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DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

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

#1. THE BIG NEWS: IRS ISSUES GUIDANCE ON VALUING EMPLOYEE USE OF DEMOS. In late November, the IRS published guidance effective January 1, 2002 on the proper valuation and tax treatment of demonstrator vehicles provided to auto dealership full-time salespersons and to other employees. This big news is really a blend of mostly good news with just a few unpleasant aspects sprinkled in.

This guidance in Revenue Procedure 2001-56 includes clarification of the substantiation requirements, limitations on mileage, how amounts to be included in income for personal miles driven are to be valued, and the proper treatment of demo vehicles provided to non-salespersons.

Certainty is provided ... Simplicity is permitted... but ***Substantiation is required.*** However, the substantiation requirements are neither onerous nor burdensome, and the customer-friendly IRS has even gone so far as to include model plan wording for some of the simplified methods.

The Revenue Procedure offers dealerships optional methods to select from for valuing the amounts to be included in income where demos are used by certain employees. These optional, simplified methods are structured so that if the use of a vehicle by an employee does not qualify for treatment under one method, that use can instead be taken into account under a subsequent method with no additional recordkeeping.

The ***three*** methods that dealerships can select from are (1) the *Simplified Full Exclusion Method*, (2) the *Simplified Partial Exclusion Method* and (3) the *Simplified Full Inclusion Method*. If none of these methods satisfies or applies, then dealers revert to the *General Rule* ... and this requires valuation of the demonstrator vehicles at their "full fair market value." There are special terms, computations and conditions to satisfy ... but they all seem to be reasonable.

WATCHING OUT FOR

If the use of a demo by a full-time salesperson fails to qualify for full exclusion under the simplified full exclusion method, the use of that vehicle may still be accounted for under the partial exclusion method based on records otherwise available or already maintained.

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FOUR KEY OBSERVATIONS

First, unless the full exclusion method applies, amounts are required to be included in employees income ***no less often than monthly***.

Second, based on a review of odometer readings, the employer is required to make a determination of whether or not the use of the vehicle by the employee has been ***limited***, and this determination must be made ***no less often than monthly***.

Third, the amounts to be included in employees income (where applicable) are based upon the value of the demonstrator vehicles as determined from tables included in the Revenue Procedure for that purpose ... i.e., the includable amounts are ***not*** determined on a cents-per-mile driven basis.

Finally, in all cases, corresponding Federal income tax withholding and other applicable employee payroll taxes and matching employer payroll taxes are required.

Dealerships have many options in applying the new rules. They can choose to use the partial exclusion method immediately for all full-time salespeople without first attempting to satisfy the requirements of the full exclusion method. What is most favorable is that the IRS will allow an employer to choose to apply the different optional methods on an employee-by-employee basis.

Most of us know that there are some employees with personality types completely resistant to all form of recordkeeping *requests*. And, if you change that *request* to a *requirement*, some become even more defiant and uncooperative. Maybe that's just human nature in some folks.

Nevertheless, to accommodate these situations, if some employees are unwilling to maintain the records necessary to satisfy the full exclusion method, the employer can account for their use under the partial exclusion method (i.e., the second method) or under the full inclusion method (i.e., the third method) while still retaining the ability to use the full exclusion method (i.e., the first method) for the other employees who are willing to comply, cooperate and assist in the recordkeeping requirements.

On Dec. 11, 2001, the IRS Motor Vehicle Technical Advisor issued an *Automotive Alert* summarizing the new Revenue Procedure. Entitled "Industry Issue Resolution Pilot Program Results in Guidance on Proper Treatment of Demonstrator Automobiles," this *Alert* indicated that the new guidance responds to concerns brought forward by the National Auto Dealer Association and several accounting firms. You can obtain a copy of this *Alert* by calling (616) 235-1655 or by e-mailing your request to Terri.S.Harris@IRS.gov.

Detailed discussion of these new rules and guidelines begins on page 4. A *Practice Guide* sample letter to clients appears on page 3.

#2. REIMBURSEMENT PLANS...APPEALS COURT REVERSES SUMMARY JUDGMENT ON PENALTY ASSESSMENTS, BUT UPHOLDS DENIAL OF PLANS BENEFITS. Recently, there was some follow-up action on a case mentioned in a previous *DTW* article on Section 62(c) accountable type plans. The case is *Shotgun Deliveries, Inc.*, in which a delivery/courier service tried to set up an accountable plan-type-payroll gimmick. Even though this case did not involve dealership service technicians (the application in which the *DTW* is more interested), most of what happened in that case is instructive for dealers considering these types of plans.

What caught our eye was that the penalties that the IRS had asserted against Shotgun Deliveries, Inc. for engaging in the dubious "accountable-plan" scheme will now have to be deliberated further because an Appeals Court ruled that summary judgment by the District Court on the penalty assessment issue was not proper. For more on this, see page 23.

#3. DEALERS CAN'T TAKE FAST WRITE-OFFS FOR VSC PREMIUMS PAID. In two recent cases, the issue was whether the dealerships (who were primary obligors on vehicle service contracts) could take accelerated deductions for the insurance premiums that were incurred in connection with the extended warranty contract sales.

The IRS said those insurance premium expenditures were required to be amortized more slowly and ratably over the years covered by the vehicle service warranty. Obviously, this is not how the dealerships wanted to treat the payments.

In the Tax Court, this case was *Toyota Town, Inc.* (T.C. Memo 2000-40). This case involved taxable years during which the Service Warranty Income Method (SWIM) was introduced. The Tax Court had agreed with the IRS that the dealerships could not expect the benefit of a tax deferral under the SWIM method and at the same time accelerate deductions of the write-off of the cost of the insurance premiums paid for loss protection on those policies.

Now, the U.S. Court of Appeals for the 9th Circuit has affirmed the Tax Court's decision in the same case which goes by the name of *Bob Wondries Motors, Inc. d/b/a Bob Wondries Ford* at the Appeals level. For more on this development, see page 24.

NEW IRS GUIDELINES FOR VALUING USE OF DEMONSTRATOR VEHICLES

SAMPLE LETTER

Mr./Ms. Dealer and/or CFO
XYZ Dealership Group

December ____, 2001

Dear _____:

For years, many dealers have provided employees with demonstrator vehicles. This practice has raised many questions and disagreements with the Internal Revenue Service over how much income, if any, employees should report in their tax returns each year for the value of this fringe benefit. In addition, dealerships have been assessed corresponding payroll taxes, and often penalties, where these issues were not properly handled.

