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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. <u>THE QUIET CONTINUES</u>. Although there haven't been any developments of an earth-shattering nature coming out of the IRS or the Tax Courts recently, there have been some developments that warrant analysis and reflection.

Despite being very busy preparing tax returns over the past several months, if you've had any spare time to glance at newspapers or magazines, you couldn't help but notice some of the articles harping on decreases in IRS audit activity and increases in corporate tax shelters, taxpayer scams and abusive trusts.

All this press may have made some taxpayers uneasy and possibly willing to be more aggressive in filing their tax returns.

The major focus of this issue of the *DTW* is to look in more detail at some of the information that's been made public and to try to draw some conclusions.

We've included a lot of information that you might find useful in discussing with your clients to put the rhetoric concerning "declining IRS audit rates" into some perspective. If you just want the bottom line, go to the *Conclusions* on page 11.

#2. <u>A NEW IRS PROGRAM</u>. The IRS appears to be investing more time and money in training and pre-filing activities. Further evidence of this is its recently implemented Industry Issue Resolution Pilot Program discussed on page 8.

The likelihood is that there will always be the need for face-to-face audits of businesses by real-live IRS examiners. However, the additional training for agents and resources available to them (such as the *Audit Technique Guide* discussed in the last issue of the *DTW*) suggests that the nature of the audit process that dealers and their CPAs will be facing in the future will be considerably different from what it has been in the past.

WATCHING OUT FOR

#3. OLDS PHASE-OUT: TAX IMPLICATIONS <u>TAKING SHAPE</u>. Dealer publications of late have included various tidbits on how dealers can better negotiate their situations without losing sight of tax considerations. A recent NADA workshop discussed considerations such as reducing basis, instead of reporting income immediately, the special rules affecting the write-off of goodwill and LIFO inventory combinations.

In February, we had the opportunity to listen in on a 90-minute virtual seminar "The Olds Buyout–How to Get the Best Deal". The principal speakers were Dan Myers, Esq. and Don Ray and Robert Davis of the George B. Jones Companies.

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This teleconference was held on February 26th and was offered by WD&S Publishing. You can obtain more information on this teleconference and purchase some of the reference materials by calling (800) 775-7654.

Several practitioners have developed templates and worksheets for projecting or computing Oldsmobile franchise value. This topic will receive significant attention at our Niche Conference in Dallas in June.

#4. UNUSUAL TAX CASE INVOLVING AUTO DEALER SUGGESTS INTERESTING POSSIBILITIES. Although we've reported that things have been relatively quiet, there is one case–a Tax Court Memo decision–*Wade H. Griffin, III v. Commissioner*, which is worth much more than a casual glance.

It appears this case didn't receive much notice, but we think it should if you're at all involved with the current crisis state many dealers have in their relationships with the Factory.

The facts center around disputes which arose in the late 80s and early 90s between Mr. Griffin and Southeast Toyota Distributors. The settlement Mr Griffin received, $6 million, took on a different light for tax purposes when he contended that he should not have to pay tax on portions of it which should be treated as damages received on account of personal injury or sickness arising out of tort or tort type rights.

This case involves the application of Section 104 before it was amended in 1996. As suggested on page 20, it may still be very instructive for dealers who, at this time, are involved in disputes with GM, Ford and other manufacturers in negotiating their settlements.

Granted, it will take the right set of facts and legal arguments to carve out a portion of any settlement payment as fully excludable from income, but the reward would be well worth the effort.

#5. NADA CONVENTION INCLUDES GOOD WORKSHOPS FOR DEALER ADVISORS. NADA Convention workshops are always a good source of information to take back and apply to your dealers. This year, two workshops in particular, are good examples. The workshop on auto dealership IRS tax issues was presented by Robert Zwiers. It is summarized on pages 15-17.

A second workshop on auto dealer estate planning strategies, presented by Stephen Wolff, also provided a wealth of information. We plan to critique this workshop in an upcoming issue of the *Tax Watch*.

In the meantime, if you're interested in such things as recapitalizations using voting and non-voting classes of stock, GRATs (Grantor Retained Annuity Trusts), "defective trusts," qualified personal residence trusts, Master trust arrangements and other sophisticated planning strategies, you might want to get the Conference tape and listen to it sooner.

#6. WHAT ARE AUTO DEALERS BIGGEST CONCERNS? Last year, after the NADA Convention in Orlando, we reported the issues dealers mentioned as their biggest concerns in looking forward to 2000. At the NADA Convention in Las Vegas earlier this year, dealers again had the opportunity to tell the Factories their biggest concerns going forward into 2001.

What's interesting to note is how some concerns a year ago either were replaced by completely new ones or reappeared this year as if the Factory had paid no attention last year.

We thought you'd be interested in comparing last year's lists with this year's, so we have included them side-by-side on pages 21-23.

#7. UPCOMING NICHE CONFERENCE. Be sure to make note of our *4th Annual CPA-Auto Dealership Niche Conference*. It will be held June 18-20, at the Westin Galleria Dallas in Texas.

Top IRS and industry speakers will provide the latest information on critical issues ranging from legal and valuation issues through technology to taxes and tax planning strategies. The Conference is divided into 5 half-day modules and will give you the opportunity to interact with all of the speakers and many other practitioners and consultants to the auto dealership industry. For more details on the Conference, see page 3.

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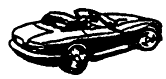

WINNING THE FRANCHISE WARS

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Legal Update

- Mark D. Schmitz, Mark D. Schmitz & Associates

What's a Franchise Worth?

- James L. "Butch" Williams, CPA, CVA, CBA
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Roundtable/Interactive Q & A Session

NEW APPROACHES TO FEDERAL TAX ISSUES

- Terri Harris, Motor Vehicle Technical Advisor
  Internal Revenue Service

IRS Current Tax Hot Topics for Auto Dealers

- Willard J. De Filipps, CPA,
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The New IRS Audit Guide for Dealers
& Assorted Other Tax Developments Including
LIFO for Used Vehicles

- Terri S. Harris & Willard J. De Filipps, CPA

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- James B. Smith, Southwest Reinsure Inc.

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IRS AUDIT & COMPLIANCE ACTIVITY ... IS IT REALLY DECLINING?

IRS AUDITS

Each year, just before individual tax returns are due for filing, the IRS does its usual job through the press of making its presence and vigilance known. However, this year, much attention has been given to the *fact*...or is it *perception?*...that there has been a general decline in IRS audit activity.

On March 28, *The Wall Street Journal* reported that IRS Commissioner Rossotti and Senator Grassley seem to have conflicting views over the real extent of IRS audit and compliance activity. Of greater concern was the fear that publicity of their discussions might cause taxpayers to be more willing to play the so-called "audit lottery." In reporting on the gradual decline of the IRS audit rate over many years, Commissioner Rossotti expressed concern that public perceptions of the fairness and general effectiveness of the tax system would erode.

From the exchange of correspondence between Senator Grassley and the Commissioner, it is evident that part of what was at issue was the precise way the IRS accumulates its "audit" statistics: what the IRS considers to be an audit, what it does not consider to be an audit, and wherein the difference lies.

Before getting into the details, there's one other point that should be factored into some of the rhetoric. That is the fact that throughout the period in which these discussions occurred, the Administration was considering the appropriation of funds to the IRS. To the extent that IRS audit statistics were portrayed as being low, might that be seen as justification of the IRS' need for more funds?

Senate Finance Committee Chair Charles E. Grassley was unhappy over the inference taxpayers might draw from the publication of inaccurate or inconsistently compiled audit rates. In a letter to the Commissioner, Senator Grassley said that he was deeply concerned that the IRS statistics don't tell the whole story of the actual number of returns that are reviewed by the Service. He also said that he was concerned that the understatement may be used to justify budget and staff increases.

Senator Grassley said, "It is painting an incomplete picture to talk about audits and reviews of taxpayer returns and yet fail to mention the IRP (i.e., the Information Reporting Program)–the invisible audits. This is not to say that an IRP contact is equal to a face-to-face audit on a one-for-one basis, but rather to highlight that (by counting only) IRP contacts, the IRS appears to be providing a distorted picture to the Congress, and more importantly, to the taxpayer–that there is no one in the guardhouse." For some help on coping with the new generation of alpha-abbreviations, see pages 5 and 14.

