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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

Volume 8, Number 2 | Publisher: Willard J. De Filipps, C.P.A. | September 2001

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. INDEX OF *DTW* ARTICLES THROUGH JUNE, 2001 IS NOW AVAILABLE. We have updated the previous index of all articles in the *Dealer Tax Watch* from our first issue, over 7 years ago (June, 1994) through June, 2001.

This *Index of Articles* has seven sections. In addition to listing all articles by subject, there are *Finding Lists* for all tax cases, IRS Coordinated Issue Papers, Field Service Advice Memoranda, Letter Rulings (including TAMs), Revenue Rulings, Revenue Procedures and the *Practice Guides* included with various articles.

You can see and print the entire *Index of Articles* on our web site, www.defilipps.com, or you can obtain the Word™ document by calling or e-mailing us with your request.

#2. STILL QUIET...NO REAL IRS AUDIT ACTIVITY TO REPORT. If no news is good news, then there's good news to report. Not much seems to be happening in the area of IRS audits of dealerships right now. At least, that's according to many conversations we've had over the summer months with CPAs niched in handling auto dealerships.

However, as each issue of the *DTW* reflects, there is certainly plenty of activity going on in peripheral areas and in the Courts. One IRS administrative development reported below suggests possibly even less hassling or scrutiny from the IRS for some dealerships.

#3. LMSB CHANGES...SOME DEALERSHIPS GET KICKED UPSTAIRS. Some dealerships may have fallen even farther out of sight or off the IRS' radar screen. As parts of its makeover in response to the 1998 IRS Reform and Restructuring Act, the IRS had created four new taxpayer divisions. These four separate compliance groups are (1) Small Business/ Self-Employed [SB/SE], (2) Large and Mid-Size Businesses [LMSB], (3) Wage and Investment and, (4) Tax-Exempt and Governmental Entities.

Originally, businesses had to have more than $5 million in assets in order to be placed in the LMSB category. In the March, 2001 *DTW* article on IRS audit and compliance activity, we predicted that the IRS audit impact on auto dealerships would further decrease as more auto dealers were mixed in with large

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WATCHING OUT FOR

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manufacturing and transportation group taxpayers in the LMSB division..

Beginning October 1, 2001, this possibility becomes even more likely. As of October 1, all of the tax administration workload related to businesses with assets between $5 and $10 million dollars will shift from the LMSB operating division to the SB/SE operating division. After that date, the LMSB division will handle only businesses with assets of $10 million or more ... while the SB/SE division will focus on businesses with less than $10 million in assets.

What does this change mean to many dealerships? Apparently, before this change, there were about 210,000 corporate taxpayers in the LMSB division and approximately 7,000,000 taxpayers in the SB/SE division. Dealerships with assets between $5 and $10 million that are "downshifted" from the LMSB to the SB/SE will now become part of a much larger pool of taxpayers over which already thinly stretched IRS personnel must be stretched even further.

Realistically, the odds seem to be moving even farther in favor of taxpayers willing to play the audit lottery and take more aggresive positions in their tax returns.

#4. SERVICE TECHNICIAN TOOL RENTAL & REIMBURSEMENT PLANS. Two Field Service Advice Memos published during the quarter shed more light on IRS resistance to plans that many dealers have patterned their service technician tool rental & reimbursement plans after. These two FSAs are discussed on page 6 and neither one is favorable to the taxpayer.

Apropos to the comments just made in Update #3, "aggressive" larger and smaller dealers alike who have already adopted plans hoping they can be defended as accountable plans now seem to stand an even better chance that they will never have to defend them to the IRS.

#5. DEALERS BEWARE: TAX COURT HOLDS THAT FIXED ASSETS COSTING UNDER $500 CANNOT BE EXPENSED. A recent case, not involving a dealership, shows just how precarious it is to arbitrarily write-off all small dollar fixed asset purchases under a certain amount. This applies even if you've been following that policy consistently for many years, if not since the business began. For more on this case, see page 4.

#6. *METRO LEASING*, A REALLY INTERESTING CASE. In case you missed it, a really interesting case was reported during the summer out of the Tax Court ... *Metro Leasing and Development Corp., et. al. v. Commissioner* (T.C. Memo 2001-119). Despite its name, this case involves issues relating to

- Reasonable compensation paid to a dealer,
- Whether the accumulated earnings tax should be imposed in a situation common to many dealerships after they are sold, and
- Penalty issues where compensation and Section 531 issues are creating the tax deficiencies.

We plan to discuss this case more fully in the next issue of the *DTW*.

#7. USED VEHICLE LIFO. Many CPAs seem to be planning to put dealers who have already elected LIFO for used vehicles on the new method approved by the IRS in Revenue Procedure 2001-23. See *Update* item #4, December 2000 *DTW*. The June 2001 issue of the *LIFO Lookout* contains a comprehensive discussion and evaluation of the new method.

If your dealers are making the change this year, you may want to look into the used vehicle LIFO services now being offered. In addition to all of the usual calculations, reconciliations and prior history rebasing, one service at no additional charge provides (1) Form 3115 filing assistance and (2) detailed listings and statistics of the days in inventory for all units in year-end inventory.

Computations are already being run for June 30, 2001 dealerships changing to the Rev. Proc. 2001-23 methodology. You can call (847) 577-3977 or go to www.defilipps.com for more information.

#8. OLDS PHASE-OUT: TAX IMPLICATIONS. Our *Update* item #3 in March referred to several dealership publications including tidbits on how dealers in transition can better negotiate their situations without losing sight of tax considerations.

CPAs involved with Olds dealers will certainly want to follow Dan Myers' comments as one of the "Ownership" columnists each month in the *Dealer Magazine*. Mr. Myers' firm currently represents 244 out of the 2,800 Olds dealers in the country.

In his September column in *Dealer Magazine*, Mr. Myers provided some very interesting statistics on the Olds "Transition Assistance Financial Package" (TAFP). He indicated that you can count on the fingers of one hand the number of his clients who have chosen to take the money.

Mr. Myers' legal update on dealership transition issues at our Dealership Niche Conference in June is reported on page 8.

#9. OOPs ... SORRY ABOUT THAT MISSING DIGIT. Last issue's *Update* item #6 reported taxpayer-favorable developments relating to dealer reinsurance company arrangements. One of the items commented on

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was a Letter Ruling providing some insight into the IRS position on what constitutes an ***insurance company*** for tax purposes. In citing that ruling, somewhere along the way, a digit was dropped. That Letter Ruling should have been cited as 200119039. Sorry about any inconvenience that may have caused if you were looking for the full text.

During the current quarter, another related IRS Legal Memoranda, ILM 200130032, also addressed the "brother-sister" captive insurance issue. That ILM also agreed that an adverse IRS position should be conceded to the taxpayer.

#10. CONFERENCE UPDATE. "Solid Ideas to Navigate Today's Turbulent Industry" was the theme of the *De Filipps 4th Annual CPA-Auto Dealership Niche Conference.* This Conference was held June 18-20 at the Westin Galleria in Dallas and provided attendees with a wealth of information shared by many speakers.

Included in this issue of the *Tax Watch* are several reports by Mark Battersby summarizing some of the Conference presentations. His reports summarize Dan Myers' comments which addressed legal matters, presentations by Mark Schmitz and Tim York on dealership valuation issues, and Sandi Jerome's update on technology trends in the industry.

The Conference tax issues coverage included presentations by Terri Harris of the IRS (see Mark's report on page 15) and by Will De Filipps (see page 17). In addition, the Tax Panel *Question & Answer* session is summarized on page 19.

Finally, John Boggs' presentation on employment issues and compensation plans included sample compensation arrangements for salespersons, parts managers, parts counter persons, closer-assistant sales managers, F & I managers and general sales managers. We have reprinted, with his permission, two of the six sample compensation agreements he provided. See pages 24-30.

As one attendee remarked, "the pay plan agreements included as part of Mr. Boggs' handouts were worth the price of admission alone."

#11. REFERENCE MATERIALS/MANUAL

From the Conference agenda on our web site, you can see the entire program, including presentations not summarized as *"Conference Reports"* in this issue of the *Dealer Tax Watch.* The only change from the announced program was the last minute substitution of Tim York for Butch Williams as one of the presenters on business valuations.

The 2001 Conference Manual includes speaker PowerPoint presentations, outlines and other materials supporting most of the presentations. Some of the presenters' supporting materials are extremely detailed and thorough, making the Manual a valuable stand-alone reference.

A limited supply of Conference Manuals is still available for purchase ($195 plus $20 shipping & handling). To order, call (847) 577-3977 and request the 2001 Conference Manual.

FIXED ASSETS COSTING UNDER $500 CAN'T BE EXPENSED ... THEY MUST ALL BE CAPITALIZED

When many dealerships purchase fixed assets, they often follow an accounting policy of not capitalizing any expenditures of less than a certain amount, say $500 or $1,000.

The March 2000 *Dealer Tax Watch* discussed IRS Legal Memorandum 199952010. This involved a taxpayer's request for permission to change its accounting method in connection with capitalizing expenditures for machinery, equipment, furniture and fixtures. Under the method it was using, the taxpayer was not capitalizing and depreciating purchased assets if they cost $1,000 or less. It was expensing the cost of all such items. The taxpayer in this ILM requested permission to be allowed to change its method of accounting by increasing this minimum amount from $1,000 to $2,000.

Not suprisingly, the Service denied the taxpayer's request. It said that "The...current method of not capitalizing assets valued at a certain amount or less is not an acceptable method of accounting. All property used in a trade or business, other than land or inventory, that has a useful life of more than one year must be capitalized and depreciated. ***Taxpayers are not permitted to treat such items as current expenses simply because the particular item has a certain minimum value or less.***"

ALACARE H.H.S., INC.

Would you get excited if a client expensed, instead of capitalized, a fixed asset purchase of $180? Or would you get excited if, in another year, that client expensed a fixed asset purchase of less than $150?

Does your reaction change if there were 2,632 fixed asset purchases in one year, with an average cost per item of $177.79 ... or if there were 2,381 similar items purchased in the next year with an average cost per item of $147.65?

Well, those are the facts in the recent case, *Alacare Home Health Services, Inc.* (T.C. Memo 2001-149). Although this taxpayer is obviously not a dealership, much of the Tax Court's reasoning and conclusion would apply to any taxpayer, including an auto dealership.

The taxpayer is a Medicare-certified home health care agency with about 98+% of its revenues coming from Medicare reimbursements. It is required to comply with accounting guidelines contained in the Medicare Provider Reimbursement Manual (MPRM). It is also required to submit to an annual compliance audit of its books and records by one of Medicare's so-called "fiscal intermediaries."

The MPRM manual containing the guidelines concerning capitalization and expensing policies stated that "if a depreciable asset has at the time of its acquisition an estimated useful life of at least two years and a historical cost of at least $500, its costs must be capitalized, and written off ratably over the estimated useful life of the asset, using one of the approved methods of depreciation. If the depreciable asset has a historical cost of less than $500, or if the asset has a useful life of less than two years, its cost is allowable in the year it is acquired ...."

The Manual further stated that "the provider may, if it desires, establish a capitalization policy with lower minimum criteria, but under no circumstances may the above minimum limits be exceeded." It is important to note that this policy statement in the Manual affords the provider an option, and it is not mandatory.

In 1995 and 1996, the taxpayer expensed a total of $467,944 (in 1995) and $351,543 (in 1996) worth of expenditures for a variety of items. These items included bookcases, chairs, credenzas, desks, organizers, file cabinets, refrigerators, microwaves, serving carts, panels and accessories, tables, telephones and typewriters.

In addition, the category of "computer items" included modems, CD ROMs, hard drives, keyboards, motherboards, memory modules, outlets, processors, servers, software and terminals.

As indicated previously, the average cost per item of the 2,632 items purchased in 1995 was $177.79 and the average cost per item of the 2,381 items purchased in 1996 was $147.65.

THE IRS OBJECTS & ASSERTS PENALTIES

The taxpayer's accounting firm was one that specialized in the healthcare industry and the chief financial officer of Alacare had reviewed the 1995 and 1996 income tax returns for accuracy after they had been prepared by the CPA firm and before they were filed.