Now there's good news. The IRS recently went on record saying what it will be looking for starting in 2002 if demonstrators are provided to full-time sales employees, as well as to other employees.

In providing this guidance and clarification, the IRS now offers dealers three optional methods to select from for valuing demonstrator use. These three simplified methods have been structured sequentially so that if the use by an employee does not qualify for treatment under one method, the use can nonetheless be taken into account under a subsequent method with no additional recordkeeping.

The three methods that dealerships can select from are the

- ***Full Exclusion Simplified Method*** ... for the full exclusion of qualified automobile demonstration use, recording use of the vehicles under a simplified out-in method.
- ***Partial Exclusion, Simplified Method*** ... for the partial exclusion of demonstration automobile use by full-time salespeople.
- ***Full Inclusion Simplified Method*** ... for the inclusion of the value of demonstration automobile use *if neither the full exclusion method nor the partial exclusion method applies.* The full inclusion simplified method also applies to employees other than full-time salespersons.

Finally, a *General Rule* will apply if/when the above Simplified Methods 1, 2 and 3 do not apply. The *General Rule* requires an employee to report the use of a demo vehicle at its ***full fair market valuation.***

If the use of a demonstrator vehicle by a full-time salesperson fails to qualify for full exclusion under the simplified full exclusion method, the use may still be accounted for under the partial exclusion method based on records otherwise available or already maintained under the full exclusion method.

At the same time, employers can choose to use the partial exclusion method immediately for all full-time salespeople without first attempting to satisfy the requirements of the full exclusion method. What is most favorable is that the IRS will allow an employer to choose to apply the different optional methods on an employee-by-employee basis.

Most of us know that there are some employees who will always resist all forms of recordkeeping requests. To accommodate these situations, if some employees are unwilling to maintain the records necessary to satisfy the full exclusion method, the employer can account for their use under the partial exclusion or the full inclusion methods while still retaining the ability to use the full exclusion method for the other employees who will be more compliant.

The IRS has even gone so far as to publish model language for two of the above methods (i.e., for the *Full Exclusion* and for the *Partial Exclusion* methods).

The use of a demonstrator vehicle is a valuable fringe benefit, and the IRS does require some recordkeeping in connection with its new policies. However, these requirements are minimal and not unduly burdensome relative to the valuable benefit conferred. It will be necessary to report the amounts of imputed employee income in their paychecks ***no less often than monthly*** and to include those amounts in the calculation of your corresponding employer tax liabilities.

Many dealers do not provide employees with demonstrator vehicles or have discontinued their policies in this regard, and some are glad they did. However, if you recently discontinued your demo policy because of concern over unclear IRS rules or interpretations, you may now want to reconsider in light of the newly issued IRS guidelines and rules.

We look forward to discussing all of this further with you at your convenience.

NEW GUIDELINES FOR VALUING AND REPORTING THE USE OF DEMONSTRATOR VEHICLES

DEMOS R.P. 2001-56

On November 29, 2001 the IRS and Treasury published Revenue Procedure 2001-56. This document presents, in question and answer format (see pages 6-7), guidance on the proper tax treatment of demonstrator vehicles provided to auto dealership full-time salespersons and other employees. This guidance includes clarification of the substantiation requirements, limitations on mileage, how amounts to be included in income for personal miles driven are to be valued, and the proper treatment of demo vehicles provided to non-salespersons.

The Service has even gone so far as to include model qualified written policy language for two of the simplified methods.

This new guidance and clarification is effective for years beginning on or after January 1, 2002.

Prior IRS activity in the general area of demo vehicle use had included the issuance of two Letter Rulings. LTR 9801002 had dealt with a dealership's sloppy recordkeeping and failure to maintain the documentation required by Section 274. LTR 9816007 involved a distributorship which was held not to have used the correct safe harbor rule in valuing demonstrator usage. In addition, in a U.S. District Court case in late 1998, *BMW of North America, Inc.,* the Court upheld the IRS in assessing a very large deficiency because of the incorrect use of the Lease Valuation Table.

In providing guidance now for this troublesome area in Rev. Proc. 2001-56, the IRS offers dealerships three optional simplified methods to select from for valuing the amount to be included in income where demos are used by certain employees. These optional, simplified methods have been structured sequentially so that if the use by an employee does not qualify for treatment under one method, the use can nonetheless be taken into account under a subsequent method with no additional recordkeeping or change in determination period.

The three methods that dealerships can select from are the

Full Exclusion: Simplified method for the full exclusion of qualified demo vehicle use (simplified out-in method).

Partial Exclusion: Simplified method for the partial exclusion of demo vehicle use by full-time salespeople.

Full Inclusion: Simplified method for inclusion of the value of demo vehicle use if neither the full nor partial exclusion method applies.

Finally, there is a general rule requiring the demos to be valued at "full fair market value" when methods 1, 2 and 3 do not apply.

If the use of a demo vehicle by a full-time salesperson fails to qualify for full exclusion under the simplified full exclusion method, the use may still be accounted for under the partial exclusion method based on records otherwise available or already maintained under the full exclusion method. At the same time, employers can choose to use the partial exclusion method immediately for all full-time salespeople without first attempting to satisfy the requirements of the full exclusion method.

What is most favorable is that the IRS will allow an employer to choose to apply the different optional methods on an employee-by-employee basis.

If some employees are unwilling to maintain the records necessary to satisfy the full exclusion method, the employer can account for their use under the partial or full inclusion methods while still retaining the ability to use the full exclusion method for the other employees.

BACKGROUND BASICS

The simplified methods are available to any automobile dealer engaged in the business of retail sales of new or used vehicles.

The demonstrator or *demonstration* vehicles are required to be currently in the inventory of the dealership and to be available for test drives by customers during the normal business hours of the employee provided its use. Demo vehicles can include passenger vans, sport utility vehicles, and light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which are also referred to as class 1, 2, or 3 trucks.