SOME STATISTICS ON GUARDHOUSE DUTY

The IRS had reported that the audit rate for individuals had dropped from 1.67% in 1995 to 0.49% in the year 2000. As computed by the IRS, the "individual audit rates" for the years 1995 through 1999 were 1.67, 1.67, 1.28, .99 and .89 respectively. Another interesting IRS statistic is the "ratio of examiners to returns." This showed the ratio as increasing (or would you say decreasing?) from one examiner for every 6,239 returns in 1995 to one examiner for every 8,331 returns in 1999, with an almost constant annual change. Also, during this period, the number of examiners decreased from 18,600 in 1995 to just below 15,000 in 1999.

Although the IRS has statistics going all the way back to the early 70s, there's not much point in trying to analyze all that to support one side or the other in this debate. One inference that would seem obvious from the way that the IRS was presenting its statistics, is that increased funding for additional examination staff would be necessary to reverse the trends.

WHAT CONSTITUTES AN AUDIT?

Does the term "audit" include only eyeball-to-eyeball or face-to-face contact with an IRS examiner? Or does the term "audit" include those invisible audits which taxpayers are not aware of until they receive a computer generated letter from the IRS saying that something doesn't match up with information in the IRS' computer? In effect, that taxpayer's return has been under surveillance and it has failed to pass or satisfy some test or standard set by the IRS.

Should ***any contact*** by the IRS with the taxpayer be counted as an audit in compiling these statistics? As the exchange of correspondence between the Commissioner and Senator Grassley disclosed, some IRS activities count as "audits," while others don't.

Only contact where the taxpayer has to provide the IRS with access to its "books and records" constitutes an audit under Section 7605(b).

This Section provides limits on "second" examinations and protects taxpayers from being "subjected to unnecessary examination or investigations." As a result, the IRS is cautious about unnecessarily conceding that its first access or request for information

see **IRS AUDIT & COMPLIANCE ACTIVITY–IS IT REALLY DECLINING?**, page 7

QUICK REFERENCE GUIDE	***IRS AUDIT & COMPLIANCE TECHNIQUES & PROGRAMS***
RRA '98	• ***RRA'98*** = Internal Revenue Service Restructuring & Reform Act of 1998 • 'Also referred to as ***IRSRRA '98***
LMSB	• ***LMSB = Large & Mid-Size Business Division*** (one of four divisions or taxpayer categories created by RRA '98) • Includes businesses with over $5 million in assets ... approx. 170,000 businesses
"Ten Deadly Sins"	• Ten infractions listed in Section 1203(b) of RRA '98 • If committed by an IRS employee, will result in termination of employment
SCA	• ***SCA = Service Center Audit*** • Correspondence sent by IRS Service Center requesting information that requires the taxpayer to substantiate a deduction, credit, cost basis of an asset sold, etc. • Considered as an ***audit*** by IRS in compiling statistical data on extent of audits
SCCC	• ***SCCC = Service Center Correspondence Contacts*** • An IRS letter that proposes an adjustment based on information reported by third parties (***document matching***) or based on inconsistent information on the face of the tax return or supporting schedules • ***Not*** considered as an ***audit*** by IRS in compiling statistical data on audits
IRP "Invisible Audits"	• ***IRP = Information Reporting Program*** • Contacts by the IRS which do not constitute audits under Section 7605(b). Therefore, ***not*** considered as an ***audit*** by IRS in compiling audit statistics. • Involves follow-up on either ◆ ***Potential Underreported Income*** ... There is a discrepancy between the income reported on the individual income tax return and the income reported by a third-party payer. The taxpayer is asked to explain the discrepancy, but does not provide books and records for IRS review. ◆ ***Potential Nonfiling*** ...The taxpayer has not filed a tax return after repeated letters requesting a return, and income reported on information documents (provided by third-parties) indicates a tax return is required to be filed. Under the authority granted in Section 6020(b), the IRS computes a tax liability based on the information documents and the taxpayer is sent a notice of the proposed tax due. The taxpayer does not provide any book and records for IRS review.
IRS Audit	• Eyeball-to-eyeball or face-to-face contact with IRS • Involves IRS gaining access to taxpayers' books and records
IIR	• ***IIR = Industry Issue Resolution Program*** (new pilot program) • Another pre-filing program announced by IRS in Notice 2000-65 • Objective is to provide guidance to resolve frequently disputed tax issues that are common to a number of large or mid-size business taxpayers • Expectation that guidance will be provided by revenue procedures that would permit taxpayers to adopt recommended treatment of the issue on future returns, usually by filing Forms 3115 with the National Office
	ANTICIPATED PROGRAMS USING NEWER TECHNOLOGY
Newer Tech Programs	• ***BSM = Business Systems Modernization Program*** • ***ACD = Automated Call Distributors*** • ***CRM = Customer Relationship Management Exam Project*** • ***STIR = Security & Technology Infrastructure Releases*** • ***CADE = Customer Account Data Engine*** • ***EDW/CAP = Enterprise Data Warehouse/Custodial Accounting Project***

IRS AUDIT & COMPLIANCE CONTACT ACTIVITY

INDIVIDUAL INCOME TAX RETURNS

FOR THE YEARS 1995 - 1999

TABLE 1
IRS EXAMINATIONS STAFF WORKLOAD AND AUDIT RATES

YEAR	EXAMINERS	INDIVIDUAL RETURNS FILED	RATIO OF EXAMINERS TO INDIVIDUAL RETURNS	INDIVIDUAL RETURN AUDIT RATE (%)	ENFORCEMENT REVENUE COLLECTED (BILLIONS OF DOLLARS)
1995	18,601	116,059,700	1 : 6,239	1.67	$31.4
1996	17,957	118,352,600	1 : 6,591	1.67	$38.0
1997	16,935	120,342,400	1 : 7,106	1.28	$37.2
1998	15,815	122,546,900	1 : 7,749	0.99	$35.2
1999	14,991	124,887,100	1 : 8,331	0.89	$32.9

TABLE 2
IRS CONTACTS WITH TAXPAYERS

			INFORMATION REPORTING PROGRAM IRP - DOCUMENT MATCHING			
YEAR	SERVICE CENTER AUDITS	FACE-TO-FACE AUDITS	UNDER-REPORTER (A)	NONFILER & OTHER (B)	TOTAL IRP CONTACTS (A) + (B)	TOTAL ALL AUDITS & ALL IRP CONTACTS
1995	1,121,952	797,485	2,711,000	1,756,000	4,467,000	6,386,437
1996	1,179,696	761,850	1,930,000	1,302,000	3,232,000	5,173,546
1997	803,628	715,615	932,000	1,917,000	2,849,000	4,368,243
1998	625,021	567,759	1,726,000	2,314,000	4,040,000	5,232,780
1999	715,789	366,657	1,771,000	1,891,000	3,662,000	4,744,446

TABLE 3
ALL IRS CONTACTS WITH TAXPAYERS

YEAR	SERVICE CENTER AUDITS	FACE-TO-FACE AUDITS	IRP DOCUMENT MATCHING CONTACTS	TOTAL CONTACTS	INDIVIDUAL RETURNS FILED	RATIO OF ALL IRS CONTACTS TO ALL INDIVIDUAL RETURNS FILED
1995	1,121,952	797,485	4,467,000	6,386,437	116,059,700	0.055
1996	1,179,696	761,850	3,232,000	5,173,546	118,362,600	0.044
1997	803,628	715,615	2,849,000	4,368,243	120,342,400	0.036
1998	625,021	567,759	4,040,000	5,232,780	122,546,900	0.043
1999	715,789	366,657	3,662,000	4,744,446	124,887,100	0.038

from the taxpayer be treated as an "audit" which may then limit the IRS' later opportunities to gather more information from that taxpayer.

In countless (?) cases where an "average" taxpayer receives a computer generated notice saying that the IRS can't match up with information on the tax return, that contact usually does not materialize further into an audit. Accordingly, for IRS statistical purposes, these contacts are not counted as audits.

At the April 3, 2001 Ways & Means Oversight Hearing, Commissioner Rossotti explained:

"With respect to the question of why document matching cases are not considered audits, the technical reason is that Section 7605(b) of the tax code generally limits the ability of the IRS to require a taxpayer to submit books and records for inspection by the IRS more than once.

"Since document matching cases do not require the taxpayer to submit books and records to the IRS, a document matching case does not preclude a subsequent audit. Revenue Procedure 94-68 specifically defines IRS taxpayer contacts, including document matching, which are not considered audits for the purpose of Section 7605(c)."

Commissioner Rossotti added, ironically, that it was his understanding that "some years ago, the IRS proposed to change the definition of an audit to permit inclusion of document matching cases in the overall reported number of audits and this proposal was criticized as possibly inflating IRS's statistics." It seems the IRS just can't win on this one.

HAVE THE *"TEN DEADLY SINS"* CAUSED FEWER IRS AUDITS?

