Willard J. De Filipps, CPA, PC
www.defilipps.com

DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?"... Here's what I'd say:

#1. THE RELATIVE QUIET IN IRS AUDIT ACTIVITY CONTINUES. Although there's nothing new to report on IRS audit activity, perhaps the Commissioner's recent comments suggest why.

IRS modernization. The major focus of the last issue of the *Dealer Tax Watch* was a look at IRS modernization, audit and compliance activity. In the meantime, Commissioner Rossotti testified again before a House Subcommittee. He reviewed the highlights of the IRS modernization initiatives and spoke candidly about three major problems: (1) the deplorable state of the IRS' computer systems, (2) document matching programs and (3) IRS employee attrition. In referring to the IRS computer systems, the Commissioner didn't use the word "deplorable"... The words he actually used were: "woefully obsolete and inefficient." For more on his comments, see page 4.

The April 2001 issue of *Money* magazine contained an interesting article on the state of affairs at the IRS. Entitled "Should You Cheat on Your Taxes?," the lead-in was "Legally, no way. Morally, not on your life. But the IRS is a mess these days–audits are down more than 60%–and a growing number of Americans seem to think that it's right to do ***the wrong thing***."

This article asserts that "back in 1995, your chance of being audited by the IRS was 1 in 60. Today, it's 1 in 202." Even more disturbing, its authors claim, "Fraud and error cost us at least ... $1,600 per return." If you missed this article, you may want to track it down and read it during your summer leisure hours.

#2. DEMOS ... BACK UNDER THE IRS MICROSCOPE. The IRS said that we can expect new guidance for dealing with the ever-popular, ever-troublesome demonstrator issues. As part of a new IRS pilot program, the IRS has said that it intends to publish specific information on how to handle valuing personal use, what records need to be kept, and in what limited circumstances no records may need to be kept at all. For more on this, see page 12.

#3. SERVICE TECHNICIAN TOOL RENTAL PLANS. Another issue selected by the IRS for its IIR Pilot Program is the "reporting of payments to employees who own heavy equipment used by their employers."

In discussing the issues selected for consideration, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, indicated that the treatment of this issue, as more broadly worded, would likely include plans

WATCHING OUT FOR

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used by auto dealers for paying their service technicians separately for the use of their tools.

This issue was submitted to the IRS for consideration by the Pipe Line Contractors Association in the more limited context of rentals for rigs and other equipment. In selecting this issue, the Service changed the wording to the application to ***heavy*** equipment. However, application of the accountable plan rules under Section 62(c) and other rental considerations of the issue as modified by the Service may still shed more light on the use of these plans by auto dealers.

#4. DEALERS LOSE IN TAX COURT OVER NON-COMPETE AGREEMENT WRITE-OFF PERIODS. In two recent Tax Court decisions, the IRS was upheld in requiring dealerships to stretch out their deductions for payments made for their non-compete agreements. In both cases, the (acquiring) dealerships tried to write-off the non-compete payments over the shorter, 5-year terms of the agreements. The IRS, and the Tax Court, required the payments to be written-off over 15 years.

In *Frontier Chevrolet Co. v. Comm.*, the question for the Tax Court was whether a non-compete agreement given as part of a broader corporate stock redemption agreement should be treated as an ***indirect*** acquisition of stock, and thus brought in under Section 197. The Court held that it should.

Form 1040 problems. The dealer involved in *Burien Nissan, Inc., et.Al. v. Comm.* also ran into trouble with the IRS over how he handled, in his personal return, (1) the gain on the sale of his dealership stock and (2) the non-compete payments he received for his agreement.

Accuracy-related penalties. In addition to substantial adjustments to the dealer's personal tax returns, the IRS also imposed accuracy-related penalties against him. Burien Nissan was also penalized for its handling of the write-offs. So, there's more than just timing adjustments involved when these things are not properly handled.

For the details on *Frontier Chevrolet Co.* and *Burien Nissan, Inc.*, see page 6.

#5. IRS AUDIT GUIDE TELLS AGENTS TO LOOK FOR CONSTRUCTIVE DIVIDENDS DISGUISED AS SHAREHOLDER LOANS. The IRS MSSP issued an audit technique guide advising agents what to look for when they encounter shareholder loans on the balance sheet of closely held corporations. A significant portion of the Audit Guide addresses the complex provisions of Code Section 7872.

Long-term readers of the *Dealer Tax Watch* may remember that the December 1995 issue devoted many pages to analyzing the Tax Court decision in *Yarbrough Olds Cadillac, Inc. et.Al. v. Comm.* (T.C. Memo 1995-538). This case involving out-of-control dealer loans by his corporation is a classic example of what can go wrong in this area. In *Yarbrough*, the IRS successfully attacked a continuously growing dealership receivable from the dealer, and recharacterized it as a constructive dividend to the dealer. In addition, the Service successfully asserted fraud penalties against the dealer individually and the dealership corporation.

Interestingly, with all its many citations to tax cases, the IRS *Shareholder Loan Guide* did not refer to the Tax Court opinion in *Yarbrough*.

#6. DEALER REINSURANCE COMPANY ARRANGEMENTS ... FAVORABLE DEVELOPMENTS. The IRS has recently conceded a change in position that will affect dealer aftermarket service activities carried on in separate companies. In Letter Ruling 20011039, the IRS provided some insight on its position on what constitutes an *insurance company* for tax purposes.

It said that "...it is the character of the business actually done ... that determines whether the company is taxable as an insurance company under the Code." Based on the information submitted, the Ruling concluded that, for Federal tax purposes, the qualifying contracts were insurance contracts, rather than prepaid service contracts.

Shortly afterward, the IRS issued Revenue Ruling 2001-31 (2001-26 I.R.B. 1348). This Ruling is uncharacteristically brief, perhaps because in it, the IRS is making a major concession. Essentially, the Ruling states that since no court, in addressing a captive insurance transaction, has fully accepted the ***economic family*** theory set forth in Revenue Ruling 77-316, the IRS will no longer invoke that theory with respect to captive insurance transactions. The Service warned, however, that it may continue to challenge certain captive insurance transactions based on the facts and circumstances of each case.

Although the IRS had been successful in its line of attack using the economic theory in cases involving wholly-owned insurance subsidiaries, the Service had not been successful in applying that theory in cases involving brother-sister corporate arrangements.

In analyzing the effect of this Revenue Ruling on the automobile aftermarket industry, here's what one industry analyst, Steve Mailho, has said:

"...Many in the IRS have (wrongly) believed that vehicle service contracts and reinsurance thereof is of a 'captive' variety, and they (IRS) have tried to challenge the transaction. Most dealers set up rein-

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surance companies, not as subsidiaries of the dealership corporation but rather, as corporations that are personally [owned]; this voided most, if not all, of the 'economic family' argument offered by the IRS.

"They always touted 77-316 as if it were the Holy Grail and expected the industry to crawl into a corner. The industry did not! Now comes this Revenue Ruling 2001-13 which pulls the guts out of the IRS (faulty) argument."

Mr. Mailho indicated that the list of factors that the IRS will be considering in determining whether a transaction is *captive* in their mindset includes:

FIVE FACTORS

- existence of unrelated risks,
- existence of guarantee and indemnification agreements,
- capitalization of subsidiaries,
- actuarially determined reserves, and
- whether premiums paid to a subsidiary are arm's-length.

As emphasized previously, most dealer aftermarket product off-shore arrangements are carried on by brother-sister corporate entities, rather than through a parent-subsidiary corporate structures. Therefore, these brother-sister arrangements should be able to rest a little easier, unless the IRS challenges them under "facts and circumstances."

In his *Reinsurance Network ENews*, Mr. Mailho provides a point-by-point analysis of the factors that the IRS said it would be looking at. You can contact him at JSMailho@ReinsuranceNet.com if you require more information on this development.

#7. MORE ON USED CAR BHPH DEALER SALES OF NOTES TO LOAN SERVICING COMPANY. In LTR 200120001, the IRS held that an automobile dealer's transfers of customer notes to a finance company were sales.

The form of the agreement between the taxpayer/financing company who requested the ruling and automobile dealers was that of a "servicing agreement," and not a sales contract. After transferring the customer notes, the dealers had little potential to realize any further gain on the customer notes.

After analyzing various factors, the IRS concluded that the transfers of customer notes were sales, rather than pledges of security for loans that the taxpayer made to the dealers.

As a result of that conclusion, the LTR addresses the following four issues:

ISSUES

- determining the taxpayer's basis in the customer notes that it has purchased,
- whether the customer notes that were purchased had market discount within the meaning of Section 1278,
- under what circumstances the taxpayer would be entitled to a deduction under Section 166 for a customer note that it purchased that became wholly or partially worthless, and
- whether the customer notes that the taxpayer purchased were required to be marked to market under Section 475.

The LTR held that the taxpayer's basis in a customer note upon purchase equals the amount of advance payment on the customer note plus any additional distribution payments that might be made. Since the Regulations under Section 483(f) did not apply to the taxable years involved, the taxpayer was permitted to use a reasonable method to determine when to attribute additional basis to the customer notes.

The LTR also held that the taxpayer would be entitled to a deduction for wholly or partially worthless debt on customer notes under Section 166. However, the taxpayer was not permitted to mark the customer notes to market under Section 475 during the tax years in question. The market discount rules in Sections 1276-1278 of the Code were found to apply in this case.