The application of the simplified methods for the full or partial exclusion of demonstrator vehicle use is limited to use by full-time salespeople. Reg. Sec. 1.132-5(o)(2) requires that the individual be employed by an automobile dealer, customarily spend at least half of a normal business day performing the functions of a floor salesperson or sales manager, directly engage in substantial promotion and negotiation of sales to customers, customarily work a number of hours considered full-time in the industry (but at a rate

see **VALUING THE USE OF DEMONSTRATOR VEHICLES**, page 8

AT A GLANCE	**DEMONSTRATOR VEHICLES** **NEW IRS GUIDELINES IN REV. PROC. 2001-56**
BASICS	• Effective for taxable years beginning on or after January 1, 2002. • IRS interpretations & rules are presented in question and answer format. • ***Three*** simplified methods are provided for dealers to use in valuing demonstrator vehicle use. • If the use by an employee does not qualify for treatment under one method, the use can nonetheless be taken into account under a subsequent method with no additional recordkeeping or other changes. • The key to full exclusion is that no less often than monthly, the employer is required to make a determination of whether or not the use of the demo vehicle by the employee has been ***limited.***
THREE (3) OPTIONAL METHODS AVAILABLE	• ***Full Exclusion***: Simplified method for the full exclusion of qualified demo vehicle use ... ***Simplified Out-In Method*** for recording mileage and for keeping records to support the full exclusion of the use of a demo vehicle from the income of a full-time automobile salesperson. *(Q&A 11-25)* • ***Partial Exclusion***: Simplified method for the partial exclusion of demo vehicle use by full-time salespeople ... This is a simplified method for determining the excludible business use of a demo vehicle provided to a full-time salesperson and the amount included in income if the full exclusion is not applicable. *(Q&A 26-39)* ... Includes ***table showing daily inclusion amount*** under a reasonable method *(Question 35)* • ***Full Inclusion***: Simplified method for inclusion of the value of demo vehicle use *if neither full exclusion nor the partial exclusion method applies* ... This is a simplified method for determining the amount to be included in income of ***any*** employee provided the use of a demo vehicle if neither the full nor partial exclusion for full-time salespeople is available. *(Q&A 40-47)* ... Includes ***table showing daily inclusion amount*** under the annual lease value table *(Question 44)* • ***General Rule If/When Methods 1, 2 and/or 3 Do Not Apply***: ... If the requirements of the simplified methods are not satisfied, generally the amount required to be included in an employee's income is the ***full fair market value*** of the use of the demo vehicle. *(Q&A 51)*
ALLOWABLE PERSONAL USE MILEAGE	• Personal use mileage, in addition to daily roundtrip commuting miles, that the IRS will allow demo driver to put on the vehicle and still satisfy the *de minimis personal use* allowance. • ***Cannot exceed an average of 10 miles per day.***
DAILY INCLUSION AMOUNTS	• Amounts to be included in income per day of use by employees driving demo vehicles. • Different daily amounts depending on which optional method applies and on the value of the demo.
AVERAGE ANNUAL LOOKBACK METHOD	• Method for computing the values of demonstrator vehicles which becomes the basis for determining the daily inclusion amounts. • Different rules apply for computation of value of ***new*** vehicles and for ***used*** vehicles. • Special rules apply where more than one franchise is operated at or from a single location.
INTERPLAY OF METHODS	• If the use of a demo vehicle by a full-time salesperson fails to qualify for the simplified *full exclusion method*, the use may still be accounted for under the *partial exclusion method* based on records otherwise available or already maintained under the full exclusion method. • Employers can choose to use the partial exclusion method immediately for all full-time salespeople without first attempting to satisfy the requirements of the full exclusion method. • The different optional methods can be applied on an employee-by-employee basis.
IF METHODS ARE MISAPPLIED	• If errors are identified and corrected ***during the calendar year*** in which the vehicle is provided, an employer may continue to use the simplified methods under this Revenue Procedure ... *Q&A 48-51*

51 Questions	REV. PROC. 2001-56 Q & A FORMAT PROVIDES IRS GUIDANCE on VALUING USE of DEMO VEHICLES
PURPOSE & SCOPE	**Section 1:** 1. What is the purpose of Revenue Procedure 2001-56? 2. Who may use the simplified methods set forth in this Revenue Procedure? 3. What vehicles are demonstration automobiles that qualify for the simplified methods? 4. For which employees can the simplified methods be used? 5. Does R.P. 2001-56 describe ***all*** of the methods for determining and substantiating the value of the use of demo vehicles provided to employees by auto dealerships?
BACKGROUND	**Section 2:** 6. What provisions of the tax law may apply to a vehicle provided to an employee by an employer? 7. When is the use of an employer-provided automobile a ***working condition fringe***?
FULL EXCLUSION FOR QUALIFIED DEMO VEHICLE USE	**Section 3:** 8. What is the ***full exclusion*** for qualified automobile demonstration use (i.e., qualified demo use)? 9. What are the requirements for the ***full exclusion*** of auto demonstration use by a full-time salesperson? 10. What is the treatment if the requirements for the full exclusion are not met?
FULL EXCLUSION OF QUALIFIED DEMO VEHICLE USE *SIMPLIFIED METHOD*	**Section 4:** 11. What are the requirements (under this Rev. Proc.) for the ***Simplified Method for Full Exclusion*** of qualified demo use? 12. What is a ***qualified written policy*** for purposes of the full exclusion? 13. When may the employer ***reasonably believe*** that the full-time auto demo user salesperson complies with the written policy? 14. What is the ***sales area*** of an automobile dealer? 15. When is the personal use of the demo vehicle ***limited*** for purposes of the full exclusion? 16. How does an employer determine the total mileage that a demo vehicle is used outside of normal working hours? 17. What is a reasonable system for recording ***out and in mileage***? 18. What is the ***applicable period*** for determining whether the average 10 miles per day is exceeded? 19. What is ***commuting*** mileage? 20. How does an employer determine the commuting mileage for a full-time salesperson? 21. Is commuting mileage limited to the most direct route between the employee's home and the sales office? 22. How does an employer using the ***full exclusion method*** calculate personal use? 23. What records must an employer maintain to satisfy the requirements for the ***full exclusion*** method? 24. What records must an employee maintain to satisfy the requirements for the ***full exclusion*** method? 25. What are the tax consequences if one or more employees fail to satisfy the limited personal use requirement?

