealership, is somewhat wealthy and owns several rental properties (passive by definition, with some exceptions, under Section 469(c)(2)). Making over $150,000 per year, taxpayer is not entitled to the $25,000 passive loss offset for rental real estate. The taxpayer's rental losses for the year are about $100,000.

The taxpayer creates a partnership which purchases assets from the C Corporation and then rents the dealership the land and building at a rent that produces partnership net income of $100,000. Taxpayer flows this $100,000 partnership net income through to his Form 1040 individual income tax return as ***passive*** income. The taxpayer is attempting to offset his passive loss of $100,000 against this income. [514]

Under Reg. Sec. 1.469-2(f)(6), the rental income is recharacterized as non-passive. This means that the taxpayer cannot offset passive losses from other activities against the rental profit. Any rental income generated from the rental of property by the taxpayer to a trade or business in which the taxpayer materially participates is treated as non-passive income. [515]

In this situation, the $100,000 profit would be recognized as non-passive and the $100,000 passive loss would be carried forward. [516]

AUDIT TECHNIQUES

- Secure (and review) all lease agreements.
- Inspect Shareholder's Forms 1040 to determine if the issue is viable.
- Question the taxpayer directly where circumstances warrant such action.

If after inspecting Forms 1040, passive income is seen to be offsetting passive losses, it should be scrutinized. Make sure the income is not subject to the recharacterization rules of Reg. Secs. 1.469-2 and 1.469-2T as well as the material participation rules of Reg. Sec. 1.469-5T. [517]

Reg. Sec. 1.469-2T(f) sets forth specific criteria for recharacterizing income from passive to non-passive. [518] Those most pertinent to auto dealerships are listed in the *Audit Guide*, but are omitted here.

If the rental income producing entity is not clearly connected to the dealership, it may still be necessary to pursue the issue. [519]

Whenever an agent encounters a Passive/Non-Passive situation it is suggested the *MSSP Guide on Passive Activity Losses* be referenced for a more detailed discussion of the passive loss rules and suggestions for (additional) audit techniques of passive loss issues. [522]

CONCLUSION

The most efficient way of looking for a passive issue is through the lens of *financial status*. Also see the chapter on *Financial Status* in this Guide. Did the taxpayer through some device mitigate his tax liability with respect to a passive loss? If so, a close scrutiny of the means by which this was accomplished is warranted and often productive. [523]

SOURCE: *IRS MSSP Audit Guide for Auto Dealerships*, Chapter 17. (Training 3147-120 ... 9/2000) year. That argument is that that year's compensation is unusually high because it is really making up for prior years in which adequate compensation was not paid. The *Audit Guide* indicates that a review of ***four years*** prior tax returns would indicate whether Officers had been underpaid in prior years and would establish a salary history for the Officers. In many instances, an appropriate period over which to make this determination might involve considerably more than four years.

Agents are also reminded to examine travel and entertainment expense as a way of determining the Officer/shareholder's business and non-business activities throughout the year.

Although several pages in the *Guide* are devoted to the discussion of legal authority including litigated cases, the majority of cases discussed are 30-40-50 years old and not of much current interest. The most recent litigated case involving auto dealers is *Automotive Investment Development, Inc. v. Comm.* (T.C. Memo 1993-298). This case...which the IRS lost...involved the Van Tuyl organization, and was written up extensively in the September 1994 *Dealer Tax Watch.*

The *William T. Wright* case, previously mentioned in connection with PORCs, is also cited in the *Audit Guide* as a case including the reasonable compensation issue in an auto dealership context. The compensation aspects of the Wright case were not litigated, and this reference is misleading as you will find nothing of substance if you track this case looking for development of (unreasonable) compensation.

SUB-PRIME ISSUES RE: SALES VS. LOAN ARRANGEMENTS WITH UNRELATED FINANCE COMPANIES. This portion of Chapter 19 is considerably developed from a technical standpoint. Note that it involves subprime issues where the dealer is conducting business with an ***un***related finance company (and not with an RFC). In this context, an IRS agent may question whether the dealer's disposition of the subprime paper should be treated as (1) a loan, (2) an assignment (3) a sale or (4) a pledge to collateralize a loan.