On audit, the IRS took the position that Alacare's policy of expensing assets that cost less than $500 was not a proper method of accounting. The Service said that Alacare should capitalize the costs of the disputed assets over their useful lives. The Tax Court agreed with the IRS.

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The IRS also asserted penalties, totaling over $39,000, under Section 6662 for substantial understatement of tax liabilities. However, the Tax Court held that Alacare had reasonably relied on its tax return preparer and therefore it was not liable for accuracy-related penalties.

THE TAX COURT'S ANAYSIS

In court, Alacare had tried to support its position by relying on two very old cases involving railroads that were subject to regulation by the Interstate Commerce Commission (ICC). The railroads in these cases were subject to the ICC's requirement to expense purchases of certain property costing less than $500 (i.e., the minimum rule expenses).

The Court opinion in *Alacare* includes a detail chart comparing the particulars of the two railroads and Alacare's facts. The ratios of the disputed items to various measures of Alacare's size are substantially greater than the ratios in both of the railroad cases. Most strikingly, the disputed items were 165% of Alacare's 1995 taxable income and 83.5% of its 1996 taxable income.

The Court in the *Cincinnati, New Orleans and Texas Pacific Railway* case considered 17 years of data including such items as gross receipts, capital expenses, total investment, net taxable income, total operating expenses, total depreciation, and the disputed minimum items ... in deciding that the railroad's method of accounting clearly reflected income. The Tax Court in Alacare said that "petitioner did not offer evidence from its years other than the years at issue."

The Tax Court also observed that in the *Cincinnati* railroad case, the record contained evidence that the Interstate Commerce Commission had adopted the minimum expense rule ***after concluding that imposition of the minimum rule would not distort income or cause the railroads' financial statements not to clearly reflect income.***

In contrast, Alacare offered no evidence that the HCFA (Federal Health Care Financing Administration) had considered whether a minimum expensing policy would cause financial statements of home health care agencies under its supervision not to clearly reflect income.

Furthermore, the Tax Court observed that the Cincinnati railroad case taxpayer was using an expensing method that was in accordance with generally accepted accounting principles. Although Alacare argued that its minimum expensing rule also complied with GAAP, it offered no evidence to support that contention.

The Tax Court noted that the Interstate Commerce Commission requirements involving both railroad taxpayers (the other case involved the Union Pacific railroad) were ***mandatory***. It noted further that, in contrast, Medicare guidelines permitted, but did not require, Alacare to expense the disputed items.

Accordingly, the determinative question was whether the method of accounting employed by Alacare clearly reflected income. The Tax Court concluded that Alacare had not shown that its accounting method clearly reflected income, nor that it was an abuse of discretion by the IRS Commissioner to require it to change its method of accounting.

Therefore, the Court held that the items expensed more properly should have been capitalized.

FACTORY ACCOUNTING MANUALS

The various manufacturers' accounting manuals seem to shy away from stating any specific dollar amount as the cut-off point above or below which expenditures for fixed assets should be capitalized or expensed. For example, GM's *Dealer's Standard Accounting System Manual* only describes for each fixed asset account what types of expenditures should be capitalized.

CONCLUDING CAUTIONS

The *Alacare* case decided by the Tax Court in June underscores the difficulty that dealerships with so-called *de minimis* capitalization policies may run into if questioned by the IRS. This case reinforces the fact that, as a matter of law, the IRS does not have to accept any arbitrary or *de minimis* cut-off amount.

Some accounting firms have "Year-End checklists" which specifically advise establishing a minimum dollar amount as the cut-off point below which expenditures for fixed assets should be expensed—rather than capitalized. This is often justified as a practical matter to simplify fixed asset recordkeeping. Perhaps these checklists should be reviewed in light of the *Alacare* decision.

Some dealers may not even be aware that if they are following the practice of writing off small-dollar equipment purchases, increasing or lowering that limit *at any time* would be a change in accounting method. Under Section 446, such changes cannot be made without filing Form 3115 in accordance with Revenue Procedure 99-49 in order to secure permission in advance to make the change.

Finally, where lesser amounts are involved, taxpayers mistakenly believe that if the purchases are not allowed as expenses because of their "capitalization policy," they will get the immediate write-off in the year anyway by electing Section 179 expense treatment. If you check the fine print, you will find that technically that election cannot be made under those circumstances.

TWO FSAs SHED MORE LIGHT ON IRS OBJECTIONS TO PLANS

TOOL PLANS UPDATE #6

This is the 6th time we have written about IRS activity addressed to businesses attempting to meet the "accountable plan" rules in Section 62(c). Businesses want to meet these requirements in order to avoid some payroll tax liabilities by splitting payments made to employees for their services between (1) wages and (2) either reimbursement or other rental payments.

The ***finalized*** IRS Coordinated Issue Paper, entitled *Service Technician Tool Reimbursements*, was issued in June of 2000 and discussed in the September, 2000 *Dealer Tax Watch*. This CIP addresses only the "accountable plan" aspects of service technician reimbursements for tool usage which are intended to qualify for favorable treatment under Code Section 62(c). It concludes that "Generally, amounts paid to motor vehicle service technicians as tool reimbursements will ***not*** meet the accountable plan requirements." Obviously, there may be exceptions, and the IRS is careful to so state in this CIP.

Our conclusion at that time was that dealers should be increasingly skeptical over any "assurances" they have received from plan providers concerning the tax-qualifications of their plans. Unless those plan providers are willing to reimburse the dealers for any additional penalties that the IRS may impose as a result of using these plans, dealers should be amply warned as to their exposure to back-taxes and penalties.

In August, 2001, the IRS published FSA 200127004 relating to the application of the accountable plan rules to rig welders. In July, 2001, the IRS had published FSA 200132003 which related to the application of the accountable plan rules to drivers employed by a courier service. In both cases, or FSAs, the IRS concluded that the plans in question would fail to satisfy Section 62(c) requirements.

In the five previous *DTW* articles related to these kinds of plans, much, if not all, of the particulars and requirements of Section 62(c) have been discussed, as have been the IRS rulings and cases typically mentioned in the literature. Therefore, this update will simply comment on these two recent FSAs which continue to expand the IRS field of resistance.

COURIER DELIVERY SERVICE FSA

Field Service Advice 200132003 involved the courier delivery situation. In that FSA, the question was whether the taxpayer's arrangement to reimburse certain expenses of its employee drivers qualified as an accountable plan. The IRS held that it did not because the arrangement failed to satisfy (1) the business connection requirements, (2) the substantiation requirements and (3) the return of excess payments requirements for an accountable plan.

This FSA said that if an employer pays an amount to an employee as a business expense regardless of whether the employee incurs, or is reasonable expected to incur, the business expense, the payment does not meet the business connection requirement. In this FSA, the taxpayer reimbursed its drivers under its arrangements regardless of actual mileage or vehicle rental expenses.

As to the return of excess payments requirement, the courier service's plan payments bore no direct relationship to any mileage or rental expenses. Additionally, since the drivers were not required to substantiate their expenses, it was not possible to determine whether the reimbursement payments made were higher or lower than the expenses incurred.

Here's what is most damaging. The FSA concluded that the taxpayer's plan was ***abusive*** under Section 1.62-2(k) of the regulations. Therefore, all payments made under the arrangement will be treated as made under a non-accountable plan. "Taxpayer's reimbursement payments were not based solely on actual miles driven or mileage expenses incurred. Taxpayer's reimbursement payments were also not based at all on the rental value of drivers' vehicles nor vehicle rental expenses incurred. Rather, the payments were based ***on other factors*** such as additional charges for rush deliveries and the weight of packages. We find this arrangement to be an abuse of Section 62(c)."

The FSA includes a discussion of Revenue Ruling 68-624 ... which the IRS believes is inapplicable because it was issued years before Section 62(c) came into the law. The FSA also includes a discussion of *Shotgun Delivery, Inc.* and of *Trans-Box Systems, Inc.*, both of which were discussed in previous *Dealer Tax Watch* articles.

RIG WELDERS FSA

The second FSA, 200127004, involved three questions, one of which was whether or not the rig welders who performed services for the company in question were common law employees of the company. On this issue, the FSA concluded that further factual development was necessary before it could reach a conclusion.

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However, the second issue was ***if*** the rig welders ***were*** common law employees of the company, ***then*** would payments by the company that were characterized as "rig rentals" be payments made under an arrangement separate from the employee relationship? The answer to this question was that ***if*** the rig welders were employees, ***then*** those payments would not be made under an arrangement that was separate from the employment relationship.

Finally, the third question was whether such payments made would be excludible from wages as payments made under an accountable plan. It was held that these payments would not be considered as made pursuant to an accountable plan. Therefore, they would be wages for employment tax purposes.

A substantial portion of this FSA addresses the common law status of workers hired by general engineering contractors as rig welders who provide their own equipment and supplies.

In the FSA, the IRS again states its position that Revenue Ruling 68-624 is not controlling. Unlike the courier delivery service FSA, this FSA discusses the *Escobar de Paz, et. Al. v. Commissioner* case and the *Trans-Box* case. The *de Paz* case was discussed in the June 2000 issue of the *Dealer Tax Watch*.

IMPORTANT FACTORS

What is new and instructive from this rig welders FSA is the later portion, which contains a listing of factors relevant in determining whether a "rental" arrangement has independent significance for tax purposes.

The first seven factors seem to be more important than the last three, which are described as also believed to be relevant.

ANALYSIS OF RIG WELDER'S PLAN

Here's what the FSA said: "The facts in the present case suggest that the rental arrangement would not have existed but for the provision of services. In addition, the facts suggest the rig welders retained control over the equipment at all times, and the rig welders were responsible for maintenance costs with respect to the equipment. Finally, the purported equipment leases were valid only during the hours of employment.

"On the other hand, consistent with its assertion that the rig rentals were separate from the employment relationship, Company did report rig rental payments on Form 1099. In addition, the rig welders were paid the same wage as single-hand welders. This suggests that the wage payments may have been at fair value.

"However, we believe that whether rental payments or wage payments were at fair market value has little relevance in determining whether a rental arrangement was separate from an employment relationship; rather, this inquiry is relevant mainly to determine whether an allocation was reasonable after it has been determined that an arrangement was separate.

"Considering all of the available facts, we believe the rig rentals were not correctly viewed as separate from the employment relationship. We believe that when a purported rental arrangement would not have existed but for the provision of services, a strong presumption exists that the arrangement is not separate from the employment relationship."

see **FSAS SHED MORE LIGHT ON IRS OBJECTIONS TO PLANS,** page 9

10 IMPORTANT FACTORS

1. Whether a worker is compensated for services regardless of whether the worker provides equipment. In other words, whether providing equipment is integral to providing services.
2. Conversely, whether the worker is paid for the rental of equipment regardless of whether the worker performs services.
3. Whether the worker retains control over the equipment.
4. Whether the worker is responsible for all operating expenses incurred while the equipment is being leased.
5. Whether there is a definite lease term, or whether the lease is valid only during the hours of employment.
6. Whether the worker is free to use the equipment in performing services for any person.
7. Whether the rental payments bear a reasonable relationship to the fair rental value of the equipment.
8. Whether the purported leases were put in place for some regulatory reason (other than federal taxes) such as, for example, to minimize overtime wages.
9. Whether the worker rents the equipment to another person under an arrangement that does not call for the worker's services.
10. Whether the employer treated the activities as separate activities for reporting purposes.

LEGAL ISSUES FACING AUTO DEALERSHIPS

BY MARK E. BATTERSBY

CONFERENCE REPORT

Attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas, heard Daniel E. Myers of Myers & Fuller, P.A., provide an update on the legal issues facing the automotive industry. This presentation naturally centered on General Motor's proposed discontinuance of the Oldsmobile franchise although it ranged onto a number of the other topical legal issues.

According to Mr. Myers, the question of whether the new BMW light truck offering is a truck or a car has prompted many BMW dealers to contemplate legal action in order to protect their franchises. Ford, as well as GM, is consolidating dealerships although their plans don't seem to have created the legal hassle surrounding the Oldsmobile franchise. Ford, however, has its own legal problems not only with tires but with its "Blue Oval" service plan.

Mr. Myers said that even without the proposed discontinuation of Oldsmobile, dealers today are involved in more litigation than he has even seen in the course of his 16+ year career.