51 Questions	REV. PROC. 2001-56 Q & A FORMAT PROVIDES IRS GUIDANCE on VALUING USE of DEMO VEHICLES
PARTIAL EXCLUSION OF DEMO VEHICLE USE BY FULL-TIME SALESPEOPLE *SIMPLIFIED METHOD*	**Section 5:** 26. What is the ***partial exclusion*** of demonstration automobile use? 27. When can an employer use the ***partial exclusion*** method? 28. What are the requirements for the partial exclusion of demo vehicle use by a full-time salesperson? 29. What is the treatment if the requirements for the partial exclusion are not met? 30. What is a ***qualified written policy*** for purposes of the partial exclusion? 31. May a qualified written policy under the full exclusion method be used for the partial exclusion method? 32. When may the employer ***reasonably believe*** that the full-time auto salesperson complies with the written policy? 33. What method does an employer use to determine the value of the demo vehicle used by a full-time salesperson? 34. How does an employer determine the ***annual average sales price*** if more than one franchise is operated at or from a single location? 35. What is the amount included in the full-time salesperson's income and wages for use of the demo vehicle under the partial exclusion method? 36. How does an employer determine the number of days that a salesperson has the use of a demo vehicle? 37. May an employer elect (under Section 3402(s)) not to withhold income taxes from the portion of the vehicle fringe benefit required to be included under the partial exclusion method? 38. What records must an employer maintain to satisfy the requirements for the ***partial exclusion*** method? 39. What records must an employee maintain to satisfy the requirements for the ***partial exclusion*** method?
FULL INCLUSION METHOD *INCLUSION OF THE VALUE OF DEMO VEHICLE ... If Neither The Full Nor The Partial Exclusion Method Applies* *SIMPLIFIED METHOD*	**Section 6:** 40. What method does an employer use to account for the use of demo vehicles provided to employees who are not full-time salespeople? 41. What method is used to account for the use of a demo vehicle by a full-time salesperson who does not qualify for the full exclusion or partial exclusion? 42. What are the requirements for using the ***full inclusion method*** for demo vehicles used by employees who are not full-time salespeople or who are full-time salespeople? 43. Under the ***full inclusion method***, how does the employer determine the value of the demo vehicle provided to employees? 44. How is the pro rata portion of the annual lease value amount included in income calculated? 45. Under the ***full inclusion method***, how does an employer determine the number of days that an employee has the use of a demo vehicle? 46. What records must an employer maintain to satisfy the requirements for the ***full inclusion*** method? 47. What records must an employee maintain to satisfy the requirements for the ***full inclusion*** method?
APPLICATION OF GENERAL RULE When Methods In Revenue Procedure Are Not Used	**Section 7:** 48. What is the interaction of the method under Reg. Sec. 1.274-6T for an employer implementing a policy of no personal use except commuting through a written policy with the full exclusion or with the partial exclusion methods? 49. What amount of personal use mileage in addition to commuting would satisfy the de minimis personal use in addition to commuting under Reg. Sec. 1.274-6T? 50. What evidence would satisfy the requirement under Reg. Sec. 1.274-6T that the employer must maintain evidence that would enable a determination whether the use of the vehicle met the requirements? 51. What amount is included in the income of an employee if the use was not taken into account and included in income for the month in which the use of a demo vehicle was provided?
Effective Date	***Effective For Taxable Years Beginning On Or After January 1, 2002***
Citation	***Revenue Procedure 2001-56; 2001-51 IRB 1 (Nov. 29, 2001)***

(Continued from page 5)

not less than 1,000 hours per year), and derive at least 25 percent of gross income from sales activities.

In addition, the Revenue Procedure provides that the simplified method for full inclusion may be applied with respect to the use of a demonstrator vehicle by ***any*** employee of an automobile dealer. This means that department managers, controllers and other office employees and F & I personnel are eligible for the benefits of the simplified method for full inclusion.

An automobile dealer is not required to use the optional simplified methods described in Rev. Proc. 2001-56. In other words, the use of a simplified method is not mandatory. An auto dealer ***may*** use any other applicable method that complies with the Internal Revenue Code and Treasury regulations to account for the use of demonstration automobiles by employees.

The Revenue Procedure emphasizes two other background points. First, the Regulations generally provide that working condition fringe benefits may not be excluded ***unless the substantiation requirements*** of either Section 274(d) or Section 162 and corresponding regulations ***are satisfied.*** Second, even if business use of an employer-provided vehicle is a working condition fringe, the value of that use may not be excluded from the employee's gross income unless that business use is properly substantiated.

FULL EXCLUSION FOR QUALIFIED DEMO USE

Section 4 of Rev. Proc. 2001-56 describes the first simplified method through Questions and Answers 11-25. This simplified method only applies to "full-time" salespeople.

In order to legally avoid reporting any income in connection with the use of a demonstrator vehicle, there must be "qualified automobile demonstration use" of the vehicle by a full-time salesperson. If there is "qualified automobile demonstration use," the value of the use of the demo vehicle is excluded from the full-time salesperson's wages. As a result, the salesperson will not owe income or FICA taxes on the value of the use of the vehicle and the employer will not be required to withhold income taxes or pay FICA taxes with respect to the value of the use.

Requirements for the full exclusion ...

1. The use of the vehicle(s) must be in the ***sales area*** in which the dealership sales office is located. The ***sales*** area of the dealership is generally defined as the geographic area surrounding the automobile dealer's sales office from which the office regularly derives customers. Furthermore, a safe harbor rule provides that, as a minimum, the sales area may be treated as the area within a radius of 75 miles of the sales office (Reg. Sec. 1.132-5(o)(5)(ii)).

2. The use must be provided primarily to facilitate the salesperson's performance of services for the employer.

3. There must be substantial restrictions on the personal use of the automobile by the salesperson. This means all four of the following conditions must be satisfied:

- Use of the vehicle by individuals other than the full-time salesperson (e.g., the salesperson's family) is prohibited,
- Use for personal vacation trips is prohibited,
- The storage of personal possessions in the vehicle is prohibited, and
- The total use by mileage of the vehicle by the salesperson outside the salesperson's normal working hours ("personal use") is ***limited*** (see page 11.)

In order to use the simplified full exclusion method, the employer must also meet two further requirements. First, it must have a written policy limiting the use of the demonstration vehicle. Also (in order to use the full exclusion method) the employer must determine that the personal use of the vehicle is limited. This is necessary in order to establish that the restrictions provided by the Code and the regulations are satisfied. (Note: A written policy limiting the use of a demonstration vehicle is also required in order to use the partial exclusion method.)

If the use of the demonstrator (by one or more employees) does not satisfy the requirements for full exclusion, the employer must include some or all of the value of the use of the vehicle in the gross income of those employees using the methods for (1) partial exclusion or (2) full inclusion described below.

Requirements for the Simplified Method for Full Exclusion ...

1. The employer must have a qualified written policy limiting the use of the demo vehicle,

2. The employer must reasonably believe that the full-time automobile salesperson complies with the written policy,

3. The employer must determine, ***no less often than monthly,*** that the personal use of the vehicle by the full-time salesperson was limited, and

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4. The employer must maintain the records supporting the determination that the personal use of the vehicle by the full-time salesperson was limited.