Troublesome issues include:

1. How should cash advances be reported?
2. How should the payment of fixed percentage collection fees be reported?
3. Should back-end distributions be treated as contingent payments?
4. When should back-end distributions be reported?
5. How should back-end distributions be valued?
6. How should interest be computed and reported? (This includes the potential application of Section 483 involving imputed interest income and how it should be calculated.)
7. How should enrollment fees and capping fees be reported? and
8. Do adjustments raised by these issues involve changes in accounting methods?

Agents are given audit techniques and examples of accounting entries including a series of entries showing "what you may find on the dealership books" and another series of entries showing "how it should be reported." It is interesting that the very troublesome aspect of computing imputed interest income is entirely side-stepped in the *Audit Guide* examples.

Readers of the *Dealer Tax Watch* will recognize that these issues have been discussed in our coverage of IRS Letter Ruling 9840001 (December 1998, *DTW*, pages 10-22) and IRS Letter Rulings 199909002 and -003 (March 1999, *DTW*, pages 8-11).

IN CONCLUSION

Depending on how long you have been a reader of the *Dealer Tax Watch,* you will find few new issues discussed in the *Audit Guide* which have not been thoroughly covered in this publication as they emerged over the years.

Interestingly, two significant current issues received scant attention in the *Audit Guide*; namely, (1) service technician tool rental and reimbursement arrangements and (2) inadequacies in dealer recordkeeping compliance with Revenue Procedure 98-25.

There are several ways CPAs can proactively use the material in the *IRS Audit Guide* for the benefit of their dealers. One of the most effective ways is to use the information to construct your own "pre-audit evaluation" checklist. This can be used in analyzing a dealer's potential exposure to IRS audit issues.

Clearly, the IRS has to walk a fine line between obtaining as much information as possible about dealerships, related entities and their owners while avoiding running afoul of the limitation on intrusive activities enacted in Section 7602(e). In this regard, practitioners should not underestimate the emphasis the *Audit Guide* places on the importance and use of related entity flowcharts. In fact, these flowcharts can be useful to everyone.

IRS AGENT INITIAL INTERVIEW QUESTIONS & CONCEPTS

1. How long have you been involved in this business? What are your duties?

2. What is your personal background? (Brief biography including education; training; or special skills.)

3. Who are the officers/general partners in the dealership?

4. Who are the shareholders/partners in the dealership?

5. Please provide an organizational chart, of all entities, business organizations, associations, or individuals related in any degree or manner to the dealership and any officers/shareholders or partners of the same corporation/partnership. (This chart to be retained by the agent)

6. Are any of these entities, business organizations, associations, or individuals involved in any degree or interest with any of the following activities:

   a. Insurance Companies

   b. Warranty Companies

   c. Advertising Companies or Associations

   d. Trucking Companies

   e. Wholesale Auto or Parts Sales

   f. Leasing

   g. What dealer associations do you belong to? (Look for political contributions; political action committees.)

7. Financing

   a. How is the corporation/partnership financing the $xxx,xxx loss incurred by the dealership during the year of audit?

   b. Are there any loans made between any related entities, business organizations, associations, or individuals?

   c. Are there any transfers of any assets between any related entities, business organizations, associations, or individuals?

   d. Are there any transactions, (i.e., a lease; management agreements) between any related entities, business organizations, associations, or individuals?