Lawmakers in many states are apparently sitting back waiting to see the outcome of a Federal court case in Arizona testing whether manufacturers can sell finance direct to consumers.

GM & THE OLDSMOBILE SITUATION

Repeatedly, however, the recurring centerpiece of every legal update today, Oldsmobile, surfaced.

The figures presented by Mr. Myers show 2,801 Oldsmobile dealers of whom 63 are stand-alone dealerships. One of his clients has had the Oldsmobile franchise since 1903. And, suddenly, GM announced its plans to discontinue the line at some, unspecified, date in the future. The immediate result has been, of course, a scramble among those 2,801 Oldsmobile dealers as they all rush to explore their legal recourse.

According to Mr. Myers, GM went into its database, using the dealer's own sales volume figures for the last three years, as well as the operating figures each dealer provided GM. The result was a general offer that may or may not be "sweetened" by GM at some future date, depending on the individual dealer's "***special circumstances***."

Mr. Myers also raised the question of what GM's proposed compensation formula might mean to those dealers who acquired an Oldsmobile franchise in 1998, 1999 or last year. How can you compensate a dealer who relocated or built a new facility in recent years at the urging of Oldsmobile? Are dealers moving into $10 million to $13 million facilities really expected to accept the $1 million offered by GM?

GM is reportedly surprised that so many dealers have so many complaints, especially when GM has publicly claimed that it is attempting to find replacement stores for so many dealers.

The chronology of the Olds-line abandonment has set many legal minds into overdrive. It was only October 31st of last year that GM required all Oldsmobile dealers to renew their five-year service agreements. Dealers are now locked into servicing Oldsmobiles for five years while GM agreed, as part of those service agreements, to put forth its energy to ensure that the value of a dealer's assets remains strong and, most importantly, to build cars that people will buy.

On December 11, 2000, Oldsmobile dealers had something to sell and people were buying. On December 12, the day of GM's announcement, the value of most dealers' Olds franchises was ***ZERO***.

September 30, 2001, is, according to Mr. Myers, the "magical" date when the Transition Assistance Release (TAR) form from Oldsmobile dealers must be in GM's hands. By signing that form, however, dealers will release GM from everything it did in the past, is currently doing or will do in the future. In other words, signing will eliminate the dealer's ability to sue.

Because confusion is the name of the game, it is difficult to determine just how many dealers are accepting GM's buyout plan. One indication: Of Mr. Myers' 244 clients with Olds franchises, only four appear to be accepting the deal. Overall, only around 10 percent seem to be accepting - principally because dollars and cents don't adequately compensate the dealers.

Mr. Myers raised several key points to illustrate why he does not think that GM's offer will be the final one. First, he asked, can GM, with its falling share of the market, afford to lose 250,000 retail registrations a year? What is GM going to do with the Alero and Aurora models, models that are currently both popular and profitable?

One possible scenario offered by Mr. Myers has GM renaming many of the more popular Olds sellers and re-branding them under the Cadillac or even Saturn labels.

Mr. Myers strongly suggested that dealers complete and send GM a "***special conditions***" letter and

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offered to provide a copy to everyone asking. After sending that letter, dealers should keep their heads down and stay in business as long as possible—according to Mr. Myers.

Mr. Myers and others believe that, based on GM's past history, it is not going to change the compensation formula that it offered earlier this year. GM may, however, be beaten into addressing individual dealer's special conditions. In fact, according to Mr. Myers, there are already rumors circulating that GM is considering giving Saturn franchises to Oldsmobile dealers in areas where GM owns the stores.

As to why most of the current legal action appears to center around the various state courts, Mr. Myers responded that the remedies under state laws are frequently far more favorable to dealers than a federal class action lawsuit. That snappy answer dovetailed nicely with his overview of the many other legal problems that are currently facing the industry.

FORD & ITS BLUE OVAL PROGRAM

According to Mr. Myers, other litigation is brewing over Ford Motor Company's Blue Oval Certification program and the resulting two-tier pricing formula. As a result of a "lack of integrity in reporting" under earlier CSI programs, Ford has come up with the Blue Oval Certification which, according to many legal experts, may be in violation of federal antitrust laws.

The coming legal showdown centers on a bedrock provision of the dealership certification program: payments given only to Blue Oval dealers. Ford maintains that the payments are legal incentives paid for exemplary performance. Critics argue that Ford is practicing two-tier pricing in violation of federal laws.

Ford's more noticeable legal problems with tires may result in at least one of its branded cars, perhaps the Explorer, being shelved. The legal question appears to boil down not to whether Firestone or Ford is more liable, but rather, whether Ford built a product to its own specifications that was unstable unless the tires were under-inflated. Ford recommended that dealers under-inflate the tires.

BMW & ITS LIGHT TRUCKS

BMW's foray into light trucks has already entered the courts as dealers begin asking when is a "car" really a "truck?" In turn, can BMW legitimately establish a BMW light-truck franchise and ignore existing BMW dealership franchise agreements?

Leaving attendees with a lot more information, a number of suggested courses of action and a lot of questions that can only be addressed by the courts, Mr. Myers returned to dealing with the discontinuance of the Oldsmobile franchise and the updating of various state franchise laws, the issues his firm is currently concentrating on.

Mr. Myers can be reached at (850) 878-6404 and/or dmyers@dealerlawyer.com.

FSAs Shed More Light on IRS Objections to Plans

(Continued from page 7)

CONCLUSION

The rig welders FSA contains much language that could easily be applied to dealership technician tool rental arrangements.

Similarly, the FSA's conclusion regarding whether the payments would qualify under the accountable plan rules and its reference there to the *Shotgun Delivery* case would also be damaging. This damage is caused because the conclusion is that all payments would be treated as made pursuant to a non-accountable plan because "the company's rental arrangement did not bear any logical relationship with actual expenses incurred." Therefore, payments under the plan evidenced a ***pattern of abuse***.

None of this bodes well for dealership technician split pay plans attempting to qualify under the accountable plan rules of Section 62(c).

VALUING DEALERSHIPS IN THE TRENCHES

CONFERENCE REPORT

BY MARK E. BATTERSBY

Attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas, had the opportunity to hear Tim York of Dixon Odom PLLC provide additional perspectives on valuing dealerships. The following summarizes some of the highlights of Mr. York's comments.

Speaking with the authority that comes from his active involvement with a number of valuation organizations, Mr. York explored questions that both those preparing valuations as well as the dealers that employ their services face in this complicated process. Even in Mr. York's hands, the entire valuation analysis process appeared quite complex making the first question he asked quite appropriate: Are credentials important?

In answer to the basic question of whether valuation credentials are necessary, Mr. York replied in the affirmative. Coming from a background as a CPA, Mr. York explained that many courts are now demanding valuation credentials such as the ABV, ASA, CBA, CVA and CICBV designations everyone is familiar with. No longer, apparently, is a CPA or any other title, sufficient credential in the extremely complex valuation process.

The Internal Revenue Service is also concerned with credentials even to the point of encouraging its own "engineers" to obtain the training and credentials necessary to value businesses. Valuations are a "hot issue" under our ever-changing tax laws and with the IRS.

Among the major reasons dealers require valuations, particularly those performed by credential experts, according to Mr. York, are those already-mentioned tax laws, especially the estate and gift tax rules. Gifts between dealers and their family members will, in all likelihood, increase as the new tax law is phased in meaning that more and more valuations will be required.

Dealerships transferred to limited liability companies (LLCs), family limited partnerships and other holding companies, all will require valuations in order to stand up to IRS scrutiny. The matters of dealer succession, factory agreements, etc., all cry out for valuations, as do mergers and acquisitions.

Those dealership valuations also play an important role in owner disputes with family members such as with those always unpleasant divorces. They're also utilized in the increasing number of shareholder "oppression" situations where minority owners are forced to litigate their minority rights with the majority owners of a dealership. Eminent domain cases where a state, city or other government entity condemns and takes a dealership's property cannot be resolved fairly without a proper valuation study.

Mr. York also pointed out that dealerships are a unique type of business complete with its own set of traits, practices and procedures that have a significant impact on any valuation study or analysis. Every valuation professional should, for instance, consider the dealership's franchise agreement, a contract unique to the automotive industry.

An awareness of what is happening to each franchise is also important when it comes to determining a franchisee's value. Also under this heading are the expectations of the Factory. After all, a value cannot be determined without knowledge of what the manufacturer has specified, requires or is planning.

Location is of paramount importance, according to Mr. York, as are the demographics of the area. Every valuation professional must know and understand the area surrounding the store being valued. Even the region of the country plays a role in the valuation process as some lines traditionally do better in different parts of the country than in others.

Fortunately, there are a tremendous number of resources available to help determine dealership values. "Valuing A Business: The Analysis and Appraisal of Closely-Held Companies, 4th Edition, by Shannon P. Pratt (New York: McGraw-Hill, 2000) is among the best on the resources list provided to attendees. It contains, as Mr. York pointed out, all of the theories and cases needed for many types of valuations.

Among the key risk areas requiring assessment when performing a dealership valuation are the following:

KEY RISKS

- What is the marketability of my store? Or, franchise? In other words, can it realistically be sold?
- Environmental issues. No dealer, to Mr. York's knowledge, has ever had environmental problems that have not affected value.
- Legal issues such as outstanding lawsuits.

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Most dealers are usually only involved in minor lawsuits. However, establishing a realistic value for the dealership must take the legal risk factor of even relatively minor legal actions into account.

The question of whether the purpose of the valuation assignment really matters when determining the value of a dealership was answered by Mr. York with an explanation of two valuation methods: "as is" value and "investment" value. Unless the purpose of the valuation analysis is known, it is impossible to establish a proper value for a dealership.

He also touched on "fair value," an intriguing concept used by all 50 states. Fair value, according to Mr. York, most often is fair market value without the discounts and adjustments. Fair "market" value, of course, is best defined by common adage: "the price established by a willing buyer and a willing seller..."

If proof of just how much importance the "purpose" of the valuation plays in the analysis process was needed, Mr. York used the illustrations of the two sides in a divorce, the disagreements that occur between the IRS and taxpayers as well as several other situations that have already been covered. All, apparently, cry out for proper valuations taking into consideration their own share of unique circumstances.

Somewhat surprisingly, in another area, Mr. York, stated that the majority of dealerships are bought and sold based on the value of assets plus the dealership's blue-sky or goodwill value. In other cases, the price may be based on a so-called "X" times value, "X" times sales, net, gross or "X" times after-tax value.

Dealership consolidations have obviously had an impact on the public market. Anticipating significant growth as a result of consolidation, these consolidators frequently offered huge multiples to acquire dealerships. In addition to driving up the price of dealerships, those consolidators may have provided a boost to understanding dealership operations, thanks to the many studies they routinely conduct.

Apparently, many of those consolidators have also, especially in recent years, conducted extensive studies of dealership facilities, demographics as well as something called "human capital" in an effort to better value dealerships. This latter, presumably, is used to determine the value of employees to a dealership.

NORMALIZATION ADJUSTMENTS

The subject of normalization adjustments cropped up a number of times in the course of Mr. York's presentation. Normalization adjustments are the adjustments that are made to a dealership's base value (1) to account for unusual items that might appear on a dealership's financial statements or (2) to adjust the assets and liabilities to their market values.

His recapping of the most common normalization adjustments included a number of factors that must be factored into the valuation analysis including these from the balance sheet:

- LIFO adjustments;
- Parts;
- Real estate value.

Mr. York also mentioned the adjustment necessary when a dealership's books contain such items as boats, condos, stocks, jewelry, silver and gold. Not only must valuation professionals determine the market value of items such as these, they must also determine whether those items help or hinder the business.

Other normalization adjustments are used to factor in the built-in gains of the business. Is there, for instance, a tax on those built-in gains that might require an adjustment by either a buyer or a seller? Does the dealership contain any "contingent liabilities" on the books that require normalization adjustments?

Does the dealership's income statement include "perks" such as club dues, travel and entertainment or even children's cars, perhaps hidden as "demos?" And, what about nonrecurring items that might require normalization adjustments?

Also often overlooked is the "marketability discount." Is there a market for this dealership?