For discussions of other Rulings issued by the IRS in this area, see the *DTW* March 1999 (analyzing LTR 199909002 and 199909003) and December 1998 (analyzing LTR 9840001). The comments in late 1999 of the IRS Motor Vehicle Industry Advisor discussing these Rulings appear in the December 1999 *Dealer Tax Watch*. Part of what she said at that time was:

"When you have sub-prime customers, you don't know **if** you're going to collect...you don't know **when** you're going to collect...and you don't know **how much** you're going to collect. So, this a very complex problem. ***We recognize that we have a technical answer, but we probably don't have a practical answer to the problem.*** We're hoping that we can try to get some sort of guidance out there—whether it's through a Revenue Ruling, Revenue Procedure, Coordinated Issue Paper. We've discussed all sorts of alternatives to try to approach this, to try to give some practical guidance."

Letter Ruling 200120001 gives practitioners just a little more insight into what this practical guidance might be.

UPDATE ON IRS MODERNIZATION & COMPLIANCE INITIATIVES

The major focus of the last issue of the *Dealer Tax Watch* was a look at IRS audit and compliance activity past, current and prospective. In what should probably be his last discussion of this for awhile, IRS Commissioner Rossotti testified before a House Subcommittee on May 2 expressing his thanks for the 6.7% increase contained in the IRS budget request for the coming fiscal year.

Three major areas he discussed in his comments before the House Subcommittee on May 2 need to be considered in trying to assess the real state of IRS compliance capability right now.

In other words, for right now, let's discount the anticipated long-term benefits expected to result from "modernization" and look very closely at what Mr. Rossotti said concerning (1) the deplorable state of the IRS' computer systems, (2) document matching and (3) IRS employee attrition.

NEED FOR MODERNIZATION OF IRS' COMPUTER SYSTEMS

Besides consultants' fees, where have all the hundreds of millions of dollars already spent on this gone?

Reality Shock. Here's what really hits between the eyes: The unbelievable contrast between what Mr. Rossotti described as the current state of the IRS computer system ... and what you or I experience every day when we call American Express, MasterCard, Visa or most other commercial businesses and get immediate answers on the status of our accounts with yesterday's transactions already posted.

Here are Commissioner Rossotti's exact words (with emphasis added):

> "For an organization so critically dependent on technology, IRS' systems are ***woefully obsolete and inefficient***. The facts cannot be disputed. The IRS is saddled with a collection of computer systems developed over a 35-year period. The most important systems that maintain all taxpayer records were developed in the 1960s and 1970s.
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> "In an age of faster and more powerful computers, taxpayers are shocked to hear that their most important personal financial data is stored and updated once a week on magnetic tape. Overlaying new software onto old has created a set of disparate data bases, many of which do not talk to one another. Until our consolidation as part of the Y2K program, there were 147 mainframes and 8,700 software products.
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> "The effect of this obsolete technology on service to taxpayers and productivity also cannot be disputed. ***As compared to what the private sector can offer, the IRS' services are wholly unsatisfactory.***
>
> "Many credit card companies and banks provide their customers with real-time account information; their phone representatives can often make adjustments on the spot. However, due to our archaic technology, IRS employees often do not have access to current taxpayer account information.
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> "Adjustments to a taxpayer's account may not take effect for up to 16 days because of delays in updating files and data among different systems. Payments and notices cross in the mail, often generating more notices and frustration. Our overall account quality for taxpayers requesting information on their accounts over the telephone is improving but this filing season is still only 70 percent.
>
> "While the IRS Web site has proven to be an extraordinarily valuable source of information for taxpayers, we cannot yet use the Internet to provide taxpayers information about their returns or their tax accounts, or to exchange messages to resolve account issues. This is because we have not yet solved the difficult security problems required to provide this service while protecting taxpayer data.
>
> "Inadequate technology and the concomitant lack of accurate data also seriously hamper our ability to identify and collect unreported or unpaid taxes. Generally, individual audits are not started until 6-18 months after a return is filed. When they are started, the information available to our auditors is limited, extending the time to complete the audits and increasing the burden on the taxpayer. Collection of outstanding balances of individual and business taxes is extremely slow, usually taking years rather than months as is done in the commercial world. When cases are appealed, as is provided for in RRA 98, the transfer of case materials is slow and cumbersome."

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... "The risks of business systems modernization are undeniably substantial. Any large and complex modernization program involves substantial risk, and by any measure, the IRS program is large and complex. However, the unique aspect of this program, as compared with any other business systems modernization program in the public or private sectors, is the exceptionally old and fragile base of existing installed systems on which the IRS totally depends for current operations.

"***Virtually every one of the IRS' 100,000 employees depends on these old, inefficient, inconsistent systems to perform their everyday job.*** There is little, if any, precedent for making a transition of an entire base of such large-scale installed systems on an enterprise-wide basis for an organization the size of the IRS. This unique situation, as undesirable as it is, also creates the necessity for the modernization program. ***There is no practical alternative to total replacement of this base of installed systems."***

DOCUMENT MATCHING FOR K-1s ... A NEW PROGRAM?

The article in our last issue (*IRS Audit & Compliance Activity ... Is It really Declining?*) described the IRS invisible audits and Information Reporting Program which includes surveillance ***of individual taxpayers and individual tax returns filed*** for potential underreported income and potential nonfiling. Commissioner Rossotti previously acknowledged (in testimony April 3) that 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.

Mr. Rossotti also indicated that the IRS plans to begin a program to match K-1 information reported by passthrough entities to individual returns. In expanding on this, he said that trust and partnership return filings have steadily grown since 1995, increasing 7.4% and 26.2% respectively. Trust return filings constitute the largest business filing population at 3.5 million filers and more than 2 million partnership returns were filed in FY 2000.

Mr. Rossotti added: ***"Research suggests that up to 20% of pass-through income is not being reported. And it is further estimated that unmatched K-1s equate to up to $500 billion in passthrough income."*** Mr. Rossotti did not go into any detail as to what "research" had been done in support of the 20% figure that he referenced.

The Commissioner also said "These passthroughs are not being identified by the IRS and therefore are not available for compliance reviews. Abusive tax shelters are taking advantage of IRS' inability to match, regulate or analyze this information."

Mr. Rossotti indicated that more than 350 employees will be deployed in FY 2001 to ensure that greater effort is placed on this problem. These employees will provide for the essential K-1 data entry. Note, however, that these data entry employees will not actually be doing any casework to follow up on matches.

IRS EMPLOYEE ATTRITION

Is there a significant "brain drain"? The Service is also facing problems in dealing with replacing attrition in front-line compliance positions, Commissioner Rossotti had the following to say:

"FY 2001, the IRS is experiencing a higher than normal attrition rate of 6.05% versus the 4.5% average annual rate. This rise is due to a number of factors, including an aging workforce. Since much of this attrition is among our senior front-line staff, our productivity measures in FY 2001 and 2002 may be affected. ***Replacement of staff lost to attrition with qualified personnel will be a major challenge over the next several years."***

MORE FOCUS

Notwithstanding these major difficulties, Commissioner Rossotti said that the number of returns audited is projected to increase by 28%. "Equally important," he said, "key areas of non-compliance, such as trusts and passthroughs, higher income returns, corporate returns and employment tax collections will receive more focus."

In describing the tasks ahead, the Commissioner said "I have likened our Business Systems Modernization plan to reconstructing New York City from the bottom up without disturbing anyone and still accommodating growth and change." He also said that he had tried to describe the process in a number of different ways, such as overhauling a passenger plane in mid-flight.

He added that "any metaphor (he) could suggest would not do justice to the magnitude and pervasiveness of the change that has occurred at the IRS and will take place for the rest of this decade."

As taxpayers, we can only hope that "rearranging the deck chairs on the *Titanic*" will not be a more apt metaphor to describe the millions of dollars slated for *IRS modernization.*

TWO MORE DEALERSHIP NON-COMPETE AGREEMENTS TRAPPED BY SECTION 197

SECTION 197 OVERVIEW

Many CPAs and tax advisors have grown up with the rule that for tax purposes, goodwill must be capitalized and could not be written off. Another rule many grew up with was that a business could write-off amounts paid for non-compete agreements over the term of the agreement.

In July of 1991, a bill was introduced that would change all of this. This bill proposed to allow the write-off of goodwill and going-concern value over 15 years. This was a major tax break. In return for this more liberal treatment, the bill included a trade-off which proposed to significantly restrict the ability of purchasers of a business to write-off over relatively short periods certain other purchased intangibles. Non-compete agreements were included as one of these intangibles.

This bill eventually made it through Congress. It was enacted as Section 197, effective for property acquired in transactions after August 10, 1993. It cut both ways. ***Winners*** were purchasers who acquired business goodwill and were able to write-off the amount paid for goodwill over a 15-year period. ***Losers*** were purchasers who paid for sellers' non-compete agreements. These purchasers were required to amortize (or write-off) the amount paid for those agreements over 15 years (instead of over the typically much shorter terms of the agreements ... usually 3 or 5 years). Thus, the purchaser's period for amortizing non-compete agreement payments was significantly extended, with a resulting loss of tax benefits.

Including non-compete agreements, Section 197 listed ten *intangibles* for which 15-year amortization became mandatory.

DEALERS LOSE IN TWO RECENT CASES

On May 14, 2001, two cases involving the application of Section 197 to non-compete agreements given by the sellers in dealership buy-sell transactions were decided by Tax Court Judge Robert P. Ruwe.

In *Frontier Chevrolet Co. v. Comm.* (116 T.C. No. 23), the Court required the dealership to use a 15-year write-off for the amount it had paid for covenants not to compete that had been part of a corporate stock redemption agreement. *Frontier* centered on whether an ***indirect*** acquisition of stock should be brought in under Section 197. The Court said it should.