SOURCE: *IRS MSSP Audit Guide for Auto Dealerships*, Part V, Appendix A. (Training 3147-120 ... 9/2000)

NOTE: The *IRS Audit Guide* states that these are suggested initial interview questions and concepts. They are not to be construed as being totally exhaustive of the subject matter nor would it be productive to ask each question listed. Their purpose is to serve as a memory jogger to enable the agent to frame the questions necessary for their specific examination. Many of these concepts can be utilized to frame questions on Information Document Requests.

e. Are there any financing and investment interests entered into between any related entities, business organizations, associations, or individuals?

f. What does the increase in short term loans represent?

g. What does long term loans represent?

h. Do any of the related entities, business organizations, associations, or individuals engage in the financing of consumer purchases of automobiles or any aftermarket product whether it be tangible or intangible? (i.e., Vehicles, Mechanical Breakdown Extended Service Contracts, any form of Credit Life Insurance.)

i. Provide a list of all bank, financing or investment accounts maintained by all the related entities, business organizations, associations, or individuals?

j. Do any of the related entities, business organizations, associations, or individuals maintain any foreign bank accounts?

k. Are any reserve, trust, or annuity accounts maintained by anybody, related or not, for any of the related entities, business organizations, associations, or individuals?

8. Books and Records

a. Provide a photocopy, to be retained by the agent, of all manufacturers' year-end statements for all related auto dealerships for the year of audit?

b. Provide access to the Manufacturers' Accounting Manual?

c. Provide photocopies, to be retained by the agent, of the following:
   - Trial Balance
   - Adjusting Journal Entries
   - Tax Classification Sheets
   - Chart of Accounts
   - List of Source Codes

d. Determine the adequacy of internal controls.

e. Determine the accounting system maintenance cycle:
   - Is the General Ledger prepared monthly?
   - Which subsidiary ledgers are maintained? (i.e., AR, Inventory, CDJ, CRJ, etc.)?

9. Assets

a. Did this corporation/partnership acquire any assets during year of audit, other than inventory or other recurring purchases? (i.e., other business, entities, or associations; real estate; exotic autos; boats; planes; club memberships; intangible assets)?

b. Provide a copy of the Fixed Assets schedule for calendar or financial year of audit

c. What assets do you personally own?
   - House or houses
   - Club Memberships; Sport Franchises
   - Planes; Boats; Exotic Cars
   - Cash; Other Valuables; Intangibles

d. Do any entities or associations own like kind assets that are made available for your use or that of another officer/partner or significant other participants use?

e. Do any officers/partners or other significant participants own any of the assets described above?

f. How was the franchise agreement treated?

10. LIFO (Last-In, First-Out) Method of Inventory Valuation

a. Provide a copy of all Forms 970 filed by the dealership or any related entity

b. Have you filed a Form 3115 electing the Alternative LIFO Election?

c. What method do you use to compute new car LIFO? 1. Unit Method? 2. Dollar-Value Method?
- External Index (CPI or PPI)?
- Internal Index (Double-Extension; Index Method; Link-Chain)?
- If an internal index is used, how do you derive that index?
- If actual invoices are used, how far back are they retained?

d. How do you value current-year cost?
• Earliest Acquisitions? •. Latest Acquisitions? • Average Cost? • Other?

e. Which pools do you maintain?

f. How do you treat new items?

g. How do you treat options?

h. Provide a copy of LIFO reserve computations from the inception of the election

i. How do you value inventory for financial reporting purposes? (Note: If LIFO on return and FIFO on the Balance Sheet, possible termination.)

j. How do you account for dealer holdbacks?

k. Do you receive rebates from anyone? If so, how are these items treated (i.e., tires, cost of sales, banks)?

11. Inventory Cost Capitalization Rules - IRC Section 263A

a. Is there any offsite storage?

b. Who does the purchasing?

c. How are prep costs handled?

d. Provide a copy of the Section 263A organizational chart identifying job positions and descriptions

12. Warranties; Credit Life

a. What type of extended service and credit life contracts do you sell?

b. How do you record sales and expenses? Which accounts are used?

c. Whose contracts do you sell? Are you a principal or do you sell as an agent?

d. Is the extended service contract between you and the customer or between the customer and another entity? If another entity, who?

e. Are any related entities, business organizations, associations, or individuals involved in any manner or degree with:
   - a captive insurance company?
   - any offshore insurance company?
   - any reinsurance agreements?