Commissioner Rossotti said that the drop in exam and collection activity in fiscal year 2000 was caused by several factors. These included: (1) the long-term decline in staffing, (2) the need to assign compliance staff to customer service duties, and (3) added RRA '98 responsibilities.

In commenting on the long-term decline in staffing, the Commissioner indicated that between fiscal years 1992 and 2000, the overall IRS workforce fell by 17%, while the number of tax returns filed increased by 13%.

Regarding the added RRA '98 responsibilities, Commissioner Rossotti said, "RRA '98 created ***very significant*** additional resource demands on the IRS Exam and Collections staffs. Expanded programs, such as the innocent spouse provisions, offers in compromise and due process in collection, required more than 4,200 IRS staff annually for administration. Other provisions, such as the requirements for notifications of third-parties, tacked on more time to complete each Exam and Collection case. ***More than 30 additional steps have been added to the completion of an exam.***" (Emphasis added)

He further singled out two provisions of RRA '98 as having "...greatly affected the time required to conduct many activities. They are: Section 1203, commonly known as the 'ten deadly sins' provision, and Section 1204 which broadly prohibited use of enforcement statistics in setting goals or making personnel evaluations at any level in the IRS."

The Commissioner said, "Section 1203 caused a great deal of concern, caution, and hesitation among front-line employees and their managers with respect to taking enforcement action." These "*deadly sins*" are really actions...including filing a late tax return...which, if taken by an IRS employee, can result in the termination of his/her job. For more about these, see page 10.

SO (CHICKEN LITTLE), HAS THE AUDIT RATE REALLY FALLEN?

It would appear that the answer partly lies in whether or not you choose to be bound by the technical distinctions the Commissioner follows in accumulating "audit" statistics.

Through its Annual Report and Media Office, the IRS has made available the information in Tables 1 and 2 on page 6. Table 3 combines some of this information into what may be a more useful presentation of the relevant data. From this, you can draw your own conclusions about the IRS audit rate for individual returns.

In replying to Senator Grassley on March 26, Commissioner Rossotti conceded, "Simply focusing on the audit rate does substantially understate the IRS's capacity to find errors in returns, especially in certain kinds of returns." He indicated that for many years, the IRS has relied on a *range of techniques* which includes document matching to verify certain items on tax returns. He also provided a number of interesting facts, some of which are incorporated into the ***True or False Quiz*** on the page 9.

More importantly, the Commissioner stated, "It is my view that there is no need to return to the levels of individual audit coverage that existed even 5 years ago, which was three times the FY 2000 level." He explained that the IRS strategic plan and budget proposals do not even call for this approach. He said: "In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities." See page 14...*In Technology We Trust.*

see **IRS AUDIT & COMPLIANCE ACTIVITY–IS IT REALLY DECLINING?**, page 8

 (Continued from page 7)

Messers Grassley and Rossotti both concluded their interchange by optimistically looking forward to "other return verification techniques" that will eventually be enabled by new technology to save the day. Also, more effective and targeted auditing should go far in limiting the number of audits that need to be performed. Certainly, quality as well as quantity needs to be factored in before any meaningful conclusions can be drawn on this broad issue.

WHEN THE IRS SUSPECTS UNDERREPORTING

The December 2000 issue of the *Dealer Tax Watch* discussed the recently issued *IRS Audit Guide for Auto Dealerships.* This article referred to the somewhat sensitive interplay between IRS audit activity and the implications of the 1998 legislation restricting the IRS use of financial status or economic reality examination techniques. The article also included passing reference to how the IRS interpreted Section 7602(e) in Field Service Advice 200101030.

In this FSA, dated October of 2000 but not released until January of 2001, the IRS focused on certain actions that agents could take prior to having a reasonable indication that there is a likelihood of unreported income. This FSA also discussed the various direct and indirect means which the IRS employs when there is a suspected underreporting of income.

The IRS may employ indirect methods to reconstruct a taxpayer's income through circumstantial evidence. These include the

INDIRECT METHODS

- Bank deposits,
- Cash transaction,
- Net worth,
- Percentage of mark-up, and
- Unit & volume methods.

Each of these is discussed briefly on pages 12-13.

This FSA further reinforces that because of the changes made in 1998, the IRS has to be very careful to respect the lines of demarcation drawn between what the statute considers to be an "audit" (i.e., the IRS gaining access to the taxpayer's books and records) and what the IRS should count as constituting an "audit" in compiling its compliance and follow-up statistics.

One of the FSA conclusions was that a revenue agent could drive by a taxpayer's house prior to having a reasonable indication that there is a likelihood of unreported income. In discussing this conclusion, the FSA indicated, "The purpose of inspecting a taxpayer's residence includes, but is not limited to, determining the validity of deductions for an office or business located in the residence, and determining the taxpayer's financial status."

Query: Does this mean that claiming a deduction on Form 1040 for expenses in maintaining an office or business in one's residence could be an automatic invitation to the IRS to come in and inspect the residence?

INDUSTRY ISSUE RESOLUTION PROGRAM

Finally, another development unveiled over the last few months has been the IRS' new Industry Issue Resolution Pilot Program. This Program was announced in IRS Notice 2000-65 (2000-52 I.R.B. 599).

The objective of this IIR Program is to provide guidance to resolve frequently disputed tax issues that are common to a significant number of large or mid-size business taxpayers. This effort is part of the IRS's strategy to resolve issues in a manner other than the traditional post-filing examination process.

The form of resulting guidance by the IRS may vary depending on the issue. However, Notice 2000-65 states, "The most likely form of guidance will be a Revenue Procedure that permits taxpayers to adopt a recommended treatment of the issue on future returns. In many cases, this may require filing a request for a change in method of accounting." In other words, more Forms 3115 activity may be on the way.

The issues most appropriate for this Program generally will have the following characteristics:

1. There is uncertainty about the appropriate tax treatment of a given factual situation,
2. The uncertainty has resulted from frequent, often repetitive, examinations of the same issue,
3. The issue impacts a significant number of taxpayers within an industry group, many of which are larger businesses (i.e., those with gross assets in excess of $5 million), and
4. Factual determination is a major component of the issue.

Section 4 of the Notice concludes with recognition of the Section 7605(b) books and records distinction. It provides that "an IIR team may consider an inspection of an individual taxpayer's records desirable as part of the factual research necessary to develop its position. Although the team may request such inspection, any such inspection will be voluntary. An inspection of the taxpayer's records under this program, whether at the initiative of the taxpayer or the team, will not preclude or impede (under Section 7605(b)...) a later examination or inspection of records

see **IRS AUDIT & COMPLIANCE ACTIVITY–IS IT REALLY DECLINING?**, page 11

IRS AUDIT & COMPLIANCE ACTIVITY	QUIZ	
Do you think each of the statements below is *True* or *False*?	***True***	***False***
1. Document matching is not useful for verifying business income, gain or loss on asset sales or most itemized deductions.		
2. The average in-person audit of an individual tax return resulted in an IRS assessment of approximately $9,500 … more than ***six times*** the average assessment from an IRS document matching case (which was $1,500).		
3. The proportion of income that ***cannot*** be verified through document matching is 10% for taxpayers with income under $100,000, as compared with 35% for taxpayers with income over $100,000.		
4. Almost all individual income tax returns are subject to IRS computer review for third party information under the Information Reporting Program (IRP) and checked for mathematical errors (*Invisible audits*).		
5. Over 14 million individual tax returns in 1998 were flagged by the IRS for potential discrepant income or deductions. This accounts for well over 10% of taxpayer returns identified by IRS computers for possible further review.		
6. The IRS plans to increase the number of exams of individuals conducted in person by more than 6 %, while also improving the quality of those exams and focusing on areas with the greatest risk of underreporting of income.		
7. To the extent that the IRS uses more and more document matching and less in-person (or face-to-face) auditing, higher income taxpayers will not have their returns verified to the same degree as middle income taxpayers.		
8. In fiscal 1999, so-called "passthrough" entities filed 7.4 million returns, reporting over $5.0 trillion in gross receipts and $680 billion in income. Out of these, the IRS audited 29,000 returns … only 1 out of every 256 returns filed.		
9. The IRS plans to begin a program to match income reported on Forms K-1 by passthrough entities to individual tax returns. However, this technique will ***not*** provide any verification by the IRS of the income reported by the business entity itself. That verification would require an audit of the entity.		
10. Every year, the IRS audits the 1,100 largest corporations. The audit rate for all other corporations has declined from 3% in 1992 to 1.1% today.		