Burien Nissan, Inc. et.Al. v. Comm. (T.C. Memo 2001-116), involved more complicated buy-sell / non-compete agreement fact patterns. After sorting out the facts, the Court agreed with the IRS that the amounts paid for the non-compete agreements must be amortized over 15 years ... instead of written-off over 5 years. *Burien Nissan* involved transactions that had critical dates which straddled the August, 1993 effective date of Section 197.

FRONTIER CHEVROLET CO.

The facts in *Frontier Chevrolet* are on the facing page. The question before the Tax Court was whether Frontier must amortize its non-competition agreement payments to Roundtree and Mr. Stinson over 15 years pursuant to Section 197.

The law seems pretty clear on this ... "A taxpayer shall be entitled to an amortization deduction with respect to any amortizable Section 197 intangible." The deduction is determined by amortizing the adjusted basis ratably over a 15-year period beginning

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SECTION 197 AMORTIZABLE INTANGIBLE ASSETS

1. Goodwill.
2. Going-concern value.
3. Workforce in place.
4. Business books and records, operating systems, or any other information base (including current or prospective customer lists).
5. Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item.
6. Any customer-based intangible.
7. Any supplier-based intangible.
8. Any license, permit or other right granted by a governmental unit or an agency.
9. Any franchise, trademark or trade name.
10. **ANY COVENANT NOT TO COMPETE**... or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete... entered into in connection with the direct or indirect acquisition of an interest in a trade or business.

THE FACTS IN FRONTIER CHEVROLET CO.

The stock of Frontier Chevrolet, an auto dealership in Billings, Montana, was originally acquired in 1987 by Roundtree Automotive Group, Inc. (Roundtree). Roundtree was in the business of purchasing and operating automobile dealerships and providing consulting services to the dealerships it owned.

Mr. Frank Stinson was involved in the operations of Roundtree during the years 1987 through 1994. Consistent with Mr. Stinson's and Roundtree's policy of management, Frontier Chevrolet filled the position of executive manager in the dealership with one of Mr. Stinson's long-term employees, Dennis Menholt. As part of his employment agreement with Frontier, Mr. Menholt was allowed to purchase 25 percent of the stock of Frontier Chevrolet from Roundtree during the period from 1987 through 1994.

During the years 1987 through 1994, Mr. Stinson had participated in the management of Frontier's business, particularly in the areas of advertising and sales training. Roundtree Automotive Group had received payments of $22,000 per month from Frontier for the management services that Stinson had provided for Frontier as an employee of Roundtree Automotive.

Immediately prior to August 1, 1994, Roundtree Automotive Group owned 75 percent of the stock in Frontier Chevrolet Co., and Mr. Menholt owned the remaining 25 percent. At that time, Mr. Menholt was the general manager of Frontier Chevrolet Co., and Mr. Stinson was the president of Roundtree Automotive Group, Inc.

The final steps in the sale of Frontier Chevrolet to Mr. Menholt took place in August of 1994. These steps involved (1) a corporate stock redemption and (2) the execution of 5-year non-compete agreements by Frank Stinson ***and by*** Roundtree Automotive Group.

Effective August 1, 1994, Frontier Chevrolet entered into a "Stock Sale Agreement" with Roundtree by which Frontier redeemed all its stock owned by Roundtree for $3.5 million. Frontier borrowed the funds to redeem the stock from General Motors Acceptance Corporation and GMAC placed liens on all of Frontier's tangible assets. Immediately after the corporate redemption, Mr. Menholt was the sole remaining shareholder of Frontier.

At the same time, Frontier also entered into a "Non-Competition Agreement" with Mr. Stinson and with Roundtree, effective August 1, 1994. The non-competition agreement stated:

> "To induce * * * [petitioner/Frontier Chevrolet] to enter into and consummate the Stock Sale Agreement and to protect the value of the shares of stock being purchased, Roundtree and [Mr.] Stinson covenant, to the extent provided in Section 1 hereof, that Roundtree and [Mr.] Stinson shall not compete with * * * [petitioner's] automobile dealership, stock of which was sold to * * * [petitioner] pursuant to the Stock Sale Agreement."

Section 1, entitled "Covenant Not to Compete", provided that Roundtree and Mr. Stinson would not compete with petitioner/Frontier Chevrolet in the car dealership business ***within Yellowstone County for a period of 5 years.***

The agreement stated that the competition restrictions against Mr. Stinson and Roundtree "are reasonable and necessary to protect the business and interest which * * * [petitioner/Frontier Chevrolet] under the Stock Sale Agreement is acquiring pursuant to the Stock Sale Agreement."

As consideration for the obligations of Roundtree and Mr. Stinson, petitioner agreed to pay Roundtree and Mr. Stinson $22,000 per month for 60 months. This consideration for their agreement not to compete was in addition to the amount Frontier Chevrolet paid to Roundtree to redeem its stock.

The non-compete agreement provided that if Frontier defaulted on the non-competition agreement payments, the entire amount of the remaining payments would immediately become due and collectible, and the covenant not to compete would terminate 90 days after such default. The agreement also provided that if Roundtree and Mr. Stinson breached their promises not to compete, Frontier would be entitled to one-half of the net profits for 5 years of any business conducted which breached the covenant not to compete.

As a result of using the GMAC loan to fund the stock redemption, Frontier Chevrolet was heavily leveraged with large interest expenses. In the summer of 1994, Frontier fell below the minimum working capital requirements of its franchisor. As a result, it had to obtain a special waiver of working capital requirements in order to continue holding its franchise. There was no known alternative to the non-competition agreement with Roundtree and Mr. Stinson in order to protect Frontier Chevrolet from their competition in the Billings, Montana market area. Without the agreement, Frontier would have had difficulty raising capital or paying its loan from GMAC. Thus, there were valid business reasons for Frontier negotiating the non-compete agreement with Roundtree and Mr. Stinson.

On its Federal income tax returns for the years 1994 through 1996, Frontier amortized the non-competition agreement payments over 15 years. In 1999, Frontier filed a claim for refund for the taxable years 1995 and 1996 on the basis that the non-competition agreement payments should be amortized over 60 months (i.e., the life of the agreement)

(Continued from page 6)

with the month in which such intangible was acquired. An "amortizable Section 197 intangible" is any Section 197 intangible acquired by a taxpayer after August 10, 1993, and held in connection with the conduct of a trade or business. A covenant not to compete entered into in connection with a direct or indirect acquisition of an interest in a trade or business is a Section 197 intangible.

The Service took the position that Frontier's redemption of its stock was an "acquisition" of an interest in a trade or business within the meaning of Section 197.

Frontier Chevrolet argued that it had not acquired any interest in a trade or business; therefore, the covenant not to compete was not a Section 197 intangible. Therefore, Frontier argued, it should be permitted to amortize the payments over 60 months, the life of the covenant. It argued that it did not acquire an interest in a trade or business pursuant to the stock redemption transaction because, both before and after the transaction, it was engaged in exactly the same trade or business and it acquired no other new assets.

The Court said "Normally, we look to the plain language of a statute to interpret its meaning.... When a statute is clear on its face, we require unequivocal evidence of legislative purpose before interpreting the statute to override the plain meaning of the words.... The legislative history of Section 197 contains no evidence that Congress intended a purchase of stock to be excluded from the meaning of the term "acquisition" simply because the purchase occurred in the form of a redemption." (citations omitted)

The Court looked to *Black's Law Dictionary* which defined the term *acquisition* as "The gaining of possession or control over something" and "Something acquired". The term *redemption* is defined as "The act or an instance of reclaiming or regaining possession by paying a specific price." Redemption, in the context of securities, is defined as "The reacquisition of a security by the issuer."

The Court said that what had happened was that Frontier entered into a stock sale agreement in which it redeemed 75% of its outstanding stock from Roundtree Automotive Group. As a result of the stock sale agreement, Frontier regained possession and control over its stock. Therefore, "On the basis of the plain meaning of the statute," the redemption was an "acquisition" within the meaning of Section 197 because Frontier received 75% of its stock as a result of its transaction with Roundtree.

The Court added that the legislative history of Section 197 provides that:

"The term 'Section 197 intangible' also includes any covenant not to compete (...or other substantially similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business.... For this purpose, an interest in a trade or business includes not only the assets of a trade or business, ***but also stock in a corporation that is engaged in a trade or business*** ...

"The legislative history explains that an "acquisition of stock that is not treated as an asset acquisition" is treated as 'an indirect acquisition of a trade or business'. Thus, the legislative history indicates that an interest in a trade or business includes not only the direct acquisition of the assets of the trade or business but, also the acquisition of stock in a corporation that is engaged in a trade or business."

The Court observed that "the non-competition agreement provides that the covenant not to compete was 'reasonable and necessary to protect the business and interest which * * * [petitioner/Frontier Chevrolet] under the Stock Sale Agreement is acquiring pursuant to the Stock Sale Agreement'."

Frontier had unsuccessfully argued that Section 197 would have applied if the dealership had acquired a ***new*** trade or business, but that Section 197 should not apply in this case because Frontier had continued the operation ***of its own existing business.*** The Tax Court pointed out that neither the legislative history of the statute—nor the statue itself—contains any indication that an interest in a ***new*** trade or business must be acquired in order for Section 197 to apply.

Therefore, when Frontier redeemed its stock from Roundtree, it acquired an "interest in a trade or business" within the meaning of Section 197 and that requires the amortization of non-compete payments over 15 years, rather than the shorter term of the agreement.