Mr. York also explored some common mistakes that many valuation professionals occasionally make. The biggest mistake is frequently that of expertise (i.e., a lack of specific expertise), according to Mr. York. Even the best valuation professional with years of hands-on experience may be of little value to a dealer unless that expertise and experience includes specific dealership valuation knowledge.

And, of course, as Mr. York pointed out, a number of dealership valuations have been prepared without any reference at all to those normalization adjustments. However, it is impossible to place a value on any dealership without taking into consideration those normalization adjustments already mentioned.

TEN DOs & DON'Ts

Mr. York concluded his session with a review of Dixon Odom's "Top Ten" list of "do's" and "don'ts" for valuing dealerships. This list appears on the following page.

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see **VALUING DEALERSHIPS IN THE TRENCHES,** page 12

"TOP TEN" LIST OF "DO'S" AND "DON'TS" FOR VALUING DEALERSHIPS

10. Study the local transactions. *"They may be unpublished and difficult to acquire but relevant data, while limited, can be very useful. For example, even just the price of the dealership as percent of revenues would be helpful. Also helpful in litigation."*

Regardless of whether those figures are expressed in pre-tax dollars or after-tax dollars, any valuation will benefit from a study of local transactions.

9. Learn about the real estate. *"What are the rents and what should they be? What is the value of the property? Investigate environmental issues."*

Seek the assistance of someone who does know about local real estate values. Get an appraisal for the real estate and investigate whether there are any environmental issues.

8. Get a retainer... get an engagement letter... and get paid. *"Often valuations involve emotional issues, and when the outcomes are bad the three items above may be difficult to obtain. This should be a primary focus of your attention."*

These are all extremely important since the majority of valuations involve emotional issues.

7. Utilize unique resources. *"There is an abundance of industry specific resources that will allow for meaningful comparisons. Examples are 20 Group data, websites, periodicals, manufacturer data, etc."*

According to Mr. York, every valuation professional and, in fact, anyone attempting to value a dealership should take advantage of the tremendous resources available, including those on the resource list provided to Conference attendees. There are also an abundance of economic and operational resources available and all should be employed when valuing a dealership.

6. Don't breeze through the methods. *"Make sure you have a thorough understanding of methodology before applying them. Make all of the necessary normalization adjustments and adapt the methods to your specific case if appropriate."*

5. Know the purpose of the valuation and standard of value. *"These two items can completely change the approach to the valuation process as well as the value itself."*

4. Time on value vs. time on discounts. *"Don't spend all of your time on calculating the value and just a few minutes on the discounts, which can play a huge role in the final determination of value."*

All too often, according to Mr. York, a valuation professional will spend a large portion of his or her time arriving at a value and only minutes figuring the adjustments and discounts to that value. This is inadvisable; there should be more of a balance, even to the point of spending more time on the discounts or adjustments.

3. Know the relevant court cases. *"Several major cases have involved dealerships. They give guidance as to the level and types of adjustments and discounts to consider."*

A number of court cases have involved dealerships. The results of those cases may impact on valuation analysis–as well as provide basis for using certain valuation methods or discounts.

2. Learn about industry and economic considerations. *"What about Blue Oval? What about the Oldsmobile franchise? What about a franchise great in cars but poor in trucks? These are the types of issues that arise in studying these areas that are very relevant to value."*

1. Do a site visit. *"How can you make an accurate assessment of value without seeing it? You need to see the store and its surroundings to do your due diligence. In some cases may have to make special arrangements to see the dealership, but it must be done."*

Mr. York said it is not enough to gather all of the facts and figures and utilize all of the resources available. A proper valuation requires a personal visit to the site.

WHAT'S A FRANCHISE WORTH?

BY MARK E. BATTERSBY

CONFERENCE REPORT

Attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas, had the opportunity to hear Mark D. Schmitz of Mark D. Schmitz & Associates in Park City, UT, provide a briefing on the subject of "What's A Franchise Worth?" The following summarizes some of the highlights of Dr. Schmitz's presentation.

Dr. Schmitz used the phase-out of the Oldsmobile franchise to illustrate the importance–and many different ways–of valuing a franchise or dealership. Vast differences exist between a dealership valued for sale between a willing buyer and a willing seller and a value placed on that same dealership or franchise by either side in those increasingly more common terminations and denial situations.

The many valuation methods and techniques offered ranged from the fabled "fair market" value, the dealership's value to a specific buyer to those "Joe Blow paid X dollars for his franchise or received a whopping Y dollars for his dealership" valuations. Despite the differences in methods used to determine the value of a dealership or franchise, as Dr. Schmitz pointed out, each of these concepts has a number of features in common, mainly potential pitfalls for the unwary or the unsuspecting buyer or seller.

The would-be buyer of a dealership must use the value of the assets of the dealership that are to be purchased along with all amounts required for working capital, equipment, signage and certified pre-owned vehicles in his or her analysis. The seller, for his part, is usually more concerned with what can be sold off, what assets are needed for future operations and, of course, those assets that it could be stuck with after any sale.

According to Dr. Schmitz, the value of any dealership or franchise depends upon the future streams of income and cash flow. And, far too often, many of these future projections involve the number of units sold, one of the few figures that can be reliably determined. Because all future projections are only as good as the figures they are based on, attendees were warned to be careful.

Even valuations based on reliable data and figures are, obviously, subject to negotiations. From a would-be buyer's perspective, the purchase price of a dealership or franchise might be determined based on the belief that the buyer will–and can–do everything that the seller did. Thus, the basic profit and loss figures will remain constant under new ownership.

A would-be buyer using a so-called "reasonable investor" approach might view a purchase price that could provide a reasonable return on the amount the buyer would invest. Naturally, this approach assumes only minor increases in sales or small reductions in the seller's expense figures.

Many buyers, however, arrive at a value from the perspective of "what could be." If, to use Dr. Schmitz's example, a buyer thinks he could increase the number of units sold by bringing in his brother-in-law as the new sales manager, the operation's value might be greater - at least in the eyes of this prospective buyer. Or, if prior experience dictates that a simple change in policy or work rules might reduce expenses for the buyer, the value assigned might be based on the franchise's "potential."

The recent situation with Oldsmobile has apparently put a severe crimp into the "bigger fool" theory of franchise valuations. Dr. Schmitz observed that as many negotiations proceed, some buying dealers move from their more objective "as is" perspectives to the "bigger fool" persuasion that sales can be made to go way, way up while expenses can be made to go way, way down. Today, of course, valuations must be based on more realistic assumptions.

How can a buyer or a seller of a dealership or franchise translate marginal earnings into franchise value? Logically, any franchise's value can be determined using a price/earnings multiple. But, what is the desired–or required–rate of return for a so-called "reasonable" investor, especially when taking into account the riskiness of the proposed investment?

More often, a figure of between seven and ten times the operation's after-tax earnings is employed to arrive at a dealership's total value (including assets). A slightly lower figure is generally used for a franchise. Oldsmobile, on the other hand, is reportedly offering compensation based on a valuation formula of $X per unit sold in the franchise's best year.

Although there is no scientific basis for it, a seller will often use a goodwill value based on two-to-six times earnings. This multiple is based on the operation's recent pre-tax earnings.

As Dr. Schmitz pointed out, value is often based on the expected future long-term increase in profits. On occasion, a dealership's value may be determined using the desired or targeted rate of return, usually about 12.5 percent. However, as Dr. Schmitz said,

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this basis for developing a franchise valuation is rarely used outside a courtroom.

While most dealership valuations are arrived at in negotiations between a willing buyer and a willing seller, there are an increasing number of sales that involve "unwilling" sellers. This poses a number of dilemmas for those sellers.

Imagine the impact on the valuation of a dealer who is forced to give up a franchise that generates 50 percent of its gross profit. Is 50 percent of the business worth 50 percent of the dealership's total value?

Would a dealership's value be zero if it lost its only franchise? What about a situation where the dealership's profits are largely attributable to the franchise that will be lost? And, there is also that old problem of taxes. How will the bite of taxes affect both the buyer and seller and how will that reflect on the dealership valuation?

Obviously, there is no answer to those questions just as there is no answer to the basic question of how much a dealership or franchise is worth. Even utilizing accurate, provable figures, unit sales or a reasonable rate of return for the investment as the basis of a dealership's value, it still boils down to what a willing seller and a willing buyer can agree upon.

Dr. Schmitz left the conference audience with a number of points they should consider when attempting to determine the value of a dealership or franchise for their clients. Could, he asked, "$ per new unit," payments truly represent "lost value" to the seller? Yes, in some cases it could; although there is no rule of thumb and the figures will vary widely.

Or, an often-overlooked question, what happens to the dealer's facility when there is a forced sale of a franchise? How do you value a facility without a franchise or after the loss of one of the dealership's two franchises?

And, finally, is there a "loss" when a potential or would-be buyer gets denied or has its offer matched by the Factory?

Dr. Schmitz's presentation led many in the audience to conclude that the process of placing a value on the dealership or franchise was an extremely complex matter. For many, it is a matter best left to experts knowledgeable in the automotive industry and familiar with the vagaries involved with placing a value on that automotive dealership or franchise. Perhaps an expert such as Dr. Schmitz?

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IRS CURRENT TAX HOT TOPICS FOR AUTO DEALERS ... FROM THE IRS PERSPECTIVE

CONFERENCE REPORT

BY MARK E. BATTERSBY

Attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas, had the opportunity to hear Terri S. Harris, the Motor Vehicle Technical Advisor for the Internal Revenue Service, provide a briefing on the IRS's new–and still evolving –"Technical Advisor Program" and other subjects. The following summarizes some of the highlights of her presentation.

DEMONSTRATOR VEHICLES

The IRS appears as anxious to find solutions ... as is the industry and its tax advisors ... to a number of tax issues. Under the IRS's pilot Industry Resolution Program, for example, they are currently asking questions and soliciting opinions in an effort to resolve several key issues. Among those issues are demonstrator vehicles.

According to Ms. Harris, a demonstrator vehicle provided for use by employers is governed by two sections of the tax law: "IRC 61," which says that income includes the value of fringe benefits and "IRC 132," a section which clearly excludes from income certain working condition fringe benefits for qualified "demo" use.

Since the IRS is not expected to issue formal guidance in this area until at least November, many questions are currently unanswered. What, for example, is "qualified" demonstrator use? Or even, as Ms. Harris asked, who do you consider to be a "sales person?"

Expanding on, but not answering, these questions, Ms. Harris revealed the dilemma facing the IRS and why it needs input from dealers and their tax advisors.

As Ms. Harris pointed out, the Code and the Regulations provide that a full-time auto sales person is one who is employed by a dealer who spends at least one-half of a normal day performing the functions of a floor sales person or a sales manager. A sales person, almost everyone agrees, is one who engages in substantial negotiation and sales to customers. A legitimate sales person usually works full-time and derives at least 25 percent of his or her compensation from sales or sales-related activities.

But, Ms. Harris asked, is a service manager who is considered to be an integral part of a sales "team" a sales person? Or, how about a F&I manager whose contributions are often critical to closing a sale?

Further clouding this particular issue, according to Ms. Harris, are other questions that the IRS must answer. Among those are: safe harbor issues such as what is limited personal use? What records must be kept–and in how much detail must those records be kept?

And, then there is the question of the value of a demonstrator. What is the fair market value and can that fair market value actually be established given the relationship between dealers and manufacturers–at least before the Oldsmobile situation? Can a rental fee charged for a monthly rental of a car similar to the demo be applied?

Ms. Harris stated that the IRS is currently working to arrive at answers to these questions as well as resolve several other issues that impact on dealers. As with the issue of demonstrator vehicles, Ms. Harris did not want to go into specifics, rather, she said that she was seeking input.

USED VEHICLE LIFO

In another area, used car LIFO is always a tough issue to resolve between the IRS and dealers. Among the used car industry LIFO issues that required resolution, according to Ms. Harris, is the basic one of how to value the items. Should the value be based on age-to-age, model-to-model? How can any dealer determine the proper valuation dates, pricing, record-keeping requirements or the proper treatment of new items added to that LIFO inventory?

There has been no official guidance since the IRS's Technical Advice Memorandum (TRM 9853003) was issued. However, one solution, according to Ms. Harris, is provided by the release of the IRS's Revenue Procedure 2001-23, earlier this year. It outlined a simplified elective model available to all taxpayers who sell used automobiles and used light-duty trucks.