All of the above statements are true and are taken from either an exchange of correspondence between IRS Commissioner Rossotti and Senator Grassley or the Commissioner's testimony on April 3, 2001 before the Ways & Means Oversight Subcommittee.

GUIDELINES FOR CONDUCT BY IRS EMPLOYEES ACTIONS THAT CAN RESULT IN LOSS OF JOB

TEN DEADLY SINS

IRS Restructuring & Reform Act of 1998 ... Section 1203
Termination of Employment for Misconduct ... Subsection (b) *Acts or Omissions*

IRS Commissioner Rossotti, in his testimony before the Ways & Means Oversight Subcommittee on April 3, 2001, stated that "Section 1203 caused a great deal of concern, caution and hesitation among front-line employees and their managers with respect to taking enforcement action." Section 1203(b) lists the prohibited activities in the order shown parenthetically following each item.

1. Willful failure to obtain the required approval signatures on documents authorizing the seizure of taxpayer's home, personal belongings, or business assets. *(1)*

2. Falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or taxpayer representative. *(4)*

3. Providing a false statement *under oath* with respect to a material matter involving a taxpayer or taxpayer representative. *(2)*

4. Threatening to audit a taxpayer for the purpose of extracting personal gain or benefit. *(10)*

5. Willful understatement of Federal tax liability, unless such understatement is due to reasonable cause and not to willful neglect. *(9)*

6. With respect to a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service, the violation of any right under the Constitution of the United States or any civil right established under six other specified laws. *(3)*

7. Assault or battery on a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service, but only if there is a criminal conviction, or a final judgment by a court in a civil case, with respect to the assault or battery. *(5)*

8. Violations of the Internal Revenue Code of 1986, Department of Treasury regulations, or policies of the Internal Revenue Service (including the Internal Revenue Manual) for the purpose of retaliating against, or harassing, a taxpayer, taxpayer representative, or other employee of the Internal Revenue Service. *(6)*

9. Willful misuse of the provisions of Section 6103 of the Internal Revenue Code of 1986 for the purpose of concealing information from a congressional inquiry. *(7)*

10. *LATE FILED TAX RETURN:* Willful failure to file any return of tax required under the Internal Revenue Code of 1986 on or before the date prescribed therefor (including any extension), unless such failure is due to reasonable cause and not to willful neglect. *(8)*

    Note: ***This provision has created much controversy. It is one of the top concerns of the National Treasury Employees Union.***

In his testimony, Commissioner Rossotti also stated that Section 1204, prohibiting use of enforcement statistics, caused a great deal of confusion and hesitation among managers to use any quantitative data to evaluate operations or to direct employees with respect to matters of time and efficiency.

 (Continued from page 8)

... nor subject the IRS to any procedural restrictions ... that might otherwise apply before beginning such examination or inspection."

From the perspective of many readers of the *Dealer Tax Watch*, at least two potential candidates as issues for consideration by the IIR Pilot Program readily come to mind:

- The use of replacement cost in valuing parts inventories, and
- Guidance on demonstrator usage by automobile dealership employees.

We shall be very interested in what issues are selected for initial processing and in all other aspects of the operation of the Program.

CONCLUSIONS

This article has discussed several recent developments which suggest that, as far as IRS audit and compliance activity is concerned, there's more going on beneath the surface than one might suspect.

The debate over whether there has been a decline in audit activity is likely to go on for some time. Keep in mind that the entire focus of the exchange between Commissioner Rossotti and Senator Grassley was on the IRS audit rate for ***individual*** tax returns filed.

Any conclusion on whether there has been a decline, or more importantly, a ***significant qualitative*** decline, in IRS audit rates of individual returns requires more consideration of several questions: The obvious two are (1) What do you mean by the term "audit?" and (2) How accurate do you believe the IRS is in compiling its statistics?

There are several other more important questions beyond these:

1. Do you believe the factors cited by the IRS as partially the cause for declining activity are temporary? If so, when brought under control and the IRS regains its balance, will it be able to devote more time and effort to audit and compliance activities?
2. What role will the use of new technology play in the overall processes? and
3. How should different categories of filers (i.e., individual, partnership, C & S corporations, trusts, etc.) and different areas receiving attention by the IRS, by Congress and in the press (i.e., abusive tax shelters, corporate tax shelters, offshore trusts, etc.) be weighted in concluding whether concern is warranted at this time?

Some information in Commissioner Rossotti's comments on the (relatively low) level of IRS audit activity concerned ***business*** returns. This information received relatively little attention. However, most practitioners have undoubtedly already noticed this over the last 18 months or so.

The IRS has created four new taxpayer divisions in response to RRA '98. The large and medium-size (the LMSB Division) splits the auto dealership population of taxpayers quite significantly by introducing the $5 million of assets benchmark. There seem to be numerous programs that the IRS could undertake in dealing with the specialized issues and problems presented by the automobile dealership population in general. These programs are readily evident from the long lists of "current tax issues for auto dealerships" which are continually discussed in this publication.

Our speculation is that many of these programs will not be undertaken ... or, if undertaken will lose significant effectiveness ... because of the artificial $5 million in assets line of demarcation that will subject "larger dealerships" to different levels of IRS program scrutiny or audit activity, while almost completely excusing other (smaller) dealerships which fall below the cut-off point.

NADA statistics indicate that many, if not the majority, of dealerships in the country require at least $10 million in assets, with the average dealership size now exceeding $10 million.

Practitioners niched in serving dealerships know that many dealership operations are set up so that the dealer and/or his family individually owns and leases real estate and other facilities to the dealership corporation. It's always better, from a tax planning standpoint, when family members and other entities are the owners and lessors. Judging strictly from Schedule L "total asset amounts" on C & S dealership corporate returns, many dealerships of significant size will fall below the arbitrary $5 million cut-off point established by the IRS for classifying businesses into its Large and Medium-Size Business Division.

From a tax administration and policy standpoint, this would seem to create regrettable and unjustifiable inconsistencies. We do expect the IRS audit impact on auto dealerships to further decrease as more auto dealers are mixed in with the large manufacturing and transportation group taxpayers, while others never even make it on to the IRS "$5,000,000 in assets" radar screen.

In short, some dealers may find safety in numbers.

Page 1 of 2	**METHODS OF PROOF WHERE IRS SUSPECTS UNDERREPORTING**
Sec. 7602(e)	• Provision added by Congress in 1998 to limit certain IRS audit activity. • "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." • Note: This only prohibits the use of such audit techniques until such time as the Service has a reasonable indication that there is a likelihood of unreported income.
Direct **(Specific Item) Methods**	• When *direct* (or specific item) methods are used, specific items are demonstrated as the source of unreported income. • IRS uses "evidence of the receipt of specific items of reportable income ... that do not appear on his (i.e., the taxpayer's) income tax return." • Because the tracking is direct, the IRS does not use these methods to support an inference of unreported income from unidentified sources. Therefore, the use of *direct* or specific item methods does not involve the provisions of 7602(e). • The Service does not have to have a reasonable indication that there is a likelihood of unreported income before it resorts to using *direct* methods.
Financial Status Audit Techniques **(*Indirect* Methods)**	• In contrast to *direct* or specific item methods, the Service may employ other *indirect* methods by which it reconstructs the taxpayer's finances through circumstantial evidence. • Accordingly, these *indirect* methods are use to support an inference of unreported income from unidentified sources. • These *indirect* techniques consist of, but are not limited to, ♦ Bank Deposits Method ♦ Cash Transaction Method ♦ Net Worth Method ♦ Percentage of Mark-Up Method ♦ Unit and Volume Method • Generally, these techniques are not used alone, but are used with other techniques to explore issues other than unreported income (such as overstated deductions). • These other *indirect* methods are commonly referred to as "financial status" or "economic reality" audit techniques.
Bank Deposits Method	• This is an analysis of bank deposits to prove unreported income from unidentified sources. • The IRS tracks funds from known sources to deposits made to a taxpayer's bank accounts, rather than analyzing bank deposits to identify unreported income from unknown sources. • This method is used to supply leads to possible unreported income from sources of such deposits.
Cash Transaction Method	• Under this method, the IRS calculates the unreported income as the amount that the taxpayer's cash expenditures exceeded the taxpayer's sources of cash, including cash on hand at the beginning of the tax period in question, for the particular year. • The IRS uses the taxpayer's tax return and other sources to ensure that adequate income has been reported to cover expenses.