BURIEN NISSAN, INC., ET AL.

In this Tax Court case, the question of whether Section 197 applied was only one of several issues. The largest dollar issue involved the personal tax returns of the dealer who had sold his stock in the dealership and failed to report payments he received under non-compete agreements he had executed. Last, and by no means least, the IRS assessments of accuracy-related penalties against both the dealership (corporate returns) and the dealer (individual returns) were upheld by the Tax Court.

The facts in this case are somewhat of a jumble. There was considerable confusion due to mathematical errors, the filing of inconsistent amended returns and transactions that were supposed to take place, but, in fact, never did.

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Don Johnson, the dealer, had owned several dealerships in the Seattle area. The case gets its name from the dealership, Burien Nissan, of which he owned 80% and his son-in-law, Mr. McLaughlin, owned the other 20%.

In 1990, Mr. Johnson and his son-in-law entered into a stock purchase agreement with four individuals, under which those four individuals would initially acquire 49% of the stock of Burien Nissan. As part of that agreement, Burien Nissan was provided with an option to acquire the remaining 51% (owned by Mr. Johnson) at a later date. As part of the 1990 stock purchase agreement, Mr. Johnson was required to execute a non-compete agreement at the time when the buyers executed the option for the remaining 51%. Under this non-compete agreement Mr. Johnson was prohibited from operating a Nissan dealership within 12 miles of the Burien Nissan location for 3 years. Burien Nissan was required to pay Mr. Johnson $355,000 in return.

As it turned out, Burien Nissan breached its obligation under the 1990 stock purchase agreement to pay Mr. Johnson for his shares. As a result, the option closing never occurred, the 1990 non-competition agreement was never signed and Burien Nissan never paid Mr. Johnson any amounts due under that non-competition agreement.

Mr. Johnson's only remedy under the agreement, in the event of default, was to force a sale of all outstanding shares in the dealership to a 3rd party. On October 14, 1993, Mr. Johnson sent a letter notifying the purchasers and Burien Nissan that they had breached the 1990 stock purchase agreement. (Note: This date is about 2 months *after* the effective date of Section 197.)

On December 13, 1993 all of the parties entered into a "supplemental agreement" amending the 1990 stock purchase agreement. Under the terms of the 1993 addendum, Burien Nissan was to redeem Mr. Johnson's stock for $434,677 and it was to pay Mr. McLaughlin $65,323.

This 1993 addendum restructuring the sale transaction (because of the breach of the 1990 stock purchase agreement) included a *new* non-compete agreement preventing Mr. Johnson "from competing with Burien Nissan from January 15th 1994 through January 15th 1999 in a geographical area defined as 'a line south of Boeing field running east and west, west, east and south King County lines.'" For this agreement not to compete, Burien Nissan was required to pay Mr. Johnson $352, 503. He was to receive 60 monthly payments of $5,117 and the balance of approximately of $45, 500 in a lump sum payment.

On January 12th 1994, Mr. Johnson and Burien Nissan entered into a Stock Redemption Agreement under which the Corporation agreed to redeem Mr. Johnson 51% share ownership for $434,677. Burien Nissan made the payments under the 1993 addendum and the 1994 agreement to a Don Johnson Family Partnership entity.

Mr. Johnson never reported receiving $434,677 as provided in the 1994 stock redemption agreement. There was also considerable confusion over the application of the other payments and the income tax reporting of the proceeds and the computation of the stock basis by Mr. Johnson. Part of this confusion resulted from the filing of two amended individual returns by Mr. Johnson for 1994.

Section 197 issues. In connection with the non-compete agreement included as part of the 1993 supplement or addendum, Burien Nissan deducted the full amount of eleven monthly payments of $5,117 on its 1994 Federal income tax return, twelve monthly payments of $5,117 on its 1995 return and twelve monthly payments of $5,117 on its 1996 return. It deducted these monthly payments on a pay-as-you-go basis.

Burien Nissan capitalized the entire lump sum payment of approximately $45,500 that it made in 1994 and amortized that cost over 15 years in the original Corporate tax return it filed for 1994. Burien Nissan's tax treatment for the 2 payment elements of the same non-compete agreement was inconsistent.

The question for the Tax Court was whether the non-compete payments were subject to Section 197's fifteen year amortization requirement, or whether Section 197 did not apply because of its August 13, 1993 effective date. How should these payments be treated given the fact that the agreements straddle the effective date of Section 197? The original 1990 stock purchase agreement clearly pre-dates Section 197, but the December 1993 addendum and January 1994 redemption post-date Section 197.

Burien Nissan argued that the agreements executed in December 1993 and January 1994 merely amended and supplemented their stock purchase agreement executed in 1990. Obviously, if the transaction originated in 1990, Section 197 would not apply since it did not become effective until August 1993. Tax Court Judge Ruwe observed that the terms contained in the non-compete agreement ratified on December 13, 1993 were different from the terms contained in the 1990 non-compete agreement. Each agreement defined different geographic zones, different time periods and different payments over different payment schedules.

see **NON-COMPETE AGREEMENTS,** page 10

(Continued from page 9)

The Court said "The later agreement did not add terms that were lacking in the previous agreement; it was a completely different agreement." Therefore, the Court found that the non-compete agreement in question was entered into after August 10, 1993, and amortization of those payments over 15 years pursuant to Section 197 was required.

Another non-compete agreement and a different tax issue. Who agreed not-to-compete? Mr. Johnson also owned 75% of the outstanding stock of another dealership corporation doing business as Aurora Mitsubishi. In October 1994 the dealership agreed to sell its assets and executed and agreement entitled "Agreement for Sale of Assets." As part of the sale agreement, Mr. Johnson executed a 5-year non-compete agreement. The agreement stated: "... As consideration for the non-competition and consulting agreement, Purchaser agrees to pay Donald W. Johnson ... $290,000, payable on closing."

The bill of sale provided a list of assets with amounts allocated to each. Included on the list was an entry: "Covenant non-competition agreement ... $290,000." Mr. Johnson had initialed the recap. In addition, he had executed the bill of sale in his individual capacity and in his capacity as president indicating that "in exchange for $290,000, Donald Johnson agrees not to compete with Buyer as specified in the Agreement for Sale of Assets."

In connection with the receipt of the payment from the purchaser for the assets and the non-compete agreement, Aurora Mitsubishi paid Mr. Johnson $200,000 and it paid $250,000 to another dealership that was controlled by Mr. Johnson. Mr. Johnson had signed both checks.

On its corporate books and tax returns, Aurora Mitsubishi recorded the payments it received for the non-competition agreement as a payable/liability to Mr. Johnson. Mr. Johnson did not report any income from this non-compete agreement on his 1994 or on his 1995 individual income tax returns, nor did Aurora Mitsubishi report any income from the non-competition agreement on its Federal income tax returns.

Mr. Johnson tried to justify not reporting the $290,000 non-compete proceeds on his personal return by taking the position that the payments had been received by his corporation, (Don Johnson, Inc. d/b/a Aurora Mitsubishi). He argued that it was his corporation-not him- that had agreed to refrain from competing in the new car automobile business.

The IRS argued that "regardless who received the income attributable to the covenant not to compete, the true earner of that income is liable for the tax on it and cannot escape that tax by assigning the income to another taxpayer. It cited the Supreme Court decision in *Lucas v. Earl* (281 U.S. 111 (1930)) as authority. It also cited *Chiappetti v. Comm.*(T.C. Memo 1996-183.

The Tax Court agreed with the IRS and held that Mr. Johnson had received those payments "in his individual capacity (and) must recognize the income attributable to that promise." It said that Mr. Johnson could not challenge the tax consequences of the agreement "which he voluntarily and knowingly made."

What is obvious is that both the IRS and the Tax Court looked carefully at how Mr. Johnson, the dealer who agreed not to compete, treated (or failed to treat) the collection of the payments in his individual income tax returns.

Accuracy-related penalties applied. In this case, the IRS asserted that accuracy-related penalties should be applied against both Burien Nissan and Mr. Johnson, the dealer. The inconsistent tax treatments of the non-compete payments by the dealership (in terms of how it was deducting the payments) and by the dealer in his individual return (in omitting income) should have been a red flag to the tax preparer who was involved with the returns for both parties to the transaction.

The taxpayers tried to avoid these penalties by arguing that there was a reasonable basis for their positions since they relied on the advice of a tax advisor. However, reliance on professional advice does not necessarily demonstrate reasonable cause and good faith. In order for a taxpayer's reliance on advice to be reasonable so as to negate an accuracy-related penalty, the taxpayer must prove ***by a preponderance of the evidence*** that:

- the advisor was a competent professional who had sufficient expertise to justify reliance,
- the taxpayer gave the advisor the necessary and accurate information, and
- the taxpayer actually relied in good faith on the adviser's judgment.

The Court said that it was not convinced that Burien Nissan and/or Mr. Johnson, the dealer, had reasonably relied on their tax return preparer in reporting the items in issue. The Court said, "The record does not contain evidence of what specific information Burien Nissan and the Johnsons gave to their return preparer. Indeed, we have found that ***petitioners mischaracterized the key transactions in this proceeding and there is every reason to believe that they made the same representations to their return preparer.***" (Emphasis added.) Accordingly, the IRS penalty assessments were withheld.

see **NON-COMPETE AGREEMENTS,** page 13

OTHER CONSIDERATIONS IN DEALING WITH SECTION 197

Non-compete agreements vs. consulting agreements. Covenants not to compete are treated as amortizable Section 197 intangible assets. As such, they must be written off over the 15-year period—beginning with the month the covenant not to compete is acquired—rather than over a 1, 3 or 5-year shorter term that otherwise would be specified in the contract and would have been allowed as the write-off period under prior law. However, payments made under ***consulting agreements*** continue to be deductible over the term of the consulting agreements, to the extent payments are for services actually rendered and are reasonable in amount.