Generally, that Revenue Procedure helps dealers compute a LIFO index using base vehicle prices. However, for determining *current cost,* a dealer who takes a car in trade can still use Official Used Vehicle Valuation Guides to determine cost, while a car purchased at auction uses the amount paid for it as its cost or value.

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Despite urging to recommend one "official" pricing guide over another, Ms. Harris claimed that almost any of the more popular price guides would be acceptable to an IRS examiner–as long as it was used "consistently." However, a dealer who changes guides would be considered by the IRS to be changing a method of accounting. Fortunately, the required IRS permission to change accounting methods can be obtained almost automatically by filing Form 3115.

Inventory valuations, as with all of the tax issues she touched on, contained its fair share of unanswered questions. Short of crawling under a vehicle, she asked, how can an IRS auditor determine whether the inventoried vehicle's chassis is that of a light truck or that of a car? (...both important factors in LIFO pooling considerations.)

COST SEGREGATION STUDIES

Cost segregation studies are rapidly becoming an issue with the IRS, according to Ms. Harris. Many firms are apparently marketing products or services that will supposedly help dealers segregate the costs of buildings and their components from assets that might be otherwise labeled and depreciated faster.

As dealers and other business owners attempt to reclassify property, the IRS struggles to keep pace. Despite the often-cited *Hospital Corporation of America (HCA)* case (109 T.C. No. 2), in which the IRS acquiesced, there is no "bright line" that either a taxpayer or the IRS can point to in order to resolve disputes.

According to Ms. Harris, in the *HCA* case, the IRS merely acquiesced to the court's use of pre-1981 tests for Investment Tax Credit property to determine whether an item is a structural component.

A cost segregation study is defined by the IRS as an emerging issue. Using an analysis of building construction costs in order to properly classify those costs into the appropriate depreciation categories can often result in much larger tax write-offs than if all costs were aggregated and labeled as "structural components."

Under current tax rules, for example, buildings and their structural components are assigned a 39-year "life" (using straight-line depreciation). Land improvements qualify for a 15-year write-off period (using 150% declining-balance method of depreciation). Personal property, however, is written-off or depreciated over five or seven years using a 200% declining balance method.

Although it acquiesced in the *HCA* case, the IRS says that cost segregation cannot be based on so-called "non contemporaneous" records, reconstructed data or taxpayer estimates with no supporting records.

The automatic consent of the IRS to change classification of property is permitted under Revenue Procedure 99-49. Again, all that is required is the timely filing of Form 3115 with the IRS.

PRODUCER-OWNED REINSURANCE COMPANIES

Ms. Harris concluded her presentation not with another question or unresolved issue. Rather, she cited the increasing scrutiny being given to what she labeled "Producer-Owned Reinsurance" companies.

Her materials overviewed the typical arrangements which are frequently established off-shore (often with minimal capitalization), may involve the reinsurance of credit life and/or vehicle service contracts, and may be conducted through a "fronting" company.

Benefits obtained by operating as a producer-owned reinsurance company include the ability to make a favorable election to be taxed as a U.S. Corporation under Section 953(d) and other special rules if a company is a ***life*** insurance company. Alternatively, the company may receive certain other benefits if it qualifies as a ***casualty*** insurance company or as a ***small casualty*** company.

The Service is giving "increased scrutiny" to what may be potentially abusive arrangements. Possible areas of abuse include (1) diversion of income, (2) lack of economic reality resulting in sham transactions, and (3) other off-shore issues.

Three areas listed as concerns arising under "diversion of income" issues are: (1) non-performing loans, of which the *William L. McCurley* Tax Court Memo Decision is a good example; (2) control of ceded funds by the shareholder; and (3) the legitimacy of the fronting company.

Potential issues under the "lack of economic reality" category are indemnification and undercapitalization concerns as evidenced by the *Malone and Hyde, Inc.* case and by sham transaction and fraud concerns as evidenced by the *William T. Wright* case.

Apparently, the IRS feels that a captive insurance company could be a tax shelter and thus required to comply with the IRS's voluminous new tax shelter accounting and registration rules.

Just something else for dealers–and their professional advisers–to worry about?

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AUTO DEALER–IRS CURRENT TAX ISSUES ... FROM THE PRACTITIONER'S PERSPECTIVE

CONFERENCE REPORT

The "Auto Dealer-IRS Current Tax Issues" presentation by Willard De Filipps, CPA, covered major developments and refinements occurring over the last year. Since he followed Ms. Harris of the IRS, Mr. De Filipps did not repeat her remarks on topics that were on both of their presentation outlines.

Also, several topics covered by Ms. Harris and/or Mr. De Filipps were expanded on during the Tax Panel Question & Answer session. (See pages 19-20.)

IRS AUDIT GUIDE

Mr. De Filipps started by commenting on *The IRS Audit Guide for Auto Dealerships* released late last year. He gave special emphasis to the "big picture" approach the Service would like its agents to adopt in their audits of dealerships.

The IRS is interested in determining a taxpayer's "financial status" and in the likelihood of whether a taxpayer may be underreporting income. Based upon these initial impressions, agents will either go forward with more or less penetrating analysis.

He commented on the so-called entity flowcharts which are part of the IRS Audit Guide/Training Manual.

However, what Mr. De Filipps emphasized was the difference between the IRS flow charts and his "pet picture" depicting *One Man's Game Plan* which, he said, can be a very useful tool in helping dealers with their business continuity and income tax planning.

Mr. De Filipps explained that a CPA's best service to a dealer is often to fragment activities and create multiple entities. From a planning standpoint, the question is: "How can we best strategically carve up the assets so they are in multiple entities owned by different types of taxpayer entities, subject to different tax rates, owned by taxpayers of different ages ... all within the very legitimate purview of not looking to avoid underreporting any income, but just looking for the best way to carve up the Thanksgiving turkey?"

He pointed out that CPAs should not be surprised if or when IRS agents request copies of related entity flowcharts. If an agent is conducting the audit "by the book," it's right there in black and white that the agent should request this information as part of an initial Document Request.

SERVICE TECH PLANS

Mr. De Filipps commented on technician tool rental and reimbursement plans which, after recounting recent developments, now appear to be significantly out of favor in the eyes of the IRS.

He added that if you have clients asking for your advice before adopting one of these plans, they should be told that tax cases involving other types of plans have not gone well for those taxpayers.

LIFO CONFORMITY REQUIREMENT

Mr. De Filipps also commented on the LIFO financial statement conformity requirements for auto dealers. His comments essentially centered on the still unanswered questions surrounding what criteria the IRS might apply to determine whether a dealer had included a ***reasonable estimate*** of the change in the LIFO reserve on the year-end financial statements.

He said that in some cases he has seen swings (from preliminary estimated amount to the actual computed LIFO reserve change amount) of several hundred thousand dollars. What is a ***reasonable*** estimate? That is still an open question.

Mr. De Filipps reminded the audience that if the dealer were applying LIFO to used vehicles, that use of LIFO required a separate estimate of the change in the used vehicle LIFO reserve, just like the requirement for an estimate for the change in the new vehicle LIFO reserve.

He added, if you don't, you better have one number or amount that is "large enough or nebulous enough" so that you can say that that one amount really includes all of the estimated changes for all of the inventories on LIFO.

Mr. De Filipps commented on the absence of any evidence that the IRS has attempted to police those who have not complied with the LIFO conformity revenue procedure that came out a few years ago, Rev. Proc. 97-44. He indicated that the IRS' Audit Guide for Dealerships tells agents they should ask dealers if they filed for the waiver of the conformity penalty by paying the 4.7% penalty tax.

He indicated that if the Service is only looking for continuity of payments by those dealers who originally signed up and made the first payment–but not all of them–then the Service would really be missing the forest for the trees. The Service should also be looking at those dealers who affirmatively indicated that they did not have any conformity violations in their past.

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USED VEHICLE LIFO

Mr. De Filipps discussed some of the practical application problems arising under the "new" Used Vehicle LIFO Method under Revenue Procedure 2001-23. He expressed his endorsement of the overall approach taken by the IRS in the LIFO computation methodology. He also said that the audit protection given by the Service to any dealer changing to the safe-harbor methodology is an incentive that is so strong that he will be advising all of his clients to voluntarily change to the Rev. Proc. 2001-23 methodology.

He discussed another requirement, namely the requirement that goes along with making the change to rebase LIFO indexes for the year before the year of change. He discussed several cautions to help in making proper rebasing calculations, especially in cases where "dual index" or "earliest acquisitions" methods had been used for valuing annual LIFO increments.

Mr. De Filipps said the key point in these rebasing activities was that "you should have no difference in the dollar amount of the change in the LIFO reserve when you rebase the LIFO indexes. That change should be no different than it would have been if you had not rebased your indexes." If handled improperly, the dealer would think he was being forced to make a large repayment of his LIFO reserve simply in order to make the change to the new method. And nothing, he said, could be further from the truth.

Mr. De Filipps pointed out some special considerations for dealers who do not currently have their used vehicles on LIFO. Careful analysis is necessary in connection with the requirement that any writedowns in inventory at the end of the year previous to the LIFO election must be restored over three years.

Analyzing this requirement more closely, that writedown would already have been included in income in the current year in most, if not all, cases. Therefore, the result of making the LIFO election would be that the adjustment required (by Section 472) to take the writedown into income over three years would result in two/thirds of the writedown at the beginning of the year being spread over the year of the LIFO election and the two succeeding years.

Mr. De Filipps commented on the IRS reliance on taxpayers to select Official Used Vehicle Guides to implement the use of the new methodology. He said that dealers should be aware that they are permitted to use a different Official Guide for determining ***current cost*** during the year than the Official Guide that is used at the end of the year in connection with repricing the inventory to determine the annual index of inflation or deflation.

In determining ***current cost***, the Revenue Procedure requires the dealer to take into consideration all pertinent factors, including age, condition of the vehicle and optional equipment and accessories. These factors, however, are to be ignored in the year-end computation of the inflation or deflation index.

If a dealer already on used vehicle LIFO is changing to the "new" method, that dealer should be aware that different results may follow from using different Official Used Vehicle Guides. More importantly, Mr. De Filipps advised that a dealer should be careful not to inadvertently select an Official Guide that produces adverse results, if a better alternative is available. After all, why penalize yourself in making a change to the new method if you don't have to?

REPLACEMENT COST FOR PARTS INVENTORIES

In commenting on the present gridlock which, Mr. De Filipps said the IRS brought upon itself through its quest for perfection, he advised that all dealers could do at the present time in valuing their parts inventories is to continue to do what they have been doing in the past.

Eventually, when the IRS issues some form of guidance in a published Revenue Ruling or Revenue Procedure, taxpayers will know what to do.

The IRS position that dealers must value their parts inventories using ***actual cost*** was upheld by the Tax Court in the *Mountain State Ford Truck Sales* decision. Mr. De Filipps indicated that until that case is reviewed by the Appeals Court, no one really knows what to expect. Furthermore, after the Appeals Court decision is handed down, both sides will have to realistically consider what their options are and take action accordingly.

TAX ISSUES FACING DEALERS IN TRANSITION

The last area Mr. De Filipps covered in his presentation was tax issues common to dealers in transition. These included General Motors dealers subject to its Oldsmobile phase-out, Ford dealers adversely affected by its Blue Oval program and a variety of others.

He discussed a number of issues involving current taxability versus timing differences, gain deferral opportunities (under Section 1031), allocation of payments to consulting agreements, non-compete agreements and goodwill. He also discussed the more specialized additional taxes resulting from the recapture of some, or all, of their LIFO reserves.

TAX PANEL QUESTIONS & ANSWERS
CONFERENCE REPORT - JUNE, 2001

Willard J. De Filipps, CPA, editor and publisher of the *DEALER TAX WATCH* and *LIFO LOOKOUT*, moderated and participated in a panel discussing various tax issues of interest to the attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas. Assisting Mr. De Filipps were Terri Harris, the Internal Revenue Service's Motor Vehicle Technical Advisor and David De Haven, of CD-View, Inc. a firm demonstrating its document management and retrieval solutions at the Conference.