Qualified written policy for purposes of the full exclusion ... A qualified written policy is considered to be in place if the employer has a written policy which establishes and communicates the following to each full-time automobile salesperson using a demo:

1. Use of the vehicle outside of normal business hours by individuals other than full-time salespeople ***is prohibited.***

2. Use of the vehicle for personal vacation trips ***is prohibited.***

3. Use outside of the sales area in which the employer's sales office is located ***is prohibited.***

4. Storage of personal possessions in the vehicle ***is prohibited.***

5. The total use by mileage of the vehicle by the salesperson outside normal working hours ***is limited to*** (a) commuting between the salesperson's home and the dealer's sales office and (b) to an additional average number of miles per day of 10 miles or less.

Reasonable belief that salesperson is complying with demo restrictions... Under the full exclusion method, the employer may ***reasonably believe*** that a salesperson complies with the prohibitions and limitations in its written demo policy where:

1. The calculations of total mileage outside of normal working hours indicate that the limit on personal use was not exceeded, and

2. The employer has no actual knowledge that the other requirements of the policy are not satisfied.

For example, if the employer had actual knowledge that a salesperson's family members used the demonstrator vehicle in violation of the policy, the use during the period does not qualify for the full exclusion even if the mileage records indicate that the limits on mileage outside of normal working hours have not been exceeded during the period.

Consider another common situation: Assume an employee using a demo is off for two weeks vacation. He or she keeps the demo during that time. The first odometer reading after returning to work shows an additional 1,800 miles driven on the vehicle during the period. The employee and his/her family took a vacation to a regional resort approximately 600 miles away. Under these circumstances, what can the employer reasonably believe (or what is the employer deemed to reasonably believe) about the use of the demo?

Limitation of personal use mileage for purposes of the full exclusion ... For a full-time salesperson, personal use is considered limited (as required under Section 132(j)(3)) if the total mileage the demo vehicle is used outside normal working hours, less commuting mileage, ***does not exceed an average of 10 miles per day.*** For this purpose, the mileage on each demo vehicle a salesperson uses for either commuting or personal purposes must be taken into account.

Determination of vehicle use outside of normal working hours ... The Revenue Procedure introduces the *Simplified Out/In Method,* by which an employer can determine the total mileage that a demo vehicle is used outside of normal working hours. Under the *Simplified Out/In Method,* the total miles that a demo vehicle is used during normal working hours is not taken into account and ***only mileage outside of normal working hours is considered.***

To satisfy this method, the mileage on the vehicle must be recorded under a reasonable system (1) at the ***end*** of the working hours of the salesperson using the automobile (out mileage) and (2) at the ***beginning*** of that salesperson's working hours on the next working day (in mileage).

Any reasonable system may be used for recording out and in mileage. For example, an employee other than the salesperson could record the mileage on the demo vehicles at the arrival and departure of the vehicle at the sales office on each workday.

A reasonable system would also include mileage entries for the vehicles by the full-time salespeople using the vehicle if there was random verification of the accuracy of the entries by an employee ***other than*** the salespeople at least once in every determination period.

Regularity of determining personal use ... The employer must regularly determine whether the average 10 miles per day of personal use has been exceeded. This determination must be made ***no less often than once each calendar month*** under the simplified full exclusion method.

If an employer chooses to make the determination every two weeks, the applicable period is two weeks, and the amount of personal use in addition to commuting allowed for the two weeks is 140 miles (14 days multiplied times 10 miles per day). If the employer chooses to make the determination monthly, the amount varies from month to month, depending on the number of days in the calendar month.

Allowable commuting mileage ... Commuting mileage is the total number of miles a demo vehicle is

see **VALUING THE USE OF DEMONSTRATOR VEHICLES,** page 10

(Continued from page 9)

driven by a salesperson when commuting to and from the dealer's sales office during the period at issue. For this purpose, ***commuting mileage*** includes only one round trip to and from the sales office per workday. The employer should assume that the commuting distance is the same for every day the employee drives the automobile to work unless the employer has reason to believe that the employee has moved.

A full-time salesperson's commuting mileage can be determined by any reasonable method. Reasonable methods include employee mileage records of a single commute, computer research programs identifying distance between the employee's home address and the dealer's sales office, or employee self-reporting that reasonably corresponds to the driving distance between the employee's home address and the dealer's sales office.

Commuting mileage is not necessarily limited to the most direct route between the employee's home and the sales office ... An employee can use any commuting route that is reasonable in time or mileage. However, an employee may not increase his or her reported commuting mileage to allow for additional personal use. The average 10 miles per day allowance is intended to provide limited personal use in addition to commuting. The Revenue Procedure provides two examples:

Example 1. A salesperson employee lives in a subdivision on the opposite side of a significant urban area from the sales office. Although a direct route through the urban area is shorter, using a highway around the urban area generally takes less time, although the actual mileage is greater. In this case, the employer can use the longer commuting mileage reflecting the use of the highway for purposes of determining the employee's personal use mileage in excess of commuting.

Example 2. A salesperson belongs to a fitness club located eight miles outside of any reasonable commuting route between the sales office and the salesperson's home. Even if the salesperson regularly stops at the fitness club on the trip home, the employer cannot include the additional eight miles in the commuting mileage for purposes of determining the employee's personal use mileage in excess of commuting.

Calculation of personal use under the full exclusion method ... The Revenue Procedure provides two examples showing the calculation of personal use and determinations of whether the requirement that personal use outside of working hours was limited in accordance with the qualified policy.

Example 1. The employer adopts the simplified out/in method and implements a written policy that satisfies the requirements of this Revenue Procedure. The employer chooses to determine personal use monthly. For a 30 day month, the total mileage for the automobiles used by full-time salesperson Y during the month is 1,450 miles. Based on the mileage recorded at arrival and departure during the month, 800 miles relate to use during normal working hours and is not taken into account. Salesperson Y's round trip commute is 15 miles and Y works 20 days during the month, for a total commuting mileage of 300 miles during the month. The total use outside of normal working hours is calculated by taking the 1,450 total miles and subtracting the use during working hours, resulting in 650 miles. Total use outside of normal working hours for the month, 650 miles, less commuting miles for the month, 300 miles, results in 350 miles. This is greater than 10 miles per day for 30 days (300 miles). Thus, use by salesperson Y is not considered to be limited during the month and salesperson Y does not qualify for the exclusion for the month. Nonetheless, salesperson Y may qualify for the partial exclusion under this Revenue Procedure if the requirements for that method are satisfied.