	METHODS OF PROOF WHERE IRS SUSPECTS UNDERREPORTING
Net Worth Method	• The net worth method establishes the taxpayer's net worth at the start of the year by listing all assets, including cash on hand, and all liabilities ... with the excess or balance being the taxpayer's net worth. • A similar analysis is made for the first day of the next taxable year. • To any change in net worth, the IRS adds non-deductible expenditures for living expenses, then deducts receipts from sources that are not taxable income and the amounts represented by applicable tax deductions and exemptions. • If the increase in net worth, as adjusted, exceeds the reported taxable income, the inference is drawn that there is unreportable income.
Percentage Of Mark-Up Method	• Under this method, the IRS reconstructs income from the use of percentages or ratios considered typical for the business or item under examination. • This method consists of an analysis of either sales or cost of sales and the appropriate application of a percentage of mark-up to arrive at the taxpayer's gross profit. • By reference to similar businesses or situations, percentage computations are secured to determine sales, cost of sales, gross profit or even net profit. • Similarly, by the use of some known base and the typical percentage applicable, individual items of income or expenses may be determined. • Sources for percentages may be Bureau of Labor Statistics data, commercial publications or the taxpayer's records for other periods.
Unit & Volume Method	• Under this method, gross receipts are determined or verified by applying price and profit figures to the volume of business done by the taxpayer. • The number of units or volume of business may be determined from the taxpayer's books and records if they adequately reflect cost of goods sold or expenses.
Field Service Advice 200101030	• Agents asked whether they could take certain actions ***prior to having a reasonable indication that there is a likelihood of unreported income.*** • These questions were asked because Section 7602(e) restricts the use of financial status audit techniques by the IRS. • ***FSA Conclusions*** ♦ A revenue agent may drive by a taxpayer's house prior to having a reasonable indication that there is a likelihood of unreported income. "This activity would not be prohibited if used in determining whether there is a reasonable indication that there is a likelihood of unreported income so that the Service could resort to setting up unreported income under an indirect method." ♦ A revenue agent may conduct a Lexis search to ascertain if the taxpayer purchased real estate during the year(s) at issue prior to having a reasonable indication that there is a likelihood of unreported income. • The FSA added that the search of property records that are available to the public (i.e., the Lexis search) is not an intrusion on a taxpayer. • Field Service Advice 200101030, dated October 25, 2000, released January 5, 2001.

IN TECHNOLOGY WE TRUST

IRS ANTICIPATED PROGRAMS USING NEWER TECHNOLOGY

BSM	• *BSM = Business Systems Modernization Program* • The *BSM* Program is the solution intended to take the IRS to the "next level" and to enable it to make longer term, fundamental changes in its business processes and practices. • *BSM* Program consists of a combination of 5 Programs and elements below.
ACD	• *ACD = Automated Call Distributors* • Hardware and software improvements to the IRS telephone system to receive, route and answer more than 150 million phone calls each year, with internet access capabilities anticipated to be added at a later date.
CRM	• *CRM = Customer Relationship Management Exam Project* • Already in development through this project, the IRS deals with complex tax calculations, including various carryback and carryforwards, the Alternative Minimum Tax and the Foreign Tax Credit.
STIR	• *STIR = Security & Technology Infrastructure Releases* • This project is intended to provide the essential underlying security infrastructure for the planned deployments of the customer account data engine, customer communications, e-services and customer account management systems.
CADE	• *CADE = Customer Account Data Engine* • This part of the data infrastructure will provide a modern system for storing, managing and accessing records of taxpayer accounts.
EDW/CAP	• *EDW/CAP = Enterprise Data Warehouse/Custodial Accounting Project* • This project is intended to integrate and coordinate the timeliness, consistency and standardization of data in various research data bases presently used by the IRS to support IRS organizational data needs.

AUTO DEALERSHIP CURRENT IRS TAX ISSUES

NADA WORKSHOP

Dealers at the NADA Convention in Las Vegas in February had the opportunity to hear Robert Zwiers of Crowe Chizek, LLP provide an excellent briefing on issues the IRS is currently raising in dealership audits around the country. He also touched on a number of other areas offering practical suggestions. The following summarizes some of his comments.

CASH REPORTING & FORM 8300

After reviewing the basic reporting requirements and addressing related transactions and "suspicious" transactions, Mr. Zwiers offered a number of suggestions (edited slightly below and put in question form) that you should be discussing with your dealer clients.

6 PREVENTATIVE STEPS

1. Does your dealership have a cash reporting ***policy***?
2. Is this policy discussed with employees periodically, and at a minimum, at least annually?
3. Is the dealership's cash reporting policy discussed in detail with each ***new*** employee when he or she is hired?
4. When is the last time your employees watched the NADA video on cash reporting?
5. Does the dealership have a designated manager on the floor ***at all times*** who will handle inquiries that come up in connection with Form 8300 questions?
6. Does the dealership use a form to assist in determining whether ***"cash"*** for Form 8300 reporting purposes has been received?

Mr. Zwiers suggested that dealers who are confident that they have good cash reporting procedures in place should try this test: Have someone come in unannounced and try and get around the system/procedures to see if the system really catches them.

Finally, it was stressed that a dealership should never accept money, no matter how small the amount, if it is known that that money was derived from illegal sources. This emphasizes a dealership's risk in being associated with money laundering, a felony, which can subject the dealership's inventory and real estate to seizure by the IRS.

DEMONSTRATOR VEHICLES

This ever-popular issue also received thorough attention. Dealers were told to expect the IRS to be looking for some substantiation/documentation/recordkeeping in connection with attempts to seek the qualified demonstrator use exemption. It does not seem unreasonable to expect that if an employee is going to receive a real tangible benefit, he or she should be willing to complete the minimal paperwork. This could be as minimally intrusive as simply having a clipboard in the vehicle on which the actual mileage is recorded every day.

In discussing the fact that personal use is limited to "commuting and other," it became evident that in Mr. Zwiers' experience, the IRS seems willing to allow a significant number of miles as a non-commuting freebie. His opinion is that in addition to commuting miles, between 10,000 and 12,000 miles per year should be considered as allowable "other" mileage.

Mr. Zwiers also expressed his opinion that F & I managers should qualify for the qualified demo exemption because their activities are so integral to the traditional sales process. However, this is a issue on which the IRS has not yet ruled.

For taxpayers who simply don't want to be bothered with keeping records, all of the use of the vehicle is required to be treated as personal. In some instances, however, IRS agents may "give" another freebie of up to 20% business use (even though they are not required to concede any amount). Where records are not kept, the standard used by the Service to measure the amount of includable income is the fair market rental value (generally based on invoice), plus insurance, sales tax and gasoline expense.

SERVICE TECHNICIAN TOOL PLANS

Technician Tool Reimbursement arrangements have received much attention from the IRS lately. Mr. Zwiers indicated that he was not aware of any plans that had received approval from the IRS. He indicated that if the dealer was being presented with a plan for consideration, that dealer should ask the company promoting the plan to go to the IRS and get a favorable ruling on the plan. In other words, right now, there is a lot of uncertainty over what the IRS might or might not accept.

Complicating matters further is the fact that what on the surface looks like a qualified plan, might not in actual operation comply with the requirements for accountable plan treatment.

There is some question over whether these plans should cover only tools purchased by the technician since the day he or she started working for the

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dealership. Alternatively, could a plan include all tools owned by the technician, including those purchased before employment began at the current dealership?

Where the nature of the compensation for tool usage is cast in the form of a "rental," there has to be a *bona fide* rental arrangement. Typically, a *bona fide* rental arrangement would not limit the use of the tools being rented to their use by only the employee who owned the tools. Casting further doubt on the tax-effectiveness of such rental plans is the likelihood that self-employment taxes assessed on the owner of the tools might negate the benefits.

LIFO CONFORMITY MATTERS

Dealers were reminded that their year-end financial statements should reflect (at least once a year) a LIFO adjustment. Mr. Zwiers commented that no one has seen any activity yet by the IRS in tracking down dealers who did not make all three of the penalty payments they were obligated to make under Revenue Procedure 97-44.

REPLACEMENT COST AND PARTS VALUATION

Not much was said about this, except to call attention to the still unresolved nature of this issue. Mr. Zwiers commented that most dealers have records that should enable them to determine actual cost but that it would be a terribly involved process to make that determination. (In my opinion, most dealers are unlikely to have retained records from which actual cost determinations could be made.)

LIFO FOR NEW VEHICLES

In discussing the application of the method approved by the IRS in Revenue Procedure 97-36 (i.e., the Alternative LIFO Method for Automobile Dealers), Mr. Zwiers pointed out that one of the drawbacks is the requirement that new items be treated as having no inflation. In this context, he stated that, "The IRS does publish an official list and there are other lists available from other vendors."