Often in buy-sell situations, the parties set up arrangements that require the former owner to continue to perform services (or to provide property or the use of property) that benefits the trade or business. Section 197 considers these arrangements to have substantially the same effect as a covenant not to compete, but only to the extent that the amount paid to the former owner under the arrangement ***exceeds*** the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. Therefore, to the extent that payments made for services under consulting agreements are reasonable, those reasonable amounts are deductible over the period over which the services are rendered.

Payments for stock. The Committee Reports state "As under present law, to the extent that the amount paid or incurred under a contract not to compete...represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account under this provision, but, instead, is to be included as part of the acquirer's basis in the stock." In other words, in a situation where the **stock** of the corporation (instead of the assets) is being acquired, the amount paid for an agreement not to compete that is in excess of a "reasonable amount" will not be amortizable over 15 years under Section 197. Instead, the excess amount paid for the agreement will be required to be capitalized as part of the cost of the stock. This emphasizes the importance of having a reasonable valuation for the amount paid for the non-compete agreement.

Special rules further restrict the treatment of covenants not to compete. If there is a disposition of any amortizable Section 197 intangible asset, loss will not be recognized on that disposition until all intangibles acquired have been disposed of. What happens, instead, is that there is an allocation of the amount of that loss to the remaining basis of the other intangible assets being amortized.

Another special rule under Section 197 provides that a covenant not to compete cannot be treated as disposed of until **all** interests in the business that were directly or indirectly acquired in connection with the creation of the covenant are disposed of or become worthless. This further restriction means that the acquiring business must continue to amortize the non-compete covenant over 15 years even though the covenant might no longer have any legal effect or value.

Selected References. Several dealerships have gone to court with the IRS over their buy-sell agreements, allocations between goodwill and non-compete covenants and a variety of other issues. Many of these cases have been written up in prior issues of the *Dealer Tax Watch* and may be useful as further background reading.

DEMONSTRATOR VEHICLES ... BACK UNDER THE IRS MICROSCOPE

That's right, the almost industry-wide practice of providing demos to dealership employees is about to be reexamined as part of the IRS' new pre-filing initiative experiment. And, the IRS expects to issue some type of guidance before year-end.

Terri Harris, the IRS Motor Vehicle Technical Advisor, speaking in Dallas at the De Filipps 4th Annual CPA-Auto Dealership Niche Conference indicated that the IRS was looking forward to dealing with this issue in a more proactive way under its new IIR (Industry Issue Resolution) Program.

INDUSTRY ISSUE RESOLUTION PROGRAM

The IRS' new Pilot Program was unveiled in IRS Notice 2000-65. This IIR Program is intended to provide guidance to resolve frequently disputed tax issues that are common to large or mid-size business taxpayers. This is part of the IRS's new strategy to resolve issues in a manner other than through the traditional post-filing examination process.

The form of resulting IRS guidance may vary depending on the issue. 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 IRS consideration under this Program generally are those where:

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.

DEMOS SELECTED AS AN IIR ISSUE

In IRS News Release 2001-48, the Service identified seven (7) issues it has selected for consideration under the Program. One of the issues is: "Demonstrator Vehicles provided for use by employees."

Request for consideration was submitted by (1) the National Automobile Dealers Association, (2) Crowe Chizek & Co., LLP on behalf of Auto Team America, and (3) O'Connor & Drew, PC. The "Submitter's Issue Description" was *Taxability of Demonstrator Automobiles Provided to Salespersons.* This more specific description that was submitted was modified by the IRS which substituted "employees" for "salespersons," thus taking demo issues out of a more limited auto dealership application only context.

The submission requested clarification of such items as (1) substantiation requirements, (2) safe harbor standards, (3) mileage limitation and (4) proper treatment of demonstrator vehicles provided to non-salespersons. It also stated, "Automobile dealers who provide demonstration automobiles (demos) for the use of their employees currently must comply with several regulatory provisions, which set forth only general standards of compliance. There needs to be developed more precise regulatory standards and safe harbors for the use of demos."

Speaking at the Dallas Conference in June, Ms. Harris indicated that the Service would welcome constructive input from any source, not limiting that input to only that provided by the three original submitters.

Ms. Harris also indicated that although the Service would like to finalize its positions on this issue before year-end, it may take a little longer in order to fully assess all of the ramifications. The contact person under the IIR Program for this issue is Joseph Brimacombe, Director, Field Operations. His phone number is 949-389-4922, and his e-mail is Joseph.Brimacombe@IRS.gov.

COMMENTS ON DEMOS AT NADA TAX ISSUES WORKSHOP

As reported in the March 2001 *Dealer Tax Watch*, the topic of demo usage was commented on by Robert Zwiers in his presentation at the NADA Convention earlier this year. He told dealers to expect that the IRS is likely to be looking for some greater degree of substantiation/documentation/recordkeeping by dealers and by employees in connection with attempts to seek the benefits provided by the qualified demonstrator use exemption.

After all, it does not seem unreasonable to expect that if an employee is going to receive a significant tax-free benefit, shouldn't that employee be willing to complete at least some minimal paperwork? This

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could be as simple as having a clipboard in the vehicle and writing down the actual mileage every day. What's so hard about that?

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 taxpayers a significant number of undocumented miles as a non-commuting freebie. His opinion was that in addition to commuting miles, the IRS should consider between 10,000 and 12,000 miles per year as allowable "other" mileage.

During the workshop, 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. It will be interesting to see how closely the Service agrees with Mr. Zwiers on these safe-harbor and employee qualification points.

For taxpayers who simply don't want to be bothered with keeping records, all of the use/mileage of the vehicle is required to be treated as personal. In some instances, however, IRS agents may generously...and often inconsistently...allow taxpayers claiming deductions for vehicles another "freebie" of up to 20% business use.

IRS agents are not required to concede or allow taxpayers any amount. Rather, the burden of proof is always on the taxpayer to document and substantiate amounts claimed for business use. Where taxpayers have not maintained adequate records, the standard used by the Service (i.e., applied by most agents) is to determine the amount of includable income by reference to the fair market rental value of the vehicle, plus insurance, sales tax and gasoline expense.

DEMO ISSUES FOR RESOLUTION

In her presentation at Dallas, Ms. Harris reviewed the demonstrator vehicle rules and listed six "Issues for Resolution."

IIR DEMO ISSUES

1. ***Safe harbor standards***
   - What is limited personal use?
2. ***Substantiation requirements***
   - What records must be kept?
   - What degree of detail is required?
3. ***Who is a full time salesperson?***
   - Sales manager?
   - Finance & Insurance (F & I) personnel?
4. ***What is the FMV (fair market value) of a vehicle?***
   - Does the relationship between dealer and manufacturer preclude this?
5. ***Treatment of demonstrators provided to non-sales persons***
6. ***Consolidation and interaction between applicable Code Sections***
   - IRC Sections 61, 132 and 274

Non-Compete Agreements

(Continued from page 10)

LESSONS FROM *FRONTIER* & *BURIEN*

Section 197 comes into play whenever a dealership or other business is buying or selling intangibles involved with the business. It is a "good news – bad news" provision of the Code. Whether the news is good or bad depends on whether you're the buyer or the seller of the business and how smart you are in structuring the transaction and allocating the total package price among the components.

In addition to the physical assets, there are typically at least three other separately bargained for assets: (1) goodwill, (2) agreements by the seller not to compete, and (3) consulting services if any are to be provided. Each of these requires separate attention, analysis and valuation in determining the final price.

These two cases suggest several observations. *Frontier Chevrolet* shows that Section 197, requiring 15-year amortization of non-compete payments, can be interpreted to involve many transactions which, at first glance, might appear to be beyond its reach.

Second, when the deduction of payments between the parties or reporting of income is either inconsistent, poorly documented, or deliberately made confusing or misleading, the IRS may successfully assert additional accuracy-related penalties against all of the parties under Section 6662.

Finally, where accuracy-related penalties are involved, the *Burien Nissan* case shows that it will be necessary to introduce evidence, and even have witnesses testify, as to what information was provided to a tax return preparer if the taxpayer is trying to avoid penalties by saying that it had relied on professional advice or advisors.

The recent cases involving *Frontier Chevrolet* and *Burien Nissan* are representative of just a few of the difficulties dealers can get into with the IRS in buy-sell situations. Undoubtedly, there are many more out there.

SHAREHOLDER LOANS OR CONSTRUCTIVE DIVIDENDS? IRS AUDIT GUIDE TELLS AGENTS WHAT TO LOOK FOR

In May 2001, the IRS Market Segment Specialization Program released an audit training guide (*#3147-118*) telling agents how to probe more deeply into loans by corporations to their shareholders. This guide targets loans and advances by corporations to controlling shareholders as an area that agents should look closely at in all situations because of the potential for abuse.

The *Audit Guide* contains two chapters and three appendices. (See facing page.) Chapter 1 explains how agents can detect and challenge loan situations which they believe to be constructive dividends (or other distributions) in disguise. Chapter 2 analyzes how Code Section 7872 applies in many of the wide-ranging situations agents may encounter.

IS THE DEBT *BONA FIDE*?