Example 2. The same facts as in Example 1, except that for a 31 day month, the total mileage for the automobiles used by full-time salesperson X for the month is 1,600 miles. Based on the mileage recorded at arrival and departure during the month, 720 miles relate to use during working hours. Salesperson X's round trip commute is 30 miles and X works 22 days during the month, for total commuting mileage of 660 miles during the month. The total use outside of normal working hours is calculated by taking the 1,600 total miles and subtracting 720 miles, the use during working hours, resulting in 880 miles. Total use outside of working hours for the month, 880 miles, less commuting miles for the month, 660 miles, results in 220 miles. This is less than 10 miles per day for 31 days (310 miles). Thus, use by X is considered to be limited during the month.

Records employer is required to maintain to comply with full exclusion method ... An employer must maintain the following records to satisfy the requirements for the full exclusion for any month:

1. A copy of the written policy on use,

2. Evidence that written policy was communicated to employees, such as a copy of a poster notifying employees of the policy, a copy of a letter or an electronic communication notifying the employee of the policy, or signed statements by the employees acknowledging receipt of the written policy,

see **VALUING THE USE OF DEMONSTRATOR VEHICLES**, page 12

CALCULATION OF WHETHER DEMO VEHICLE USE IS CONSIDERED LIMITED AND ELIGIBLE FOR THE FULL EXCLUSION METHOD

The Employer Must Determine, ***No Less Often than Monthly***, that the Personal Use of the Demonstrator Vehicle by the Full-Time Salesperson Was Limited. This Computation Format Follows the Examples in Rev. Proc. 2001-56.		***Example 1*** ***Applicable Period 30 Day Month***	***Example 2*** ***Applicable Period 31 Day Month***
Total Mileage Driven During Applicable Period	***(A)***	1,450	1,600
Normal Business Use (Miles Driven During the Day) (Based on Simplified Out/In Method) ... Presumably Bona Fide Demonstrator Drives with Potential Customers	***(B)***	(800)	(720)
Excess of (A) over (B) ... Equals Total Commuting & Other Personal Use Miles Driven	***(C)***	650	880
Commuting Miles			
• 20 Days x 15 Miles Daily Round Trip Commute	***(D)***	(300)	
• 22 Days x 30 Miles Daily Round Trip Commute	***(D)***		(660)
Excess of (C) over (D) ... Equals Personal (Non-business) Miles Driven Excluding Allowable Commuting Mileage	***(E)***	350	220
Question: Does ***(E)*** Exceed Average of 10 Miles Per Day Multiplied by the Number of Days in the Applicable Reporting Period? (Assuming Employer Establishes 10 Miles Per Day as the Maximum Non-Commuting Personal Mileage) Allowable Personal (Non-business) Use Excluding Commuting Use Cannot Be More than on Average of 10 Miles per Day, however, the Employer Can Make It Less in the Written Demo Policy Agreement			
Limitation on Use of Vehicle for Personal, Non-Commuting Purposes Assume Employer Limits Personal - Non-Commuting Miles to 10 Miles Per Day ... Number of Days in Applicable Period (AP)			
• 30 Days Monthly x 10 Allowable Non-Commuting Personal Miles Per Day	***(F)***	(300)	
• 31 Days Monthly x 10 Allowable Non-Commuting Personal Miles Per Day	***(F)***		(310)
Excess, If Any, of (E) over (F)	***(G)***	50	None
Note: The Question is: Is ***(G)*** a Positive Number? If the Answer Is "Yes," (i.e., if ***(E)*** Exceeds ***(F)***), then There Has Been too Much Non-Commuting Personal Mileage and the Use of the Demo Vehicle by the Employee: • Is Not Considered Limited (for this Applicable Period), and • The Demo Use ***Does Not Qualify for Full Exclusion***.		**Vehicle Use Is Considered *Not* Limited** **Eligible for Full Exclusion Method**	**Vehicle Use Is Considered Limited** **Eligible for Full Exclusion Method**

(Continued from page 10)

3. Records establishing that the salesperson's personal use by mileage was calculated no less often than once each calendar month. These records ***may*** include:

- Records identifying each demo vehicle assigned to each salesperson during the period.
- Records identifying the total mileage for each demo vehicle assigned to a salesperson during the period.
- Records supporting the total use outside of normal working hours under the *Simplified Out/In Method* and any verification of those records. In particular, the employer would maintain records of out and in mileage of the demo vehicles provided to full-time salespeople for each day the demo vehicle is used.
- Records identifying the round trip commuting mileage of each salesperson assigned a demo vehicle from salesperson's home to the dealer's sales office during the period.

The employee is required to maintain no records except to the extent that he or she is required to provide information to the employer to allow the employer to maintain the records and/or information noted above.

What if the limited personal use requirement is not satisfied?... In other words, what if the employee using the demo puts more personal miles on the vehicle than he or she is allowed to by the written policy? For each such full-time salesperson, ***the employer must include all or a portion of the value of the use of the demo vehicle for the period in the income of that full-time salesperson.***

For those employees, the employer may implement the partial exclusion method by including amounts in income either (1) in the current period or (2) in the period immediately following the current period.

Whichever method is chosen, the employer must implement the exclusion in a consistent manner. Thus, after determining that an employee does not qualify for the full exclusion for the month, the employer can include an amount in the employee's income for the current month. Alternatively, the employer can include an amount in the employee's income during the next month. In that case, the amount included in the next month under the partial or full inclusion method is determined by the number of days in the next month.

With respect to other full-time salespeople using demos whose mileage does not violate the personal use restrictions, the employer may continue to use the full exclusion method.

PARTIAL EXCLUSION FOR QUALIFIED DEMO USE

Section 5 of Rev. Proc. 2001-56 describes the second simplified method through Questions and Answers 26-39. This simplified method also only applies to "full-time" salespeople.

Partial exclusion method ... Under the partial exclusion method, an amount is included in the full-time automobile salesperson's income and wages no less often than monthly. The amount to be included in income reflects personal use of the demo vehicle and is based on the value of the use of that vehicle. Note: The amount included in income is not a function of non-business (personal) miles driven multiplied by a cents-per-mile amount.

The determination of the value of the use of the vehicle (to be included in income) for all practical purposes is determined by using the ***Annual Average Look Back Method.*** This is a new method, described in more detail below. Although employers are not required to use this method exclusively, the very presence and discussion of it in the Revenue Procedure suggest that few employers will want to wander from it using some other method, since this one has the IRS' blessing.