f. Does any related entity, business organization, association, or individual have any involvement in any manner or degree with:
   - any retrospective arrangement?
   - any administrator in regard to the sale of any extended service or credit life contract?
   - any reserve, trust, or annuity account in regard to the sale of any extended service or credit life contract?

g. Does any unrelated party or person hold any reserve, trust, or annuity on behalf of any related entity, business organization, association, or individual in regard to the sale of any extended service or credit life contract?

h. Did you file any Forms 3115 to elect the Service Warranty Income Method (SWIM)?

i. Did the corporation/partnership, any related entity, business organization, association, or individual file a Form 1120-L or Form 1120-PC?

j. Provide a copy of all contracts related to all extended service contract plans

13. Advertising

a. What type of advertising do you do?

b. Do you belong to an advertising co-op, pool, or association?

c. Does this co-op, pool, or association file a tax return?

d. Do any funds revert to officers, shareholders or partners or related parties?

e. Who determines the per car advertising amount for the co-op, pool, or association?
   - Is participation mandatory or voluntary?

14. Demonstrator vehicles (Since 1989), need IRC Section 274(d) substantiation

a. Do you have demonstrator vehicles available for use by any officer, shareholder, partner, relative of these same or any employees? If yes, provide a list of individuals who have demonstrators and their relationship to the dealership

b. Do you maintain agreements for such use? Provide copies

c. Sample the substantiation

15. Items to request or remember

a. Obtain copies of all related returns affecting all years of examination

b. Is the current year dealership return filed?

c. What Federal returns is the dealership responsible for? Are these returns filed? Excise Tax, 720? Small casualty or life, Form 1120-L or Form 1120-PC?

d. Ask for copies of Forms 940, 941, W-2, 1099 and the appropriate state tax returns, i.e. California's Form DE-3. (Determine how shareholder is compensated.)

e. Corporate minutes; by-laws

f. Employee Benefits
  - Form 5500?
  - Determination letter?
  - Payment?

g. Rent: Related parties? Disguised dividends?

h. Forms 8300
  - Did you receive any payments over $10,000, as defined for purpose of compliance with the requirements of Form 8300, for the years in question?
  - Did you file all necessary Forms 8300?
  - Are you aware of the definition of cash? (Cash, traveler's checks, cashier's checks. "Any monetary instrument whether or not in bearer form." Form 8300 instructions.)

i. Prior audits; individuals; entities? Get copies of relevant correspondence, RARs, etc.

j. Copies of all Forms 3115 filed by the dealerships or any related entity

16. Where appropriate, additional questions to cover the following areas and associated issues should be developed:

a. LIFO conformity (manufacturer statements, creditors, owners)

b. Extent and degree of LIFO comparability (coordinated issue)

c. IRC Section 263A organizational chart identifying job positions and descriptions

d. Writedowns (accuracy and validity per Reg. Sec. 1.471 et. al., *Thor Power*, Rev. Rul. 67-107)

e. Existence and economic substance of intangibles, e.g. Covenant not to compete

f. Existence and sale of receivables to a related finance company

g. Existence and flow of funds to a producer-owned reinsurance company (does not have to be offshore)

h. Types and tax treatment of all sales transactions (deferrals, liabilities)

i. Sources of other income (commissions, referrals, money held back, rebates, warranty, etc.)

j. Existence of reserves (not limited to extended service contracts or credit insurance) in varying forms (self- insured, escrow and trust accounts, finance, etc.)

k. Treatment of lease capital cost reduction payments

l. Employment tax treatment of salesperson incentive programs established by the manufacturer

m. Economic performance of advertising expenses and accrual of rebates

n. An understanding of all insurance and financing arrangements and any money received as a result of these arrangements

o. An understanding of all related party and entity transactions and arrangements resulting in deferrals, losses, at less than arm's length sales, loans, diverted funds, etc.

p. Did the taxpayer file any Form(s) 3115 to change any method of accounting?

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