There are many Code Sections relating to various aspects of loans, including those addressing (1) arms-length concerns, (2) the timing of the recognition of income and (3) matters involving the allocation of payments between interest and principal. The *Guide* immediately makes clear that it is addressing only potential audit issues arising in the context of corporate loans ***to shareholders***. In this capacity, the *Guide* only deals with flushing out transfers of money to shareholders that are masquerading on the corporate books as loans which are not expected to be repaid.

Chapter One lists the critical or "key" factors that agents should consider whenever they see loans to shareholders on the corporate books. Laying the groundwork, it tells agents that the first question they should ask is ... "whether there is a bona fide debt. The primary determination as to whether or not the debt is bona fide hinges on a key question: When the loan was made, was there a ***genuine intent*** that the borrowed funds would be repaid?"

The *Guide* adds that over time, the "Courts have looked not to mere labels or to the parties' own testimony, but to the objective facts and circumstances surrounding a transaction." In support, it cites a 1955 case, *Baird v. Commissioner*, where the Court said: "The treatment of petitioners' withdrawals on the corporate books as 'Notes Receivable' is not controlling, since it is well settled that book entries may not be used to conceal realities as a means of relieving the taxpayer from liability for income taxes."

The *Guide* discusses twelve common law factors (see pages 16-17) which, when viewed as a whole, generally lead to a proper conclusion as to whether or not debt is bona fide. There is inherent difficulty in determining the proper result because no single factor is determinative. Therefore, examining agents are reminded that they should not be hesitant to request assistance from their district counsel office. In other words, bring in the specialists!

CONSISTENT TREATMENT IS IMPORTANT

Chapter One also includes discussions of (1) tax return reporting positions, (2) attempted recharacterizations of transactions and (3) arguments agents may raise where they feel taxpayers are taking inconsistent positions. If a taxpayer has consistently reported an item as debt (or equity) on its tax return—and if applicable—for financial and regulatory purposes, then the IRS can hold that taxpayer to that reporting position.

Agents are warned to be on the lookout for situations where a taxpayer that has treated an item in a certain manner for one taxable year may, after the period of limitations for that year has expired, attempt to treat the item in an inconsistent manner. There are two related judicial doctrines available to agents to counter such an attempted change in position by the taxpayer.

These judicial doctrines are: (1) equitable estoppel and (2) duty of consistency. In addition to these, an agent can always simply raise the challenge that the attempted change in position by the taxpayer is solely tax-motivated. If not for these doctrines, a shareholder could classify advances as loans until the statute expired, and then, to achieve more favorable tax treatment, claim that the loans should have been classified as dividends. No assessment would be possible, unless some exception to the normal 3-year period of limitations applied.

After discussing and contrasting these legal doctrines, the *Guide* illustrates how the "duty of consistency" doctrine may be used by an agent in a case involving shareholder loans. It cites *Bartel v. Commissioner,* in which the taxpayer was the sole shareholder of a corporation that was liquidated in 1964. During the 11 years preceding the liquidation, the taxpayer received disbursements from the corporation, which he treated as loans for income tax purposes. At the time of liquidation, the taxpayer attempted to avoid paying tax on the gain recognized from the corporation's cancellation of his indebtedness by representing that the prior disbursements

see **SHAREHOLDER LOANS OR CONSTRUCTIVE DIVIDENDS?**, page 18

AT A GLANCE	***IRS/MSSP AUDIT GUIDE FOR SHAREHOLDER LOANS***
CHAPTER 1 **CONSTRUCTIVE DIVIDEND VERSUS BONA FIDE DEBT**	Bona Fide Debt vs. Non Bona Fide Debt • In General • Key Determinative Factors ... 12 Factors • Taxpayer May Be Held to Its Reporting Position • Equitable Estoppel & Duty of Consistency Reasonable Compensation Considerations (S Corporations) ... Possible Employment Tax Issues Non Bona Fide Debt • S Corporations with Ample Accumulated Adjustments Account (AAA) • Forgiveness of Indebtedness • Distributions with Respect to Stock ... C Corporations and other Situations • Earnings and Profits (E & P) Considerations
CHAPTER 2 **BONA FIDE DEBT (MECHANICS OF)**	Below Market Loans • In General • Loans ... Transfers of Money that Provide the Transferor with Right to Repayment • Demand Loan Defined • Term Loan Defined • Applicable Federal Rates ... Reg. Sec. 1.7872-3 Identification • Identifying a Below-Market Demand Loan ... Requirements for Continuous Monitoring • Identifying a Below-Market Term Loan Exceptions • De Minimis Exception • Other Exceptions Computations • Computation of "Forgone Interest" in a Below-Market Demand Loan • Balance Outstanding for the Entire Year and "Blended Annual Rates" • Short Period Computations: *Exact* vs. *Approximate* Interest Computation Methods • Loans with Increasing Balances ... Procedures to Compute Interest • Loans with Decreasing Balances ... Procedures to Compute Interest • Computation of Imputed Transfer & Original Issue Discount for Below-Market Term Loan Interest Issues on Market Rate Loans • Demand Loans with Stated Interest at or above AFR (Applicable Federal Rate) • Market Rate Term Loans • Waiver or Cancellation of Interest
APPENDICES	**A** Below-Market Term Loan Example ... With Semi-Annual Repayments **B** Below-Market Demand Loan Example ... With Fluctuating Loan Balances **C** Key Court Cases ... 13 Cases Cited
CITATION	IRS Market Segment Specialization Program Shareholder Loan Audit Technique Guide Training 3147-118 (May 2001) ... TPDS 86798J

All scenarios below assume that the distribution in question is being treated as a loan to the shareholder.

1. The extent to which the shareholder controls the corporation.

If a shareholder controls the majority of a corporation's stock, he or she can exercise direct control over the corporation's earnings and profits .

That condition tends to suggest a constructive dividend. For example, if shareholder controls exactly 50 percent of a corporation's stock, and if an equal distribution is not made to the other 50 percent shareholder, and the other shareholder did not object to the loan treatment of the distribution, that suggests that a loan was made. The probability of an arm's-length transaction is far greater if the shareholder receiving the loan does not own a majority (directly or through attribution) of the corporate stock.

However, the critical element is the extent to which the shareholder is able to control the affairs of the corporation, irrespective of whether that control derives from stock ownership, family relationship, or some other source. In some situations, a shareholder may exert nearly total control of a corporation but directly own only a small percentage of the stock. See *Baird v. Commissioner*, 25 T.C. 387 (1955).

2. Whether security was given.

In most circumstances, the failure to provide security may be an indication that a distribution was intended. However, the Court noted in *Shea v. United States*, 83-1 USTC "9115 (N. D. Ala 1982), that where a corporation's articles of incorporation provide that the corporation has a lien on its shares of stock for any debt or liability incurred to it by a stockholder, the fact that no security is given for the advances made to a shareholder does not preclude a finding that the advances constituted bona fide loans, even though the shareholders were unaware of the provision in the articles at the time the advances were made.

3. Is the shareholder in a position to repay the loan?

The shareholder's salary, other income, and net worth are relevant in determining the shareholder's ability to repay. If the shareholder is in a position to repay the advances based on his current financial status, that supports a bona fide loan. In *Smith v. Commissioner*, T.C. M. 1980-15, however, the mere fact that the shareholder had a good credit rating was not conclusive to establish that the shareholder was in a position to repay the advances.

4. Adequate earnings and profits.

If there are no current or accumulated earnings and profits (E& P) at the time of distribution, the distribution will not be treated as a constructive dividend under Section 301. See Section 316 (Dividend Defined). That does not mean that because a corporation has a deficit or no E & P, a distribution is a bona fide loan. It simply means that the distribution cannot be classified as a dividend, but could be a return of capital or capital gain. See Sections 301(c)(2), (3). Thus, before an agent challenges the validity of a loan, the issue of adequate E& P must be considered.

5. Certificate of indebtedness is given to the corporation.

The fact that no note of indebtedness was issued to the corporation is not a determinative factor. There are numerous court cases where no note was issued for advances, but, based on other factors, the advances were accepted as bona fide loans.

The lack of a certificate of indebtedness has been considered an indication of a constructive dividend. In *Smith*, supra, the shareholder made an advance to the corporation and received a promissory note or a certificate of indebtedness, but no note was given when the corporation made an advance to the shareholder. That circumstance weighed strongly in favor of constructive dividend treatment.

6. Is there a repayment schedule or an attempt to repay?

Even if the repayments are made, if the amount advanced continues to increase over a sustained period of years, that would tend to support constructive dividend treatment. Repayments made either by direct payments or by such means as bonus credits would support a debtor-creditor relationship. If a regular repayment schedule is being followed for the payment of interest and reduction of principal, that would be a factor favoring a bona fide loan.

7. Is there a set maturity date?

Generally, a fixed maturity date is significant, *United States v. Title Guarantee & Trust Co.*, 133 F. 2d 990 (6th Cir. 1943). However, even in the absence of a fixed maturity date, a loan will be respected as such if it is repaid within a reasonable period of time. In *Shea* supra, there was no set maturity date, but systematic payroll deductions were being made that would have paid the advances off in a few years. In that case, the lack of a set maturity date was not held against the shareholder. An examination may reveal that a shareholder annually reissued a term note for the previous amount owed, plus some or all of the accrued interest. In that situation, a pattern of setting a maturity date, but never repaying the loan often indicates constructive dividend treatment.