The remaining portion of vehicle usage is deemed to represent business use that is excludable from income and wages of the employee as a working condition fringe benefit.

Use of the partial exclusion method ... An employer choosing not to use the full exclusion method can use the partial exclusion method to account for the use of any demo vehicle by a full-time salesperson if the requirements of Rev. Proc. 2001-56 are satisfied.

Moreover, the partial exclusion method is also available if a full-time salesperson employed by a dealer otherwise satisfying the requirements for the full exclusion exceeds the average 10 miles per day of personal use ... if the full-time salesperson does not provide records with respect to business use of a demo vehicle. In such cases, the employer will generally be able to account for the use of the demo vehicle by using the partial exclusion method rather than including the full value of the use of demo vehicle in the income of the full-time salesperson.

Requirements for partial exclusion of demo vehicle use by a full-time salesperson ...

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1. The employer must have a qualified written policy limiting the use of the demo vehicle,

2. The employer must reasonably believe that the full-time automobile salesperson complies with the written policy,

3. The employer must account for the nondeductible personal use by any full-time automobile salesperson by including in gross income and wages a ***daily inclusion amount*** (specified in a table for that purpose) no less often than monthly, and

4. Maintain records which are necessary to support that accounting.

If requirements for the partial exclusion method are not met... If the use of the demo vehicle by a full-time salesperson does not satisfy the requirements for partial exclusion, the employer must include all of the value of the use of the vehicle in gross income of that employee using the method for full inclusion (described in Section 6 of the Revenue Procedure).

Qualified written policy for purposes of the partial exclusion ... A qualified written policy is considered to be in place if the employer has a written policy which establishes and communicates the following to each full-time automobile salesperson using a demo:

1. Use of the vehicle outside of normal business hours by individuals other than full-time salespeople ***is prohibited.***

2. Use of the vehicle for personal vacation trips ***is prohibited.***

3. Storage of personal possessions in the vehicle ***is prohibited.***

A model written policy for purposes of the partial exclusion is included in Appendix B of the Revenue Procedure. It should be noted that a qualified written policy under the full exclusion method may also be used for the partial exclusion method.

Reasonable belief that salesperson is complying with demo restrictions... Under the partial exclusion method, the employer may reasonably believe that a salesperson complies with the written policy if the employer has no actual knowledge that the other requirements of the policy are not satisfied. For example, if the employer had actual knowledge that a salesperson's family members used the demonstration automobile, the use does not qualify for the partial exclusion.

Determination of the value of the demo vehicles used by full-time salespersons ... An employer may use any reasonable method to determine the value of the demo vehicle used by a full-time salesperson. After the value has been determined, that amount is used in applying a per day inclusion amount taken from a table in the Revenue Procedure.

The Rev. Proc. indicates that it considers the ***Annual Average Look Back Method*** to be a reasonable method. Under this method, the value of the use of any new demo vehicle is based on the average sales price of all vehicles sold in the prior year. The average sales price is calculated by taking the sum of the sales prices of all new car and truck sales in the prior calendar year and dividing that sum by the number of new vehicles sold in the prior year. The average sales price is used to determine the value of the demonstration automobile and the corresponding daily inclusion amount under the table in Answer 35. This amount is included in the employee's income and wages for each day the employee used a demonstration automobile. The amount must be included in income at least monthly. The average sales price must be determined in January of each year and must be applied no later than February of that year.

For ***used*** vehicles that are being driven as demonstrator vehicles, the average sales price is calculated by taking the sum of the sales prices of all used vehicles for the prior year and dividing by the number of vehicles sold in the prior year. The value of a demo vehicle may only be based on used cars for salespeople using only used cars as demonstration automobiles; the average sales price of used cars cannot be combined with the average sales price of new cars for purposes of determining the value of demonstration automobiles that are new. If a dealership sells both new and used vehicles, the employer may use the value based on new vehicles as the value of the demonstration automobiles used by all salespeople. Alternatively, the employer may calculate the value of the demonstration automobiles separately for salespeople using used vehicles and salespeople using new vehicles.

An employer using the annual average look back method must maintain evidence supporting the calculation of the annual average sales price.

The Revenue Procedure provides two computation examples. In addition, it describes how an employer may determine the annual average sales price if more than one franchise is operated at or from a single location.

Example 1. In 2001, an employer sold 948 new vehicles for total gross sales of $23,226,000 (as shown on the year-end standard financial statement that the dealer provided to the manufacturer). In January 2002, the employer calculates the average

see **VALUING THE USE OF DEMONSTRATOR VEHICLES**, page 14

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sales price by dividing $23,226,000 by 948 vehicles, resulting in $24,500. For each month ending on or after February 1, 2002 to January 31, 2003 of the next year, for each full-time salesperson provided the use of a demonstration automobile, the employer includes in the salesperson's gross income $6, the amount from the table in Answer 35 based on that value, for each day in the month. This treatment is proper even if one full-time salesperson was provided only used demonstration automobiles. In addition, the employer keeps a copy of the factory statement that provided the amount of the 2001 sales and the number of vehicles sold as a record of his calculation.

Example 2. The same facts as in Example 1, except in addition to the new cars, the employer sold 233 used vehicles in 2001 for a total sales price of $2,903,248. Thus, the average sales price for the used vehicles is $12,456. While all the full-time salespeople sell used vehicles, only two full-time salespeople are provided used vehicles as demonstration automobiles. In this example, the value of the demonstration automobiles for the salespeople provided new cars as demonstration automobiles may not be based on the used cars sold in 2001. However, the employer may use $12,456 to determine the amount included in the income of the two full-time salespeople provided used cars as demonstration automobiles.

Determination of the annual average sales price if more than one franchise is operated at or from a single location ... The employer must use a consistent method for calculating the value of the demo vehicles. If more than one franchise is operated at a single physical location ("store"), the annual average sales price for all salespeople may be based on the combined sales of all franchises operating at the store. The value of a demo vehicles may only be based on used cars for salespeople provided used cars as demo vehicles; the average sales price of used cars cannot be combined with the average sales price of new cars for purposes of determining the value of the use of demo vehicles that are new.

However, if a salesperson is only provided demo vehicles from a single franchise operating out of the store, the employer may base the annual calculation of value for that salesperson on the sales of the specific franchise. In that case, the value for all salespeople in the store must also be based on specific franchises.