It is my understanding that the list published by the IRS is not an official list, despite the fact that agents often do refer to it for guidance.

In discussing a recent Technical Advice Memo which allowed a dealer to have new automobiles from several manufacturers in the same LIFO pool, Mr. Zwiers indicated that this might be something Olds dealers could use to help limit their exposure to LIFO reserve recapture.

ADVERTISING CREDITS

Mr. Zwiers pointed out that dealers are entitled to take an immediate deduction for advertising expenses, including advertising credits which appear on inventory invoices. Many dealers presently capitalize the entire invoice cost, including these credits.

How these advertising credits are treated technically involves method of accounting considerations. If a dealer now wants to change his method of accounting for these advertising credits, Form 3115 must be filed to request permission to make this change. Mr. Zwiers indicated that his Firm has been successful in taking advertising credits off of the invoices and converting them to immediate deductions.

FLOORPLAN ASSISTANCE PAYMENTS FROM THE MANUFACTURERS

In a sense, these payments are the opposite of advertising credits. Dealers were told they can inventory these costs, rather than immediately reporting them as income. This gains a timing or deferral advantage for these payments. As with advertising credits, changing to the more favorable tax treatment requires filing Form 3115, but there seems to be little IRS resistance to permitting the change.

FORD BLUE OVAL REBATES

Last year, on many new vehicle invoices, some Ford Blue Oval dealers had the base prices of certain models go up with a corresponding rebate from Ford for a portion of the increase. These rebates, Mr. Zwiers pointed out, can be handled as a reduction of the inventory value, similar to the interest assistance payments mentioned above.

USED VEHICLE LIFO

The recently announced IRS-approved methodology for valuing used vehicles on LIFO was briefly discussed (Rev. Proc. 2001-23). What makes this most attractive is the opportunity it gives dealers to lock in all previous LIFO benefits with the audit protection it provides for prior year calculations.

The comment was made that the fact that a dealer cannot use ACV (actual cash value) when taking a vehicle in trade seems to be a small price to pay for the certainty of acceptance by the IRS of this LIFO method. Mr. Zwiers indicated that most dealers would probably be making this change in used vehicle LIFO calculations at the end of 2001, instead of 2000.

Instead of using LIFO, some dealers simply write-down their used vehicle inventories at the end of each year. In order to elect LIFO, these dealers would have to restore the prior year-end write-downs. Mr. Zwiers pointed out that the impact of restoring these write-downs would be cushioned because of the "4-year spread on the restoration of write-downs." It would appear that under these circumstances, the 3-year spread required by the Internal Revenue Code would take precedence over the 4-year spread afforded by →

revenue procedures implementing changes in accounting methods.

Even more significant, however, is the fact that the dealer's accounting system, by the end of the following year, would have included all of the prior year used vehicle write-downs in income. Thus, the dealer would receive a timing benefit in the restoration of these write-downs, rather than incurring a more immediate detriment.

SECTION 263A COSTS TRAPPED IN INVENTORY

In advising dealers to avoid having certain costs trapped in their inventory as a result of the Section 263A Regulations, Mr. Zwiers made things easy by boiling it down to three simple questions. If the dealer could answer these questions ... "no" ... "no" ... "yes" ... respectively, then the dealer should expect to have very little, if any, costs capitalized by the application of these rules.

1. Do you have any off-site storage facilities?
2. Do you have any person that spends over one-third of his or her time in purchasing activities?
3. Are your retail sales over 90% of your total sales?

In answering question 3, be sure to look closely at how much revenue is derived from the disposition of used vehicles through non-retail sales channels (i.e., auction, wholesalers, etc.). By taking advantage of several elections that are available to simplify the calculations and by filing Form 3115 to make these changes, dealers might be able to significantly reduce their inventory costs.

MAXIMIZING DEPRECIATION DEDUCTIONS

An article in the September 2000 issue of the *Dealer Tax Watch*, "Cost Segregation Studies Maximize Depreciation Opportunities," pointed out opportunities to speed up depreciation write-offs by utilizing a cost segregation study approach. Mr. Zwiers encouraged dealers to be sure they were using the correct lives on new construction and existing facilities. He pointed out that the IRS does not have a requirement that these studies must be conducted by engineers.

DEFERRING GAINS ON THE SALE OF FACILITIES, ASSETS, ETC.

When assets are being sold or exchanged, another way for dealers reduce their taxes is to structure the transactions so that the gains are not immediately subject to tax (i.e., they are tax-deferred.) Under recent changes, it is no longer necessary to sell property and acquire property to replace it on the same day. Although there are time constraints during which replacement property must be identified and acquired, in the right situation, the deferral of gain on the property sold can be accomplished.

Mr. Zwiers noted that dealers with leasing companies often can obtain similar advantages with properly structured entities and transactions with qualified intermediaries. However, he warned, "you can't touch the money."

EXTENDED SERVICE CONTRACTS

Mr. Zwiers indicated that the IRS is currently looking at certain situations involving dealers who have set up their own extended service contract companies or entities. Some dealers have been charged with the receipt of constructive dividends if the Service has found that the dealer has directed that a larger than necessary amount be paid to a related party.

Typically, this involves what are called "oversubmits" or payments made to others for which there is no legitimate business service performed. This area of potential exposure has been previously mentioned by Terri Harris in a number of presentations.

There is a planning opportunity available to companies that only sell extended service contracts. Mr. Zwiers pointed out the advantage of having the company treated for Federal income tax purposes as an ***insurance*** company, even though it might not be treated as an insurance company for state tax purposes. The key distinction is that for Federal purposes, it be so classified. If it is, then it can be exempt from tax on up to $350,000 of premium income and as premium income increases from $350,000 to $1.2 million there is a sliding scale of tax benefits.

OTHER FACTORY INCENTIVE PAYMENTS

Many dealerships are receiving payments from the manufacturers which are in the nature of incentive payments for image enhancement, assistance in acquiring another dealership, protesting a competing dealership or compensation for goodwill or other franchise-related assets. Although, at first impression, these payments should be taxed immediately as ordinary income, there may be arguments for either reducing basis or otherwise deferring the tax impact.

Mr. Zwiers discussed some of the case law and theories that might be available in this regard to Oldsmobile dealers and other dealers in light of the current GM-Olds phase-out situation. He also discussed the special rules applicable to the write-off of goodwill which depend on whether the goodwill was acquired before or after August, 1993.

CONCLUSION

CPAs can't afford to be unfamiliar with the tax information and advice that dealers received when they attended Mr. Zwiers' Conference workshop.

DEALER FULLY TAXED ON PROCEEDS FROM FRANCHISE-RELATED SETTLEMENT

DEALER VS. MFGR.

In a case recently decided by the Tax Court, dealer Wade Griffin, III was required to pay tax on a settlement award that he received arising out of disputes with Southeast Toyota Distributors, Inc. The case was decided January 9, 2001, and its citation is *Wade H. Griffin, III, v. Commissioner* (T.C. Memo 2001-5).

The facts in this tax case involve disputes between Mr. Griffin and Southeast Toyota which arose in the late 80s and early 90s. The settlement, $6 million, took on a different light for tax purposes when Mr. Griffin contended that he should be able to exclude portions of it as damages received on account of personal injury or sickness arising out of tort or tort type rights. The IRS did not agree.

Although this case involves the application of Section 104 before it was amended in 1996, it may be instructive for dealers who are now involved in disputes with GM, Ford and other manufacturers in negotiating their settlements.

BACKGROUND FACTS

The findings of fact make very interesting reading for anyone involved with Toyota dealerships. In 1985, Mr. Griffin became aware of the availability of a Toyota dealership in Alabama and was impressed by representations as to anticipated monthly sales and profits. He went into business with his sales manager, forming an Alabama corporation ... Hamp Griffin Toyota-GMC, Inc., ... to purchase and operate a Toyota dealership in May of 1987.

Mr. Griffin and his partner had invested in the dealership with the expectation of selling approximately 30 cars and 30 trucks per month at a profit of about $800 or $900 per vehicle. Their expectations had been "*based on representations of SET (Southeast Toyota Distributors, Inc.) employees and others.*"

After guaranteeing a $1 million line of credit and personally borrowing another $350,000 seed money for the dealership, Mr. Griffin *learned that some of the representations, including the ability to generate income in the expected amounts were exaggerated and/or false.* Complicating matters further were disputes over whether, in order get better allocations of vehicles, the dealership had been (1) forced to participate in multiple-dealer "tent sales;" (2) encouraged to engage in questionable vehicle information reporting practices; and (3) required to sell extended service policies and financing.