8. Whether the corporation charges interest.

The failure to charge interest may indicate that those advances are constructive dividends. However, when no interest is charged in the closely held context, Section 7872 may apply. In *Shea*, supra, the corporation had an across-the-board policy for all employees that no interest would be charged on outstanding loans. At the other end of the spectrum is *Thielking v. Commissioner*, T.C. M. 1987-227. The Court concluded that the petitioner caused a journal entry to be made on the books of the corporation reflecting accrued interest on the net withdrawals he made from the corporation with a corresponding credit to interest income of the corporation each year. Although the facts seem to strongly indicate a bona fide debt, the Court examined the shareholder's actual intent to repay the advances. The Court held that the advances were constructive dividends and not bona fide debt. Generally, a failure to charge interest supports constructive dividend treatment or imputed dividends under Section 7872.

9. Whether the corporation has made systematic efforts to obtain repayment.

What action has the corporation taken to obtain repayment? The shareholder's failure to make payments, or only minimal payments, indicates a constructive dividend, particularly if the corporation is not taking steps to enforce the loan. If a closely held corporation does not apply pressure on a borrowing shareholder for repayment, the transaction may not be at arm's length. However, the fact that a shareholder is making reasonable payments is not one that is considered in this analysis.

10. Magnitude of the advances.

Another indication of a constructive dividend is if a corporation makes large advances to a controlling shareholder, and the shareholder's ability to repay is essentially contingent on future events.

11. Whether a ceiling exists to limit the amount the corporation can advance.

A numerical ceiling on the amount that can be advanced to a shareholder would tend to support bona fide debt. The courts have also held that if a corporation is required to obtain the consent of an equal controlling block of stock to make an advance, that action imposes a de facto ceiling on the amounts which can be advanced. This is seldom a key factor, but advances in cases of a ceiling may be treated as constructive dividends in some instances.

12. Dividend history of the corporation.

Adequate earnings and profits with respect to the advances made, coupled with no history of paying dividends, favors constructive dividend treatment.

Five Concluding Comments

- ***It cannot be emphasized enough that the above-listed factors must be viewed as a whole.***
- ***Any factor considered on its own will probably not be determinative.***
- ***The purpose for analyzing the above factors is to determine the parties' intent at the time of the distribution.***
- ***In addition, this list of factors is not all- inclusive.***
- ***Any facts that may provide insight into the parties' intent at the time of the distribution should be developed.***

Source: *IRS Market Segment Specialization Program Shareholder Loan Audit Technique Guide* Training 3147-118 (May 2001) ... TPDS 86798J

(Continued from page 14)

were, in fact, compensation and dividends, rather than loans. The Tax Court held that the taxpayer was required to continue treating the disbursements as loans, consistent with their having been treated as loans in earlier years.

AN UNUSUAL TWIST:
S CORPS & REASONABLE COMPENSATION

The issue of reasonable compensation may be tied in with S Corporation shareholder loan balances in order to create a deficiency in employment taxes.

The *IRS Shareholder Loan Guide* says that, if the entity making the advances is an S corporation and the agent's initial determination (using the key determinative factors) is that a debt is bona fide, then ***another test*** of the validity of the debt must be considered. That test is...Did the S corporation pay a reasonable amount of compensation to the shareholder who received the advances or loans? If not, the examining agent is instructed to evaluate whether all or part of the advances to that shareholder should be reclassified as compensation, ***subject to employment taxes***.

In this context, it would appear that if there were compensation reclassifications, with attendant employment tax issues, there would also be income tax adjustments among shareholders in any situation where the S Corporation has more than one shareholder.

Agents are also instructed to pursue other alternative compensation issues (with related employment tax issues) if the agent's initial determination is that the shareholder loan or advance was not bona fide debt. According to the Guide, either way, i.e., whether the debt is bona fide or not, imputed compensation in S Corporation situations could result in additional employment taxes.

INTEREST COMPUTATIONS

Chapter Two of the *Audit Technique Guide*, as its title indicates, gets into the definitions, mechanics and details of the computation of interest and related tax issues when the shareholder loans on the Corporate books are accepted as bona fide debt.

This chapter is an extended analysis of the application of Code Section 7872 with even further detailed examples included in Appendix A (involving a below-market ***term*** loan) and Appendix B (involving a below-market ***demand*** loan).

A below-market loan is a loan in which the interest rate charged is less than the applicable Federal rate. Section 7872 characterizes a below-market loan as two transactions. ***First***, the lender is treated as making a loan to the borrower, requiring the payment of interest at the applicable Federal rate. ***Second***, there is an *imputed* transfer of funds from the lender to the borrower in an amount sufficient to fund the payment of the interest by the borrower. The imputed transfer from the lender to the borrower is characterized in accordance with the substance of the transaction. In other words, the IRS may consider the transaction as involving the making of a gift, the payment of compensation to an employee, or the payment of a dividend to a corporate shareholder. The characterization all depends on the facts and circumstances.

Section 7872 generally does not impute interest on loans that require the payment of interest at the applicable Federal rate, as defined in Section 1274(d). If the loan document requires interest to be paid or accrued at a stated rate that is **at least equal** to the applicable Federal rate, then Section 7872 generally does not apply, although there are certain exceptions to this for waiver, cancellation or forgiveness of interest payments.

If the stated interest on the loan is adequate, but interest is not being paid or accrued at least annually, then interest income may be *imputed* to the lender under the original issue discount rules of Sections 1271-1275.

In discussing the use and importance of Applicable Federal Rates in interest computations, the *Guide* points out that "the law is intricate in its application" because (1) a loan balance can fluctuate throughout a tax year and (2) the Applicable Federal Rates are continually changing. Consequently, the myriad of situations an agent may encounter involve enormous complexity, which the remainder of Chapter 2 addresses.

For example, demand loans must be differentiated from term loans. Each receives different treatment. Further complicating matters are the facts that (1) not all loans are entered into or outstanding on January 1, (2) loan balances frequently increase or decrease, and (3) incremental increases in loans are considered to be *new* loans under Section 7872. Consequently, short period interest computations are often necessary. These computations may be made under either an "exact" method or an "approximate" method, both of which are explained in detail in the *Guide*.

The only saving grace taxpayers may hope for is in the de minimis rules and in certain other limited exceptions. Under the de minimis rules, Section 7872 does not apply to any corporation-shareholder loan so long as: (1) the loan is not a tax avoidance loan, and (2) the aggregate amount of loans (below and at or above market) outstanding between the lender and the borrower does not exceed $10,000.

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POTENTIAL AUDIT ADJUSTMENTS

In below-market term loan situations, there are two areas that may potentially generate audit adjustments. The *Audit Guide* identifies these as involving situations where:

1. The initial deemed transfer will produce dividend income to the shareholder, and
2. The corporation will recognize imputed interest income as original issue discount generated in the deemed exchange.

In the latter situation, over the term of the loan, the amount of the original issue discount (OID) will equal the imputed transfer, which was a dividend to the shareholder. Note also the possibility that if the shareholder is the lender, the imputed transfer will result in interest income to the shareholder and a capital contribution by that shareholder to the corporation.

The *Guide* also states that he corporation must recognize qualified periodic interest and/or OID that is computed under Sections 1272 and 1273 on an economic accrual basis over the term of the loan. Sections 1272 and 1273 generally require interest to be recognized on a constant yield regardless of the lender's accounting method. Therefore, if the lender is on the cash method, these original issue discount rules force the lender onto the economic accrual method of accounting for the interest earned on the loan for a given period. This would involve a change in accounting method, and all of the applicable Form 3115 filing procedures related to such changes.

COMPLEX EXAMPLES

Appendix A of this the *Guide* includes the following detailed example. A corporation loans a shareholder $100,000 payable in equal semiannual payments over 3 years at 8%. The Applicable Federal Rate in effect at the inception of the loan is 11%. The shareholder adheres to the terms of the loan.

This loan is a below-market term loan subject to Section 7872. The payments of principal and interest per the stated terms of the loan are computed by using an Excel spreadsheet described in the example. Since the AFR for the loan is 11% compounded semi-annually, the loan is subject to Section 7872. The present value of the semi-annual payments at 11% compounded semi-annually will compute the issue price of the debt instrument. The difference between the issue price and the $100,000 stated value will equal the original issue discount.

Under Section 7872, the example shows that the shareholder will have a dividend of $4,703 on the day the loan is made. Also, depending upon what purpose the shareholder uses the loan proceeds for, the shareholder may be entitled to a Section 163 interest deduction for amounts of OID he is deemed to have paid under Section 7872. The corporation will report interest income for the three years in the following amounts: Year 1 : $9,721 (consisting of $7,397 of stated interest + $2,324 of OID) ... Year 2: $6,509 ($4,888 + $1,621) ... Year 3: $2,931 ($2,173 + $758).

Where demand loans with stated interest at or above Applicable Federal Rates are involved, agents are advised that "If the demand loan is not below-market based on the terms of the note, there generally will be no dividend to the shareholder. However, the terms of the loan should be analyzed to determine if the corporation is properly recognizing the interest that is allocable to the period."

The rule of thumb is that where there is a loan, there must be interest income at an arm's-length rate recognized on a yearly basis, regardless of the corporation's method of accounting. Even if the corporation is on a cash basis, Section 1272 requires it to recognize the interest annually. If not, this may generate a change in the method of accounting, resulting in an adjustment for all prior years' unrecognized interest income in the year under examination. The original issue discount rules can apply to demand loans.

Appendix B of the *Guide* includes a complete workpaper format analysis of the application of the Reg. Sec. 1.1272 and 1.1273. These examples give readers a look at the complexity of the provisions involved in computing interest under different circumstances.