ELECTRONIC RECORDKEEPING REQUIREMENTS

The first portion of the Tax Panel was devoted to Revenue Procedure 98-25 and the implications it has on dealers - and their advisors. Rev. Proc. 98-25 outlines the Internal Revenue Service's requirements for computerized recordkeeping.

HARRIS: A basic problem experienced by many IRS auditors is that a dealer's books and records are not always available. With records maintained on electronic media, if they are available, retrieving or reading them may be impossible. Rev. Proc. 98-25 basically addresses a couple of problems experienced by IRS auditors, namely that dealers may not have backup tapes and, if the dealer does have a backup tape, the auditor may not be able to read it.

In essence, IRS auditors need the same information in computerized recordkeeping systems that they would need in a hardcopy format. If that data is available, it makes the auditors job easier. Anyone lucky enough to be audited certainly wants to get it over with as quickly as possible. So does the IRS.

DE HAVEN: Dealers don't view Rev. Proc. 98-25 as having any teeth and recordkeeping seems to be a problem that many dealers are ignoring.

DE FILIPPS: One thing Rev. Proc. 98-25 is quite clear on is the loss or destruction of books and records. Under this procedure, the dealer must notify the IRS of that loss or destruction as well as inform the IRS of the dealer's plans for dealing with that loss or destruction.

The books and records retention requirement also applies to parts inventories recordkeeping and LIFO computations.

As for this revenue procedure not having "teeth," last year, I believe that I heard or read that the IRS was working on this. Perhaps Terri has another view?

HARRIS: An IRS working group is working on the lack of teeth as well as trying to come up with a better definition and guidelines for just what records should be retained.

QUESTION: Under Revenue Procedure 98-25, is Product "X" adequate?

HARRIS: Obviously, I can't recommend any product over another. I will, however, provide you with a list of what the IRS wants for those who send me an e-mail.

QUESTION: Dave, is your product adequate under Rev. Proc. 98-25?

DE HAVEN: ADP uses a non-proprietary system. This means that the system is stored along with the data. Several years down the road, either the IRS or the dealer are able to go back and retrieve that data in an easily read format.

HARRIS: But does a "CD" capture all required data?

QUESTION: What about scanned images such as dealer invoices, etc.?

DE HAVEN: Some problems may exist plus it may be difficult to access those scanned images for the same reasons it is often difficult to access stored data -- lack of an operating system. Fortunately, much of that scanned data only has to be kept for two or three years so scanned images such as supporting data is not such a problem.

QUESTION: Under Rev. Proc. 98-25, whom should a dealer notify about records that have been lost or destroyed?

HARRIS: Revenue Procedure 98-25 says that taxpayers are to notify the "*District Director.*" However, there are no more "District Directors!" A simple letter to the attention of the "Territory Manager" should be adequate.

(Continued)

TAX PANEL QUESTIONS & ANSWERS
CONFERENCE REPORT - JUNE, 2001

LIFO & THE BOOKS AND RECORDS REQUIREMENTS

DE FILIPPS: What about Rev. Proc. 98-25 on records as it applies to LIFO inventory computations?

HARRIS: The Revenue Procedure says only that a taxpayer must maintain proper books and records. But, it is obvious that Rev. Proc. 98-25 also applies to LIFO. Take those valuation guides, for example. Every dealer must keep the valuation guides they use to price their inventories, along with invoices showing the costs of purchased vehicles.

Naturally, those dealers who use electronic versions of those industry guidebooks would retain the electronic version. But, remember, dealers must keep LIFO records as long as they are on LIFO.

QUESTION: We use a December 31 tax year but used a November guidebook, which one do we keep?

HARRIS: You - or your dealer - must use the December book.

QUESTION: Will the use of an outsource vendor satisfy the recordkeeping requirements?

HARRIS: A dealer must know what guidebook the outsource vendor is using. The vendor must also assure the dealer that the guidebook will be retained.

QUESTION: Can a dealer use one guidebook while the tax practitioner uses another guide?

HARRIS: Yes, it is perfectly acceptable for both to use a different book.

QUESTION: Does the dealer retain or keep the guidebooks or does the practitioner?

HARRIS: The dealer might want to keep the books for another reason: to verify or document a Rev. Rul. 67-107 adjustment.

DE FILIPPS: Rev. Rul. 67-107 relates to dealers who value used vehicles at other than their cost at year end. Rev. Rul. 67-107 says, in essence, that a dealer may value his used vehicles for inventory purposes at valuations comparable to those listed in an official used vehicle guide as the average wholesale prices for comparable vehicles.

QUESTION: Does a dealer on LIFO have to retain books forever?

DE FILIPPS: Every dealer should keep books permanently, if only to verify "current cost" and to compute or "***reprice***" the ending inventory to determine the figure which is used to make the inflation adjustments.

SECTION 263A

QUESTION: Is it true that Section 263A, the uniform capitalization rules, no longer apply to automobile dealerships?

HARRIS: Speaking for the IRS, I feel that it does apply. Although we have issue specialists working on the question of how to apply those rules to dealers, right now, I can't firmly state that it does or does not apply.

TERMINATING LIFO ELECTIONS

QUESTION: If a dealer has both new and used vehicles on LIFO (ignoring their parts inventory), and wants to take both classes of vehicles off LIFO, how is this accomplished?

DE FILIPPS: Taking all inventories off LIFO at the same time qualifies as an automatic change in accounting method. Filing Form 3115, Automatic Change In Accounting Method, before filing the income tax return is usually all that is required.

In a situation where the new vehicle inventory remains on LIFO and the used vehicle inventory is taken off, that would not qualify as an automatic change in accounting methods. The dealer must first obtain permission (and pay a filing fee). And, he must file Form 3115 before the end of the tax year -- not before the tax return is filed.

HARRIS: It is usually an automatic change when a dealer goes on LIFO. It is not always automatic when the dealer wants to go off LIFO.

TECHNOLOGY TRENDS IN THE AUTOMOBILE INDUSTRY

BY MARK E. BATTERSBY

CONFERENCE REPORT

Attendees at the De Filipps 4th Annual CPA-Auto Dealership Conference in Dallas, Texas, had the opportunity to hear Sandi Jerome of SJCC, Sandi Jerome Computer Consulting, provide a briefing on the subject of "Technology Trends In The Automobile Industry." The following summarizes some of the highlights of Ms. Jerome's presentation:

Ms. Jerome stated that currently the three biggest technology trends in the automotive industry are

- Manufacturer involvement,
- DMS (dealer management systems), and
- CRM (customer relationship management).

In fact, the involvement of automobile manufacturers in the information technology (IT) arena may be coming full circle if Ms. Jerome's experience is any indication.

Automobile manufacturers originally pressured dealers to computerize their operations, often developing the necessary software. Then, many manufacturers left the technology issue to the dealers and third-party vendors to concentrate on manufacturing autos. Today, Ms. Jerome sees many of those manufacturers returning to the playing field as partners in—and suppliers of—dealership technology.

A number of new players are entering the IT business with a variety of offerings specifically tailored to dealerships. The "big four" players currently are firms such as ADP and its current model 9200—Milennia 3 system, Reynolds and Reynolds—ERA, with their Advantage S, M and new Hewlett Packard model, UCS/FDCS with IBM and TI 7000 and 9000 models and, of course, EDS.

Ms. Jerome attempted to answer the question of just why DMS often appears to be so old. At the root of this problem, other industries are not as integrated as the automotive industry. Integration means, of course, that DMS is somewhat cumbersome although this issue is currently being addressed by many of the newer systems.

Suppliers and vendors to the automotive industry are moving more and more into PC-based add-ons, service write-ups and CRM—Dealerkid, Automotive Directions and others are good examples of this trend. The industry is also seeing more and more external devices such as hand-held personal digital assistants (PDAs), scanners and document storage being utilized to update DMS—but not fast enough according to Ms. Jerome.

Service write-ups and now being done on PDAs and CRM systems now share data with everyone on the system, not merely the sales force. The challenge that remains, however, is that old bugaboo, integration.

Third party and DMS integration presents a major challenge according to Ms. Jerome. Third party vendors need to grab information but aren't always successful in dealing with and distributing the information that they've grabbed. ADP and Reynolds and Reynolds, for instance, have a CPA function but the problem is how to extract data from the system.

As the manufacturers return to the field, they all want to create Web sites. To many observers, the manufacturer appears to want to control the customer database. There is a widely-held belief that many manufacturers believe that a customer belongs to them.

Whether or not their purpose is solely customer identification and retention, manufacturers are becoming more involved in the development of customer databases as well as DMS systems and interfaces. The role that appears to be emerging for manufacturers is moving data from stock orders, financial statements, CDR and warranty claims into data warehousing, marketing, CRM and, EDI/XML.

For the latter purpose, several manufacturers, working with third party providers are attempting to create a common file format. The "STAR" program undertaken by several industry groups is attempting to create a standard format that can be used for a variety of applications. XML, similar to a vocabulary language, labels stuff while a header explains those labels in a manner that allows the transferred data to be used in a variety of applications.

Naturally, each manufacturer has differing requirements all aimed at increasing value to the dealer. Among those requirements is developing a common file format that can be published for all vendors to utilize. According to Ms. Jerome, the thrust is share, share, share in order to provide value for the dealer.

Ms. Jerome also outlined the requirements for DMS. DMS should, in her opinion, be an open system

see **TECHNOLOGY TRENDS IN THE AUTOMOBILE INDUSTRY...**, page 22

 (Continued from page 21)

with a common platform and involve third party integration. It should also offer a variety of options such as ASP, Internet/Intranet, Client/Server and, perhaps, utilize the Windows operating system.

ASP APPLICATIONS...WHAT IS ASP?

What is ASP? An application service provider or ASP was defined by Ms. Jerome as a third party that does the number crunching, compiles data and provides required reports to the dealership's management.

ASPs may be found that specialize in one or more of the following:

ASP APPLICATIONS

- Customer relationship management (CRM),
- Desktop applications,
- E-business,
- Enterprise resource planning (ERP),
- Human resources planning (HR),
- Information sharing and management, and
- Vertical markets (Automotive DMS).

One example of an ASP that was provided by Ms. Jerome was WebEx.com (www.WebEx.com). This ASP offers a low cost service that can even be free depending upon the user's tolerance for advertising and length of usage. Information is available on demand and in easy to use formats. And, best of all, no specialized software or equipment is required. All data is transferred and stored via the Internet by the ASP.

Despite the influx of new providers such as EDS Diamond Manage, Arkona (Ensign) and Ocentrix, ASP has a number of drawbacks. There is the loss of control experienced by the dealership, downtime, pricing and even questions of access that are not problems with a DMS.

Ms. Jerome also pointed up a problem that goes far beyond ASP. That is the fact that many areas of the country still do not have broadband available. Her own home base in the Northwest, for example, does not have reliable, widely-available broadband services.

A variety of security issues are among the drawbacks users face with ASPs. Those dreaded hackers are far more likely to target an ASP with the data of many businesses stored on its computers and servers than to hack into a specific dealership's computer system.

On the plus side, the benefits of an ASP may, for some dealers, outweigh the drawbacks. With an ASP there is generally less downtime. There are fewer midnight or all night updates. The dealership does not have to invest in expensive CPUs.

Also a benefit, software is usually updated faster and far less expensively through an ASP. Secure backups of a dealership's data is usually guaranteed by an ASP. And, bottom-line according to Ms. Jerome, ASPs mean less system administration and fewer time-consuming backups.

CRM APPLICATIONS

Changing subjects, Ms. Jerome delved into the increasingly more popular–and more necessary–customer relationship management (CRM) programs and strategies. CRM and its lead generation and management, allows prospect tracking and helps with customer retention.

Ms. Jerome believes that many dealerships will need a consultant to help them choose the right CRM solution. While many companies offer CRM software, she said, each is good at one thing. One company may, for example, specialize in lead generation management. Another may be more into showroom control, tracking prospects. A third firm may feature its customer retention abilities–working with large data base, pulling customers using service department over a three-year period while identifying all owners of a specific model within that data pool.

Every attendee who is thinking about jumping into the role of computer consulting–if they already haven't –should be aware of the keys to managing any dealer's IT. The first step, as Ms. Jerome pointed out, is to evaluate the dealer's current system, a system that is usually old.