Adding more intrigue, Mr. Griffin's partner was ousted and replaced by an individual connected with Southeast Toyota, and this new individual lasted less than a year in the dealership. Following his departure, certain irregularities were discovered and the dealership's financial problems became public, and Mr. Griffin experienced great stress for which he was treated by a doctor. Consequences included hospitalization and subsequent treatment by a psychiatrist for "major depression" as well as symptoms of stress and anxiety.

In April of 1989, Mr. Griffin had received a purchase offer for the Toyota dealership, but SET would not approve a sale. Instead, SET instituted a foreclosure action against the dealership. In May of 1989, the dealership voluntarily filed for a Chapter 11 bankruptcy (reorganization), which was converted to a Chapter 7 (liquidating) proceeding in November of 1989.

In September of 1990, Mr. Griffin retained an attorney under a contingent fee arrangement to take action against Southeast Toyota. This attorney brought in an associate who had been involved with a law firm representing other dealers in connection with other Toyota cases. As it turned out, there was a North Carolina dealer's case against Southeast Toyota in which a state administrative judge had issued extensive findings of fact. These findings of fact and the record in that case became the source of the allegations in the complaint Mr. Griffin's attorneys filed on his behalf against SET.

An important finding of fact in Mr. Griffin's case is that the complaint he filed against SET "was designed to replicate the approach used in other suits, (and) it focused on the commercial losses of the dealership attributable to the defendant's (SET's) misconduct."

The complaint contained 123 jurisdictional and factual allegations and 13 counts. None of the factual allegations contained a claim or allegation that Mr. Griffin had suffered any mental stress or depression. The allegations in the complaint addressed the business relationship and the improper and unfair tactics and activities of SET that resulted in the "demise" of the dealership. Similarly, the 13 counts alleged injuries and damages that were commercial in nature

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and, although some of the counts sounded in tort as the cause of action, no claim of mental stress or depression was set forth in the 13 counts.

After subsequent legal activity, Mr. Griffin filed an amended complaint. This amended complaint outlined the personal items of fraud and coercion and the nature of the personal services contract between himself and Southeast Toyota Distributors. The amended complaint contained allegations that Mr. Griffin:

ADDED COMPLAINTS

- Had been personally involved in the transactions with SET,
- Had a financial stake and obligations in connection with the dealership, and
- Was harmed because of the flow-through nature of the dealership which was an S-corporation.

However, the amended complaint did not contain allegations that Mr. Griffin suffered any mental stress or depression. Furthermore, the amended complaint made no demands for damages attributable to his mental stress or depression.

In late 1993, a settlement agreement containing a confidentiality clause was negotiated and approved by the bankruptcy court involving a total settlement amount of $6 million.

The settlement agreement and release were in exchange for Mr. Griffin's general release of all claims against Southeast Toyota. The language of the settlement was that it was to cover "all pending and potential claims (including, but not limited to, e.g., potential mental anguish claims by Wade H. Griffin, III...) that might have been brought."

THE MAJOR ISSUE: SECTION 104 EXCLUSION

The major tax issue was whether Wade Griffin could exclude any part of the settlement proceeds from his taxable income under Section 104(a)(2). There were also two other issues.

Rather than going into all the specifics of these other issues, the following will focus only on whether Mr. Griffin could exclude any portion of the settlement proceeds under Section 104.

In general, Section 61 of the Code provides that gross income includes all income a taxpayer receives from whatever source derived. This Section is to be broadly construed. In contrast, Code sections allowing specific exclusions from gross income...such as Section 104...must be narrowly construed.

The taxability of the payments received by Mr. Griffin was determined by the pre-1996 law. Under these circumstances, the payments would have to satisfy a two-pronged test in order to be excluded.

First, Mr. Griffin would have to show that the underlying cause of action giving rise to the recovery was based upon tort or tort type rights. As to this test, the Court concluded that Mr. Griffin had shown that some tort or tort type rights were pleaded in the proceedings which ended in the settlement, but there was no specific pleading of personal injury or sickness.

Second, Mr. Griffin would have to show that the settlement was received ***on account of*** personal injuries or sickness. As to this second test, the Court observed that Mr. Griffin had received a "global settlement intended to release the defendants from any claims that Petitioner might have had." In *Commissioner vs. Schleier*, the Supreme Court established the precedent that there must be a direct link between the personal injury and the recovery of damages for the Section 104(a)(2) exclusion to apply.

TAX COURT DISALLOWED EXCLUSION

The Court said, "Although Petitioner has shown ... that he experienced mental anguish and psychological problems around the time of the 'demise' of (the dealership), he has failed to show a direct link between his mental anguish and the settlement recovery." The Court observed that although there was a tangential reference to mental anguish in the settlement agreement, no specific amount was allocated to that mental anguish.

The Court also looked to the intent of the payor. It added that where a settlement agreement lacked express language stating what the payment was being made to settle, the intent of the payor as to the purpose of making the payment becomes the *most important factor* in determining whether any exclusion under Section 104(a)(2) is allowable.

The settlement agreement between Mr. Griffin and Southeast Toyota was global in nature and was intended to settle the pending lawsuit and any other claims that might have been brought. There was no specific allocation to any other item and mental anguish was only tangentially referenced as a possible claim in addition to the others. The Tax Court thus was unable to find that a specific portion of the settlement was intended by Southeast Toyota to settle any potential claim Mr. Griffin might have had for mental anguish.

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There is additional discussion in the Tax Court's opinion related to the holding of the Court of Appeals for the Eleventh Circuit in *Fabry v. Commissioner.* In the *Fabry* case, based on its "unique facts," damages to that taxpayer's business reputation were construed to result in a personal injury within the meaning of Section 104(a)(2). The Tax Court distinguished Mr. Griffin's case from the facts and appeal in the *Fabry* case.

OTHER ISSUES

The thrust of the article has focused on the issue of whether Mr. Griffin could exclude any portion of the settlement proceeds under Section 104.

A second issue in this case was whether a portion of the settlement paid by him to his attorneys under a contingency fee agreement was required to be included in his gross income. The third issue was whether Mr. Griffin was liable for certain accuracy-related penalties.

Practitioners may want to read the *Griffin* case specifically for the comments made by the Tax Court judge who expressed surprise that Griffin's tax return preparer failed to make certain inquiries in connection with the preparation of his personal tax return.

CHANGE IN SECTION 104 AFTER 1995-96

Section 104 was amended by the Small Business Job Protection Act of 1996 to narrow the exclusion and thereby make more damage payments taxable.

Prior to its amendment, Section 104(a)(2) more broadly allowed exclusion from taxability for any damages received ***on account of*** personal injury or sickness. The 1996 changes amended this Section to (1) limit this exclusion to those damages received ***for*** personal injury or physical sickness; and (2) to require that punitive damages received would always be taxable.

These changes were effective for all damages received after August 20, 1996. *

POSSIBLE IMPLICATIONS FOR DEALERS IN TRANSITION APPLICATION OF ISSUES IN THE CURRENT ENVIRONMENT

Many auto dealers, including among others GM's Oldsmobile dealers and Ford's Blue Oval dealers, are under tremendous stress and pressure. Much has been written about the toll these pressures can take on a dealer physically and emotionally. Each dealer has his or her own story to tell about the specifics of his or her relationship with the manufacturer, what promises were implied or made–and reduced to writing–as inducements for financial and other commitments the dealer made.

Similarly, in some instances, the more recent events and actions by the Factory may have taken an enormous physical toll affecting the dealer's health. To the extent that connections can be made and sustained between the dealer's impaired health (using that term in its broadest sense), it may be possible to structure a portion of the any settlement proceeds so that they may be tax-exempt. For example, can it be argued that the exclusion in Section 104 should cover reimbursement for payments to seek medical help or assistance even though it may turn out that there is no specific award for the claimed damages?