KEY COURT DECISIONS

Appendix C includes a partial listing of the cases cited throughout the *Audit Guide* which are described as key court cases involving bona fide debt vs. constructive dividend issues. These cases are a good place to start your research in this area.

In this regard, you also may want to review the write-up in the December 1995 *Dealer Tax Watch* of the "Case of the Out-of-Control Dealer Receivable: *Yarbrough Oldsmobile Cadillac, Inc. et.Al v. Commissioner* (T.C. Memo 1995-538)."

CONCLUSION

This IRS *Audit Guide* bears the subtitle ***Shareholder Loans***. So it's obvious that this is an important area the IRS wants to police.

Dealerships with loans to shareholders on their books may want to take a fresh look at their situations in light of this guidance that the IRS recently released to examining agents.

Also, the accompanying *Practice Guides* for identifying possible loan-constructive dividend problem areas on the following pages may be helpful.

CHECKLIST FOR IDENTIFYING POSSIBLE LOAN—CONSTRUCTIVE DIVIDEND PROBLEM AREAS

PRACTICE GUIDE

COMMENTS

DOCUMENTATION, BONA FIDES, GROWTH AND ACTIVITY

1. Do loan documents exist?
2. Does the loan documentation appear to be adequate?
3. Is the receivable balance collateralized or otherwise secured?
4. Does the security or collateral appear to be adequate?
5. Has interest been regularly charged and paid? If not, why not?
6. Is there a fixed repayment schedule? If not, why not?
7. Realistically, what limits exist in connection with what goes in and out of this account?
8. Has the total loan balance each year, net of repayments, been steadily increasing?
9. What is the average loan balance amount for the

	Mid-year	Year-end
• Past 3 years	$_____	$ _____
• Past 5 years	$_____	$ _____
• Past 10 years	$_____	$ _____

10. Are repayments substantially through bookkeeping entries and salary adjustments? If so, to what extent?

CONSISTENCY WITH OTHER DATA AND EVENTS

1. Is the receivable from the dealer, as shown on the dealership's books and records and in the financial statements, treated as a liability in the dealer's personal financial statements submitted to banks and other prospective lenders or business associates?
2. How has the receivable from the dealer been treated in any dealership valuation computations? Has the balance been *adjusted, modified or reclassified* in any way?
3. How has the receivable from the dealer been treated in dealership working capital computations? Has the receivable from the dealer been included as a current asset?
4. Has the corporation ever paid any dividends? If so, to what extent?
5. Does the dealer have any unusual or special interests and hobbies? Have these interests been reflected to any extent in the dealership's investments or in advances to the dealer?
6. Does the corporation own any "toys," unique or "nondepreciable" assets which the dealer uses almost exclusively or considers his own?
7. If yes, under what circumstances were these assets acquired? How are they titled? Are they insured? Are there any co-owners?
8. Can any of the documentation relative to quasi-personal use assets be interpreted as potentially misleading or inconsistent with other facts or documentation or classification in the accounts and tax returns?
9. Is the documentation (including insurance policy coverage) consistent starting with the acquisition of the asset, continuing with the maintenance of the asset and concluding with the ultimate disposition of the asset?
10. Have you analyzed detail supporting schedules listing all of the items or assets in the following accounts? Are there any questionable items included in these accounts?

- Used vehicle inventory
- Non-franchise assets
- Any other unusual account(s): _____ →

PRACTICE GUIDE

BENEATH THE SURFACE AND BEYOND THE OBVIOUS

	COMMENTS
1. Is the dealership a member of a controlled group of corporations? List below all related or controlled entities with which the dealer or the dealership does business. _____ _____ _____	
2. Have any other loans or advances (or guarantees) been made to other related entities that might be characterized by the IRS as having been made *"for the benefit of"* the dealer?	
3. Are you aware of any other direct transactions between the dealership and the dealer which might be subject to recharacterization (fully or partially) as constructive dividends?	
4. Has the dealership paid any professional fees for the personal benefit of the dealer?	
5. Have any payments been made by the dealership in connection with divorce proceedings or settlements involving the dealer or any other members of the dealer's family?	
6. Are you aware of any other similar direct or indirect transactions?	
7. How has the dealer secured financing for any additional franchise purchases or expansion activities?	
8. In connection with these events, does all of the documentation appear to be in order and to reflect arms-length negotiations?	
9. Have there been any "diversions" of assets which the dealer may have "quarterbacked" that might be characterized as constructive dividends?	
10. Has the risk of recharacterization of activities or transactions by the IRS been considered and discussed with the dealer? If yes, explain below.	
11. If potential exposure exists, have accuracy-related penalties and preparer penalties been considered and discussed?	
12. Have you considered including a representation from the dealer in connection with these matters in the engagement letter or elsewhere? If not, explain below.	

ADDITIONAL COMMENTS & EXPLANATIONS

_____
_____
_____
_____
_____
_____
_____

Preparer's signature and date *Reviewer's signature and date*

"TYPICAL" PROBLEM AREAS

1. "Loans" by the corporation to the shareholder for which the shareholder cannot demonstrate intent to repay and/or the bona fides of the loan.
2. Excessive or unreasonable compensation paid by the corporation to a shareholder-officer.
3. Improper travel and entertainment or other business expenditures incurred by the shareholder and charged to the corporation.
4. Sale of property by the corporation to the shareholder at less than fair market value (i.e., a bargain purchase of corporate property by a shareholder).
5. Purchase of property by the corporation from the shareholder at a price in excess of fair market value (i.e., a sale of property by the shareholder to the corporation at an excessive price).
6. Excessive rentals and other payments (royalties, license fees, etc.) for use of property owned by the shareholder.
7. Shareholder use of corporate-owned property or facilities for non-business/personal purposes (where adequate rent payments are not made for such use).
8. Forgiveness by the corporation of shareholder indebtedness to the corporation.
9. Assumption by the corporation of shareholder indebtedness to other (related) corporations.
10. Payments made by the corporation for the benefit of the shareholder, either directly or to discharge any obligation of the shareholder. This could include the payment of legal fees, alimony or other support obligations arising out of divorce proceedings or settlements.
11. Excessive compensation, rental or other payments by the corporation <u>to other members</u> of the shareholder's family.
12. Advances or other transfers of funds between related corporations may be treated as constructive dividends to the common shareholders.
13. Where a shareholder loans money to the corporation, if the loans by the shareholder are treated as contributions of capital, any *"interest"* the corporation pays to the shareholder on the alleged "loan" will be characterized as (constructive) dividends.
14. Payment by the corporation of premiums on life insurance policies which the corporation's shareholders own directly.
15. The supplying of corporate employees for labor, or materials or other assets to maintain or construct assets or other activities for the benefit of the shareholder.

POSSIBLE LIMITING OR MITIGATING FACTORS

- The amount of any constructive dividend taxable to a shareholder is limited to corporate earnings and profits, as computed under Section 312.
- It may be possible to demonstrate that the shareholder has not received any economic benefit from the corporation's expenditure. If this can be demonstrated, there should be no constructive dividend equivalent taxable to the shareholder.

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ELEMENTS

- There must be a distribution of money, property or an economic benefit from the corporation to the shareholder.
- The distribution to the shareholder must be from the corporation's earnings and profits.
- The distribution (of money, property or economic benefit) is not recorded or treated in the corporate records as a formally declared dividend.
- The amount or fair market value of the distribution is taxable to the shareholder at regular income tax rates to the extent of the corporation's earnings and profits. Beyond that amount, the distribution in excess of earnings and profits is treated as a return of capital to the extent of basis in the stock. Once basis has been reduced to zero, any additional amount is treated as capital gain.

Note: The term "distribution" includes more sinister activities (diversions) which are intended to reduce corporate taxable income by by-passing the corporation or by not involving the corporation directly. A diversion may also be accomplished through the use of intermediaries acting for or on behalf of the shareholder.

IRS MANUAL INSTRUCTIONS TO AGENTS IN AUDITING SHAREHOLDER ACCOUNTS AND LOANS

LOANS TO SHAREHOLDER

The IRS/MSSP Auto Dealerships Manual identifies the following discretionary audit procedures for the loans to shareholders account:

1. Analyze the composition of the account balance.
2. Trace the source of repayments.
3. Determine whether or not a bona fide debtor-creditor relationship exists.
4. Ascertain whether the current year's increase represents dividend distribution, compensation or possible diversion of income.
5. Determine that interest income has been properly recorded.
6. Follow SAIN (Standard Audit Index Numbers) program for loan to shareholders/ liability, where applicable.

LOANS FROM SHAREHOLDER

With respect to Loans From Shareholders, the IRS audit techniques include:

1. Analyze the composition of the account balance.
2. Determine if the corporation is "thinly capitalized."
3. Consider factors bearing on the debt to equity ratio.
4. Review the recording of interest expense and verify the interest accrued at year-end is paid within the statutory period.

OTHER COMMENTS

Note that one of the items on Form 4564, Information Document Request (as reflected in the June, 1995 *Dealer Tax Watch* on page 17) relates to a request for: "Information regarding any loans during the year, including loans to/from shareholders. Shareholders information should include notes and payment schedule."

As discussed in the September, 1995 *Dealer Tax Watch*, the IRS' Used Car Dealers Audit Manual contains a fairly comprehensive discussion of constructive dividend issues, including much of what the Tax Court said in *Yarbrough*. Also, in connection with its discussion regarding fixed assets, this Manual states that "an inspection of the assets on a surprise basis could indicate that some assets are located at the owner's residence." Indeed, some of them may actually be the owner's residence.

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De Filipps' DEALER TAX WATCH
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

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