Consolidating and eliminating duplicate applications is a good second step, one that inevitably improves the IT operation and makes a hero out of the advisor.

Direct manufacturer systems, it should be kept in mind, are just one vendor possibility for the dealership to consider. Closer to home, the DMS system is often an emotional issue and should be approached as such. Every computer professional, according to Ms. Jerome, should find out what the dealer–and those who use and rely on the system–like and don't like about it.

Although not first on her list, Ms. Jerome's suggestion to hire an IT professional may be among the most important options available to a dealer. Today, virtually every CPA firm has an IT department or professional on staff. Dealers, on the other hand, apparently haven't been as quick to hire IT professionals. Here too, security is an important consideration and is enhanced when an IT professional is hired.

Managing the dealership's technology will probably involve consideration of new technology, ASPs,

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Client/Servers, etc. Dealers are usually just reaching the point where they've figured it all out when their systems are four or five years behind times. With new software and technology emerging all the time, considering new solutions and vendors has become an overlooked necessity.

Computer consulting, according to the experienced Ms. Jerome, is the next big "pie" for the consulting industry. Those who already consult on technology are finding that it is a big pie out there.

SOME WARNINGS

Ms. Jerome concluded her presentation with a warning, a suggestion and by answering several important questions from the attendees. The warning was about contracts that many dealers willingly or unknowingly sign. One DMS contract mentioned, for instance, clearly allows a dealer's data and information to be made available to a third party–without saying whether that third party might be a competitor or the tax collector.

When signing any contract in this area, according to Ms. Jerome, it is extremely important to know what you are signing. She cited one contract with a DMS provider that states that if an employee of the DMS provider is hired, the DMS provider will immediately be owed an amount equal to that newly-hired employee's first year salary.

Obviously, as Ms. Jerome pointed out, knowing what you are signing is secondary to a "bail out" strategy. How can you get out of a contract and what will happen during the transition period are both matters that should be discussed and understood before any contract is signed.

The question of privacy is apparently a big issue. However, as Ms. Jerome explained, if someone is trying to break into a computer system, they will. The solution is not to hire people who want to break into the system or steal.

Ms. Jerome concluded her presentation with the assertion that the value of a CPA's services are 90 percent appearance (in other words, if numbers have been prepared by a CPA, they must be accurate). This revelation was used by Ms. Jerome to suggest that the best solution to most privacy and security problems is to prevent desire and create the appearance that the system can't be easily broken into–whether true or not.

Ms. Jerome can be reached at (360) 565-1208 and/or sandi@crsauto.com.

QUICK REFERENCE TO FEDERAL EXEMPTIONS

POSITION	EXEMPT-MINIMUM WAGE	EXEMPT-OVERTIME	EXEMPT-RECORDS
DEALER	YES	YES	YES
GENERAL MNGR	YES	YES	YES
DEPARTMENT MNGR	YES	YES	YES
CONTROLLER	YES	YES	YES
OFFICE MANGER	YES	YES	YES
OFFICE CLERICAL	NO	NO	NO
SERVICE WRITER	NO	YES	NO
FOREMAN	MAYBE (E)	MAYBE (E, C)	MAYBE (E)
TECHNICIAN	NO	YES	NO
TECHNICIAN TRAINEE	NO	MAYBE (ME)	NO
DISPATCHER	NO	MAYBE (C)	NO
BOOKER	NO	MAYBE (C)	NO
LUBE TECH	NO	MAYBE (C)	NO
PARTS COUNTER	NO	YES	NO
PARTS DRIVER	NO	MAYBE (M)	NO
PARTS STOCKER	NO	YES	NO
DETAILER/GET READY	NO	MAYBE (C)	NO
WARRANTY ADMIN	NO	NO	NO
ESTIMATOR	NO	MAYBE (S)	NO
BODYMAN	NO	YES	NO
PAINTER	NO	MAYBE (C)	NO
DEALER TRADE DRIVER	NO	MAYBE (M)	NO
SALES MANAGER	YES	YES	YES
F&I MANAGER	NO	MAYBE (C)	NO
CLOSER	NO	YES	NO
SALES PERSON	NO	YES	NO
AFTER MARKET SALES	NO	MAYBE (C)	NO

(E) = EXECUTIVE EXEMPTION
(C) = COMMISSION-PAID EXEMPTION
(S) = SALESMAN EXEMPTION
(M) = MOTOR CARRIER EXEMPTION
(ME) = MECHANIC EXEMPTION

EMPLOYMENT ISSUES & COMPENSATION PLANS FOR KEY DEALERSHIP EMPLOYEES

CONFERENCE REPORT

At the 4th Annual CPA-Auto Dealership Niche Conference, John P. Boggs of Fine, Boggs, Cope & Perkins LLP provided an enormous amount of information on dealership pay issues and the Fair Labor Standards Act. He covered the basics of child labor law, minimum wage and overtime requirements, recordkeeping, equal pay and many other provisions.

Mr. Boggs is amazingly well versed in all of these broad areas, as well as in many, many of the specific state variations on each theme. The risks of noncompliance are great, including liability for backwages, "liquidated damages," interest, injunctions, attorney's fees up to 3 years of liability, liability for individual management members, and even criminal sanctions.

Still worse, employers who willfully or repeatedly violate the FLSA's minimum wage or overtime provisions can be subject to civil penalties of up to $1,000 per violation, in addition to the civil and criminal remedies already available.

Mr. Boggs presented numerous examples of traps and pitfalls awaiting dealers who incorrectly compute their employees' weekly paychecks. Mr. Boggs discussed overtime exemptions for commission salespersons. He also presented examples (1) where the "pay-fluctuating work week" approach is cheaper to use than satisfying the overtime exemption requirements; (2) where supplementing pay to meet the overtime exemption requirements is cheaper than paying on the basis of a "fluctuating work week" approach; and (3) where the minimum wage must be paid.

Any CPA or consultant to dealerships who appreciates the distinctions and significance of these examples can save his or her dealer clients thousands of dollars through careful review and modification of existing employment practices.

Mr. Boggs emphasized a number of ways that dealers can minimize their costs and/or exposure to liability. His suggestions explored the opportunities to restructure: (1) job duties, (2) pay plans to make certain employees commissioned, and (3) pay plans to incorporate the "fluctuating work week" approach.

His "Quick Reference to Federal Exemptions" covers every position in a dealership and appears on page 23.

COMPENSATION PROGRAMS

The last part of his presentation addressed dealership compensation programs for key employees. Included with his materials were sample compensation agreements for the following key employees:

1. Salespersons,
2. Parts Managers,
3. Parts Counter Persons,
4. Closer-Assistant Sales Managers ,
5. F & I Managers, and
6. General Sales Managers

The two sample compensation programs on pages 26-31 are reproduced, with permission, from Mr. Boggs' Conference materials.

ARBITRATION CLAUSES

Mr. Boggs closed by emphasizing that including binding arbitration provisions in employment applications, agreements and manuals can result in astonishingly favorable results.

Binding arbitration provisions literally make plaintiffs disappear. More accurately, arbitration clauses make plaintiffs' lawyers see no real hope for any monetary recovery. These provisions replace juries with judges, result in the need to spend less time and money and avoid unfavorable publicity.

Mr. Boggs can be reached at his San Francisco Bay area office: phone: (650) 712-8908 or e-mail: jboggs@employerlawyers.com.

Example Where The Minimum Wage Base Must Be Paid.

- If a sales person works 50 hours (40 straight time hours and 10 overtime hours) in a pay period and earns a total of $250.00 in commissions.

- <u>Overtime Exemption Calculation</u>
- 1.5 x Minimum Wage ($8.63) x hours worked (50)= Exempt Base **($431.50)**

- <u>Fluctuating Work Week Overtime Calculation</u>
- Total Earnings ($250) ÷ Total Hours Worked (50)= $5.00 regular/base rate
- 1/2 of Base Rate ($2.50) x Overtime Hours (10)= $25 overtime pay
- Total Earnings ($250) + Overtime Compensation ($25)= Total Comp. ($275)

- <u>Minimum Wage Base Calculation</u>
- Straight Time Hours (40) x Minimum Wage ($5.75)= $230.00
- Overtime Hours (10) x 1 1/2 minimum Wage ($8.63)= <u>$ 86.30</u>
- Minimum Wage Base **$316.30**

Example Where Paying Fluctuating Work Week Is Cheaper Than Satisfying the Overtime Exemption Requirements.

- If a sales person works 50 hours (40 straight time hours and 10 overtime hours) in a one-week pay period and earns a total of $330.00 in commissions (total earnings).

- <u>Overtime Exemption Calculation</u>
- 1.5 x Minimum Wage ($8.63) x hours worked (50)= Exempt Base **($431.50)**

- <u>Fluctuating Work Week Overtime Calculation</u>
- Total Earnings ($330) ÷ Total Hours Worked (50)= $6.60 regular/base rate
- 1/2 of Base Rate ($3.30) x Overtime Hours (10)= $33 overtime compensation
- Total Earnings ($330) + Overtime Compensation ($33)= Total Comp. ($363)

- <u>Minimum Wage Base Calculation</u>
- Straight Time Hours (40) x Minimum Wage ($5.75)= $230.00
- Overtime Hours (10) x 1 1/2 minimum Wage ($8.63)= <u>$ 86.30</u>
- Minimum Wage Base **$316.30**

Example Where Supplementing Pay To Meet The Overtime Exemption Requirements Is Cheaper Than Paying Fluctuating Work Week.

- If a sales person works 50 hours (40 straight time hours and 10 overtime hours) in a pay period and earns a total of $400.00 in commissions.

- <u>Overtime Exemption Calculation</u>
- 1.5 x Minimum Wage ($8.63) x hours worked (50)= Exempt Base **($431.50)**

- <u>Fluctuating Work Week Overtime Calculation</u>
- Total Earnings ($400) ÷ Total Hours Worked (50)= $8.00 regular/base rate
- 1/2 of Base Rate ($4.00) x Overtime Hours (10)= $40 overtime compensation
- Total Earnings ($400) + Overtime Compensation ($40)= Total Comp. **($440)**

- <u>Minimum Wage Base Calculation</u>
- Straight Time Hours (40) x Minimum Wage ($5.75)= $230.00
- Overtime Hours (10) x 1 1/2 minimum Wage ($8.63)= <u>$ 86.30</u>
- Minimum Wage Base **$316.30**

SAMPLE

SALESPERSON COMPENSATION PROGRAM

SALES REPRESENTATIVE: EFFECTIVE DATE:

Earned Commission Compensation Program

On all new vehicles, you will be paid Earned Commissions on each Closed Sale or Lease (collectively referred to as "Closed Sale") equaling ______% of the Commissionable Gross. Notwithstanding the above, a minimum of $____________.00 will be paid as Earned Commissions on each Closed Sale of a vehicle.

Bonuses

The Salesperson will receive a bonus as follows:

[insert bonus language]

Adjustments To Earned Commissions and Bonuses

The Salesperson agrees that the Earned Commission and Bonuses may be adjusted at any time, (i) to correct any error in the calculation, whether that error is the result of miscalculations by the Company, the Sales Manager, any salesperson or any other person; (ii) if any sale or lease is subsequently determined not to have been a Closed Sale, or (iii) if a Closed Sale is rescinded, reversed, rolled back or otherwise unwound for any reason within 90 days of the payment of the Commission for such Closed Sale. Any such adjustment that results in a decreased Earned Commissions will be treated as an Advance, as defined below. Any such adjustment that results in an increased Earned Commission will be paid at the next payment date.

Definitions

Commissionable Gross Defined: Commissionable Gross is the vehicle's selling price plus dealer-installed aftermarket products (but excluding security systems, insurances, warranties, sealants) minus: (1) the vehicle's cost as defined below, (2) a dealer pack Of $______ (which is determined by the dealership at its sole discretion and which may vary from vehicle to vehicle), (3) all costs in any way associated with the sale of the vehicle including but not limited to: costs related to dealer trades or similar transportation costs, costs related to commitments made by the dealership to the customer at the time of the sale for additional equipment, accessories or alterations or repairs, bank and finance company fees, management fees, (4) a pre-delivery preparation fee of $_____ (which includes such items as detailing, preparation for sale, and alarm wiring harness), (5) the difference between the trade allowance credited to the customer for their trade minus the trade's actual cash value determined by the sales manager (over allowance amount). Commissionable Gross does not include factory incentives, holdback paid to the dealer or the amount of an under allowance on a trade.