Advisors to dealers currently involved in disputes with Ford, GM and other manufacturers should consider the *Griffin* case as a challenge and an opportunity to try to structure some portion of the settlement payment to dealers with unusual health ramifications in a way that qualifies those payments for exclusion from income under the current law.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION - LAS VEGAS, NEVADA - FEBRUARY 2001

ACURA	1. Continue to improve communication with the factory. 2. Improving CSI and SSI scores while growing the brand. 3. Future product development.
AUDI	1. Dealing with the growth. 2. The economy. 3. Changes at Audi.
BMW	1. Communications between factory and dealers. 2. Communications within the BMW National Dealer Forum. 3. Consistency in representing the brand.
BUICK	1. Product. 2. Product. 3. Product.
CADILLAC	1. Keeping the sales momentum with the 2002 Escalade that was established with the 2000 DeVille. 2. Dealership upgrades. 3. People-skills training.
CHEVROLET	1. Product. 2. Communication. 3. Trust.
CHRYSLER-JEEP	1. The franchise system. 2. Balance inventory, incentives and sales. 3. Future Product
DODGE	1. Dealers must unite to protect themselves against manufacturer-driven margin reductions – that is, wholesale price increase without price increase at MSRP or MSRP decrease without wholesale decrease. 2. The manufacturer must maintain the integrity of future product development 3. Manufacturers must end the practice of diluting dealer territories, or at a minimum, change the punitive and outdated formulas used in the less-sophisticated, high-margin, rough-and-tumble days of the business.
FORD	1. Vehicle quality. 2. Parts availability. 3. Labor time standards.
HONDA	1. Regional advertising. 2. Sharing product with Acura. 3. Internet communications.
HYUNDAI	1. Continued profitability. 2. Communications with the manufacturer. 3. Ongoing new product from Hyundai.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO, FLORIDA, JANUARY 2000

ACURA	1. Increase dealer profitability 2. Introduce competitive products in the right niches 3. Build Acura's brand image
AUDI	1. Big peaks and valleys with car distribution 2. Part order fill rate 3. More aggressive and proactive customer leasing programs
BMW	1. Constant monitoring of the Value 2000 program, a best-practices program for dealers 2. The desire for an on-time allocation and market-driven production system 3. Certification program for pre-owned and leased vehicles
BUICK	1. Expand product offerings to cover more segments of the market 2. Appeal to younger buyers 3. Increase the volume of sales per dealership, especially single-point Buick stores
CADILLAC	1. Successful launch of new products 2. Help Cadillac become a market-driven company 3. Establish proper dealer representation for Cadillac
CHRYSLER- PLYMOUTH JEEP	1. Continuing the Five Star process 2. Total integration of technology for the dealer body 3. Standardization of the Web sites
DODGE	1. Product, including a convertible 2. Quality 3. Brand differentiation
FORD	1. Customer satisfaction and continuous product quality improvement 2. E-commerce 3. Order-to-delivery system
GENERAL MOTORS NORTHEAST	1. New, more competitive products 2. More advertising 3. Competitive incentives
HONDA	1. The appropriate use of the Internet 2. Expansion of the product line 3. Continued growth of American Honda Finance Corp. subsidiary
HYUNDAI	1. Adequate supplies of vehicles and continued development of new products 2. More communication among dealers and between dealers and council 3. Increased brand recognition - for Hyundai to continue to be on more shopping lists

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION - LAS VEGAS, NEVADA - FEBRUARY, 2001	
INFINITI	1. Profitability. 2. Product. 3. Prestige.
ISUZU	1. More new product. 2. Require more and different type of advertising. 3. Must strengthen partnership with new financial arm.
JAGUAR	1. Help launch the X400 "Baby Jaguar" scheduled to debut in mid-2001. 2. Help manufacturer understand that dealers are independent entrepreneurs. 3. Increase dealer profitability.
KIA	1. Continued open communications between factory and dealers. 2. Good incentive programs. 3. New product.
LAND ROVER	1. Assimilation of Land Rover by Ford 2. How quickly new products will arrive. 3. Growing competition in luxury sport-utility segment.
LEXUS	1. Maintaining customer care and satisfaction, with increased sales volume. 2. Desire for new and derivative products. 3. Maintaining competitiveness of Lexus Financial Services.
LINCOLN MERCURY	1. Profitability. 2. Quality. 3. Future product.
MAZDA	1. Dealer profitability. 2. Product, product, product. 3. Get product to the dealers fast – without sacrificing quality.
MERCEDES-BENZ	1. Retailer profitability must remain the industry benchmark. 2. Client care. The client's experience at any retail center must be the best in the industry. 3. Continue the open dialogue between the retail body and the manufacturer.
MITSUBISHI	1. Continued growth of the company. 2. Successful launch of the entry-level Lancer. 3. Continued work with Mitsubishi to improve customers' buying experiences.
NISSAN	1. The economy. 2. Consistency of factory management. 3. Keeping Nissan profitable through the current fiscal year.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO FLORIDA, JANUARY, 2000	
INFINITI	1. Development and availability of new products 2. Dealer profitability 3. Improvement of volume sales
ISUZU	1. Incentives 2. Product 3. Isuzu needs to establish a captive finance unit that will support the brand
JAGUAR	1. Maintain profitability and growth 2. Internet retailing 3. Keep Jaguar a distinct brand
KIA	1. More product 2. Successful launch of new products 3. Further development of a captive finance company
LAND ROVER	1. Quality 2. Product 3. Communication with Land Rover and BMW
LEXUS	1. More product. The Lexus business is so strong, our only need is for more product. 2. Internet/e-commerce. Lexus and the dealers need to continue to work as partners to further develop the Lexus brand image and support customer needs. 3. Owner retention. Lexus, Lexus Financial Services and the dealers need to work together to maintain the owner base, promote loyalty and customer satisfaction.
LINCOLN MERCURY	1. Dealer trust 2. Internet sales 3. The shift of costs from manufacturer to dealers
MAZDA	1. Build brand image 2. Increase market share 3. Boost profitability
MERCEDES-BENZ	1. Maintain supply-demand balance plus highest quality 2. Increase home office-dealer communications through regular face-to-face meetings 3. Involve the dealer council earlier in issues and program planning
MITSUBISHI	1. Implementing its e-commerce strategy 2. Expanding to new market segments 3. Successful launch of the Eclipse Spyder and the redesigned Montero
NISSAN	1. Return Nissan to industry value leader 2. Support Nissan in becoming a market-driven auto company 3. Strengthen Nissan's captive finance company

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION - LAS VEGAS, NEVADA - FEBRUARY, 2001

OLDSMOBILE	• None provided.
PONTIAC-GMC	1. Launch of new products. 2. Increase in local advertising. 3. Softening of the economy and subsequent profit pressure on dealers.
PORSCHE	1. To ensure every Porsche model sold in the world is sold in the United States. 2. A more definitive course of action with reference to the Cayenne sport-utility. 3. Continued positive growth within the credit arm of Porsche.
SAAB	1. Aging 9-3. 2. Expected sales decline in the next two years, while they await new products. 3. Advertising.
SATURN	1. Product. 2. Product. 3. Product.
SUBARU	1. Scarcity of hot product, especially the Forester. 2. Not knowing what influence 20-percent-owner General Motors will have on the franchise. 3. Growing competition in the all-wheel-drive hybrid segment.
SUZUKI	1. Maintaining success during a slowing economy. 2. Expanding product portfolio. 3. Boosting product awareness.
TOYOTA	1/ . Dealer standards. 2. Toyota Financial Services reorganization. 3. Advertising and branding. 4. Internet communications.
VOLKSWAGEN	1. Quality product priced right. 2. Quality product priced right. 3. Quality product priced right.
VOLVO	1. Penetrate the area of responsibility effectively to capture an above-average percentage of the luxury market. 2. Make sure they qualify for Volvo incentive programs. 3. Make sure they focus on the customer.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION, ORLANDO, FLORIDA, JANUARY, 2000

OLDSMOBILE	1. Attract new customers to new products 2. Expand product offerings to include more truck-type vehicles 3. Put enough advertising and marketing dollars toward attracting new customers
PONTIAC-GMC	1. Vehicle distribution 2. General Motors Retail Holdings 3. Regional marketing
PORSCHE	1. Lack of product 2. Lack of color and interior combinations that U.S. customers would like to see 3. Settling sport-utility issues
SAAB	1. Improve profit margins 2. Expand the product line, including a 9-3 replacement 3. Understand what GM's purchase of the rest of Saab means to dealers
SATURN	1. Regain volume momentum 2. Exploit the Internet 3. Expand product portfolio more quickly
SUBARU	1. Increase the flow of vehicles to dealers 2. Monitor General Motors' recent purchase of part of Subaru 3. Protect the market niches Subaru has carved out and dominated
SUZUKI	1. Improve and increase the dealer network 2. Modernize its marketing approach 3. Continue to add competitive product
TOYOTA	1. Protect the franchise 2. Get to the youth market 3. Maintain dealer margins
VOLKSWAGEN	1. Offering products of the highest quality 2. Distribution: having the right car at the right place with top quality 3. Developing an infrastructure for growth that will take care of customers
VOLVO	1. Successful launch of new products and management of profitable growth 2. Improving the communication and decision-making process of the dealer council 3. Customer satisfaction

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