The vehicle's cost, for a new vehicle, is the vehicle's "invoice" cost plus the costs related to any equipment, flooring fees and/or dealer pack as determined by the dealership, accessories or alterations or repairs made to the vehicle and any related factory delivery fees or charges (e.g. Express Delivery fees).

The vehicle's cost, for a used vehicle, is the vehicle's actual cash value or its acquisition cost (or the averaged or adjusted cost) plus all costs related to the vehicle's acquisition, reconditioning, and warranty including but not limited to: buyer fees, transportation fees, auction and bank fees, all reconditioning costs, costs related to accessories and alterations, flooring costs and/or management fees determined by the dealership, and costs related to warranties included as standard equipment on the vehicle.

From time to time at the dealership's sole discretion, the dealership may, and has the right to, average a vehicle costs between two or more vehicles purchased by the dealership, may make internal cost allocations between different departments, or may adjust the vehicle's cost up or down to reflect market conditions or the vehicle's history (e.g., the length of time the vehicle has been in stock).

Closed Sales Defined: No commission or unit credits will be awarded on any deal until the deal is "closed." A deal is not "closed" until the Dealership has been paid in full on the transaction and all related paperwork is properly completed and approved. To be a Closed Sale, the vehicle must have been delivered to the customer. A sale (including a special order vehicle) is not a Closed Sale until all paperwork is completed, the vehicle is fully paid for and/or funded by a financial institution, the vehicle is delivered to the customer, and the deal meets the requirements of Earned Commissions, as defined below.

Earned Commissions Defined: A salesperson must be an employee of the Company at the time a vehicle is delivered and the sales paperwork totally completed and the vehicle transaction paid in full before a commission is considered earned, regardless of the work done or the fact that he/she was employed when the vehicle was sold or the order was taken. In simple terms, the salesperson must be employed at the dealership at the time the deal becomes a Closed Sale. Until that time, no commission has been earned by the salesperson.

Split Commissions: Occasionally it will necessary to split the commission and the unit credit on the sale of a unit between two or more people. Management reserves the right to split all relevant commissions and unit credits by any percentages it deems appropriate. The decision of the General Manager on the division of commissions and unit credits is final. A split commission equals less than a full unit for the purpose of a Closed Sale, but can be combined with other Split Commissions to result in full units (Closed Sales). For example, two 50% Split Commissions equal a full unit (that is, one Closed Sale).

Draws Against Commission/Advances

All advances/draws against future Earned Commissions will be treated as loans and will be deducted from future Earned Commissions, Wages and/or any bonuses prior to the payment of same. The Salesperson acknowledges that such Advances/Draws are for the Salesperson's benefit and authorizes such deductions. Any overpaid commissions or advances must be paid upon your separation from the Company and will be deducted from any pay or benefits (including vacation) you may have coming. A draw/advance against future commissions will be paid on 20th day of each month at the following rates: ____, less any spiff already paid in during the pay period. The Salesperson is only entitled to the full draw if he/she works every scheduled workday.

Payment of Commissions and Bonuses

On the ________ day of the following month, all Earned Commissions on Closed Sales for the month will be totaled and you will receive the total of your Earned Commissions on Closed Sales for the month, less any advance/draw.

Attendance Documentation

You are required by federal and state law and by this Dealership to keep an accurate record of all the hours you work each day. Hours worked in excess of your scheduled hours require approval in advance by the Sales Manager. Failure to comply with this requirement can result in discipline up to and including termination.

Minimum Sales Volume

You must maintain an average of ______________ closed sales per month to maintain full-time employment.

NOTICE:

This is the total pay package and no further payments are anticipated or expected. The Dealership reserves the right to amend or terminate this compensation plan and/or rate (with the exception of the arbitration agreement) at any time without notice at its sole discretion. This agreement supersedes any previous agreements with respect to your pay plan.

If it becomes necessary for the Dealership to amend this plan or if it is terminated, commissions will be paid at the next scheduled payroll disbursement based on "closed" sales as described above, at the date of the amendment or termination of this plan.

I understand that nothing in this pay plan creates or is intended to create a promise or representation of continued employment and that my employment, position and compensation is for no definite period, regardless of payment of wages. I have the right to terminate my employment at any time, with or without cause or notice, and the Dealership has a similar right. I further understand that my status as an "at-will" employee may not be changed except in writing signed by the President of the Dealership.

Additionally, I understand and voluntarily agree that any disputes regarding the terms of this pay plan or my employment or termination from employment (including claims of discrimination and/or harassment) will be resolved exclusively in accordance with binding arbitration governed by the Federal Arbitration Act, and carried out in conformity with the procedures of the Uniform Arbitration Act. Unless otherwise specifically covered by the Uniform Arbitration Act's provisions, the Arbitrator shall be governed by the Federal Rules of Civil Procedure and Evidence. To the extent applicable, the following shall also apply and be observed: all rules of pleading (including the right of dismissal), all rules of evidence, all rights to resolution of the dispute by means of motions for summary judgment, judgment on the pleadings, and judgment under the Federal Rules of Civil Procedure. I further understand and voluntarily agree that this alternative dispute resolution program shall also cover claims of discrimination or harassment under Title VII of the Civil Rights Act of 1964, as amended. Although I understand that signing this arbitration agreement is not required as a condition of my employment, I desire to take advantage of the benefits of arbitration and understand that I give up the right to a trial by jury and instead will have my claims resolved by a retired trial court Judge. By marking the box to the right, I elect to give up the benefits of arbitrating such Title VII claims only. ☐

Agreed to:

_______________________________ Date: ___________________________

Employee Signature

Approved by:

_______________________________ Date: ___________________________

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[MANAGER'S NOTE- IN ORDER TO BE OVERTIME EXEMPT, A CLOSER MUST EARN MORE THAN HALF OF TOTAL EARNINGS FROM COMMISSIONS AND MAKE MORE THAN 1 ½ TIMES THE MINIMUM WAGE]—REMOVE BEFORE DISTRIBUTION

CLOSER-ASSISTANT SALES MANAGER COMPENSATION PROGRAM

Closer: EFFECTIVE DATE:

Base Salary

The Closer will receive a base salary of $______ per month, which shall be paid at month end.

Earned Commission Compensation Program

On all new vehicles, you will be paid Earned Commissions on each Closed Sale or Lease (collectively referred to as "Closed Sale") at the rate of 10% of the commissionable gross on all closed sales during the month.

Notwithstanding the above, a minimum of $_____ will be paid as Earned Commissions on each Closed Sale of a new vehicle, or a minimum of $_____ on used vehicles, except as set forth below. On Closed Sales of Advertised Unit deals, the Salesperson will only receive the minimum commission if the Commissionable Gross exceeds $______.

In addition, the Closer will receive $_____ for ATS and $_____ for Service Contracts (S/C), excluding S/C's sold by the F&I Department.

On Closed Sales of Special Finance deals, the Closer will receive a flat commission of $______.

Adjustments To Earned Commissions and Bonuses

The Closer agrees that the Earned Commission and Bonuses may be adjusted at any time, (i) to correct any error in the calculation, whether that error is the result of miscalculations by the Company, the Sales Manager, any Closer or any other person; (ii) if any sale or lease is subsequently determined not to have been a Closed Sale, or (iii) if a Closed Sale is rescinded, reversed, rolled back or otherwise unwound for any reason within 90 days of the payment of the Commission for such Closed Sale. Any such adjustment that results in a decreased Earned Commissions will be treated as an Advance, as defined below. Any such adjustment that results in an increased Earned Commission will be paid at the next payment date.

Definitions

Commissionable Gross Defined: Commissionable Gross is the vehicle's selling price plus dealer-installed aftermarket products (but excluding security systems, insurances, warranties, sealants) minus: (1) the vehicle's cost as defined below, (2) a dealer pack of $ _____ which is determined by the dealership at its sole discretion, (3) all costs in any way associated with the sale of the vehicle including but not limited to: costs related to dealer trades or similar transportation costs, costs related to commitments made by the dealership to the customer at the time of the sale for additional equipment, accessories or alterations or repairs, bank and finance company fees, management fees, (4) a pre-delivery preparation fee of $______ (which includes such items as detailing, preparation for sale, and alarm wiring harness), and (5) the difference between the trade allowance credited to the customer for their trade minus the trade's actual cash value determined by the sales manager. Commissionable Gross does not include factory incentives, holdback paid to the dealer or any amount on the under allowance on a trade in vehicle.

The vehicle's cost, for a new vehicle, is the vehicle's "invoice" cost plus the costs related to any equipment, flooring fees and/or dealer pack as determined by the dealership, accessories or alterations or repairs made to the vehicle and any related factory delivery fees or charges (e.g. Express Delivery fees).

The vehicle's cost, for a used vehicle, is the vehicle's actual cash value or its acquisition cost (or the averaged or adjusted cost) plus all costs related to the vehicle's acquisition, reconditioning, and warranting including but not limited to: buyer fees, transportation fees, auction and bank fees, all reconditioning costs, costs related to accessories and alterations, flooring costs and/or management fees determined by the dealership, and costs related to warranties included as standard equipment on the vehicle.

From time to time at the dealership's sole discretion, the dealership may, and has the right to, average the vehicle cost's between two or more vehicles purchased by the dealership, may make internal cost allocations between different departments, or may adjust the vehicle's cost up or down to reflect market conditions or the vehicle's history (e.g., the length of time the vehicle has been in stock).

The dealer pack amounts are as follows:

USED CARS AND TRUCKS	$________.payable at window per vehicle
NEW CARS AND TRUCKS	$________ per vehicle
LEASES	$________ per vehicle

Closed Sales Defined: No commission or unit credits will be awarded on any deal until the deal is "closed." A deal is not "closed" until the Dealership has been paid in full on the transaction and all related paperwork is properly completed and approved. To be a Closed Sale, the vehicle must have been delivered to the customer. A sale (including a special order vehicle) is not a Closed Sale until all paperwork is completed, the vehicle is fully paid for and/or funded by a financial institution, the vehicle is delivered to the customer, and the deal meets the requirements of Earned Commissions, as defined below.

Earned Commissions Defined: A Closer must be an employee of the Company at the time a vehicle is delivered and the sales paperwork totally completed and the vehicle transaction paid in full before a commission is considered earned, regardless of the work done or the fact that he/she was employed when the vehicle was sold or the order was taken. In simple terms, the Closer must be employed at the dealership at the time the deal becomes a Closed Sale. Until that time, no commission has been earned by the Closer.

Split Commissions: Occasionally it will necessary to split the commission and the unit credit on the sale of a unit between two or more people. Management reserves the right to split all relevant commissions and unit credits by any percentages it deems appropriate. The decision of the General Manager on the division of commissions and unit credits is final. A split commission equals less than a full unit for the purpose of a Closed Sale, but can be combined with other Split Commissions to result in full units (Closed Sales). For example, two 50% Split Commissions equal a full unit (that is, one Closed Sale). This may be done, in management's discretion, if a Closer is dismissed or quits and another Closer has to take care of any aspect of the Closed Sale.

Draws Against Commission/Advances

All advances or overpayments, whether intentional or by error, will be treated as loans and will be deducted from future Earned Commissions, Wages and/or any bonuses prior to the payment of same. The Closer voluntarily authorizes such deductions. Any overpaid commissions or advances must be paid upon your separation from the Company.

Payment of Commissions and Bonuses

The Closer will receive all Earned Commissions on the 15th and last day of the month, for all Closed Sales occurring before the second working day before pay day.

Attendance Documentation

You are required by federal and state law and by this Dealership to keep an accurate record of all the hours you work each day. Hours worked in excess of your scheduled hours require approval in advance by the Sales Manager. Failure to comply with this requirement can result in discipline up to and including termination.

NOTICE:

Each Closer must maintain a sales force of NO FEWER than five salespersons and is responsible for all sales generated by his/her team, including necessary stips to obtain financing. In addition, each Closer is responsible for training, motivating, and controlling each member of his/her team. His/Her team MUST always be to work on time.

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Agreed to:

______________________________ Date: __________________________

Employee Signature

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