Similarly, if some salespeople receive demo vehicles exclusively from the store's used car inventory and other salespeople received demo vehicles exclusively from the store's new car inventory, the value must generally be calculated separately for each group of salespeople. However, if the store sells both new and used vehicles, the employer may also use the value based on sales of new vehicles as the value of the demo vehicles for all salespeople.

A special consistency rule is available if some salespeople sell automobiles and provide demo vehicles from more than one franchise operating out of the store; in that case, the value must be calculated consistently within groups of salespeople. For example, all salespeople assigned demo vehicles from a single franchise may have the value based on the specific franchise, and all salespeople assigned demo vehicles from more than one franchise may have the value based on the combined inventories of the franchises.

However, if two franchises operate out of a store, the employer could not base the value for salespeople of the less expensive franchise on the less expensive franchise while basing the value for salespeople of the more expensive franchise on the combined inventory. In that case, either the value for all salespeople must be based on the combined sales or the value for the two groups of salespeople must be based on the respective franchise sales.

Amount includable in income under the partial exclusion method ... For each day (including non-workdays) a full-time salesperson is provided the use of a demo vehicle, an amount is includable in income based on a special table according to the computed value of the demo vehicle. This daily inclusion amount must be included the full-time salesperson's income and wages ***no less often than monthly.*** The daily inclusion amounts range from $3 per day (if the computed value of the demo vehicle is less than $15,000) up to $21 per day (for demos with values in excess of $75,000).

Absent evidence to the contrary, full-time salespeople are assumed to have the use of a demo vehicle for every day of the period under consideration. Salespeople hired during the period are assumed to have use of a demo vehicle for every day from the date of hire to the end of the period. Salespeople that separate from service are assumed to have had the use of a demo vehicle from the first day of the period to the date of separation.

An employer may not elect (under Section 3402(s)) not to withhold income taxes from the portion of the vehicle fringe benefit required to be included under the partial exclusion method. Under Rev. Proc. 2001-56, the periodic inclusion inherent in the requirement to include amounts in income not less often than monthly is intended to substitute for more specific recordkeeping

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TABLES	PARTIAL EXCLUSION METHOD DAILY INCLUSION AMOUNTS BASED ON VALUE OF DEMOS
IF THE APPLICABLE METHOD IS ... *PARTIAL EXCLUSION BY FULL-TIME SALESPEOPLE* *(QUESTION 35)*	• These are the daily inclusion amounts, effective for years beginning on or after January 1, 2002. • These amounts must be included in a full-time salesperson's income and wages *no less often than monthly.* • Corresponding Federal income tax withholding and other applicable employee payroll taxes and matching employer payroll taxes are required. • Valuation of demonstrator vehicle must be determined under a ***reasonable method.*** The ***average annual lookback method*** is considered a reasonable method.

Value of the Demonstration Vehicle	*Daily Inclusion Amount*
$ 0 - $ 14,999	$ 3
$ 15,000 - $ 29,999	$ 6
$ 30,000 - $ 44,999	$ 9
$ 45,000 - $ 59,999	$ 13
$ 60,000 - $ 74,999	$ 17
$ 75,000 and above	$ 21

Valuing the Use of Demonstrator Vehicles

(Continued)

requirements for substantiating the use of the demo vehicle.

Annual inclusion and withholding of other employment taxes with respect to non-cash fringe benefits allowed under Announcement 85-113 (1985-31 I.R.B. 31), is unavailable under the methods provided by Rev. Proc. 2001-56.

Records employer is required to maintain to comply with partial exclusion method ... An employer must maintain the following records to satisfy the requirements for the partial exclusion for any month:

1. Records supporting the determination of the value of the use of demo vehicles. For these purposes, records identified in the description of "annual average look back method" for determining value will be considered adequate.

2. Evidence that the amount was timely included in the employee's income and wages. For example, copies of wage statements showing inclusion of the amounts no less often than monthly.

3. A copy of the written policy on the use of demonstrator vehicles.

4. Evidence that the written policy was communicated to employees, such as a copy of a poster notifying employees of the policy, a copy of a letter or an electronic communication notifying the employee of the policy, or signed statements by the employees acknowledging receipt of the written policy.

What records must an employee maintain to satisfy the requirements for the partial exclusion? The answer is simple: the employee is required to maintain no records.

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FULL INCLUSION FOR QUALIFIED DEMO USE

Section 6 of Rev. Proc. 2001-56 describes the third simplified method through Questions and Answers 40-47. In addition to applying to full-time salespeople who do not satisfy the requirements for either the full exclusion method or the partial exclusion method, the full inclusion method applies to any other dealership employees using demonstrator vehicles.

If the employee provided the use of a demo vehicle is not a full-time salesperson, the full exclusion and the partial exclusion methods do not apply.

To reduce recordkeeping with respect to use of a demonstrator vehicle by an employee who is not a full-time salesperson, the employer may include in the employee's income and wages each month the full value of the demo vehicle determined with no reduction to take into account business use. This method is called the ***full inclusion method.***

The amount to be included in income under the full inclusion method is based upon an annual lease value table which provides gradually increasing "daily inclusion amounts" corresponding to gradually increasing demo vehicle values. These are set forth in the table at Question 44.

Rev. Proc. 2001-56 states that other methods for excluding from an employee's income a portion of the value of the use of an employer-provided vehicle remain available for those employees that are not full-time salespeople.

Specific reference is made to Reg. Sec. 1.274-6T which generally allows an employer implementing certain written policies restricting personal use to account for commuting and de minimis personal use by any employee by including the $1.50 per one-way commute (provided under Reg. Sec. 1.61-21(f)(3)) in the employee's income and providing other evidence allowing a determination that use was actually limited. Generally speaking, however, this will not be applicable.

If use of a demo vehicle by a full-time salesperson does not qualify for the full exclusion or for the partial exclusion method, an amount is included in the full-time salesperson's income and wages no less often than monthly that reflects the full value of the demo vehicle, with no reduction to take into account business use.

An employer may use any reasonable method to determine the value of the demo vehicle provided to the employee. For this purpose, a reasonable method includes the "annual average look back method" which was identified and discussed as a reasonable method for determining the value of a demo vehicle under the partial exclusion method in Section 5 of the Rev. Proc.

The employer must account for the use of a demo vehicle by an employee who is not a full-time salesperson by including in gross income and wages for each day in each period (no less often than monthly) the greater of $3 per day or the pro rata portion of the amount specified in the annual lease value table (at Reg. Sec. 1.61- 21(d)(2)(iii)) using the value of the demo vehicle.

Simplified calculation of the pro rata amount to be included in income ... The pro rata portion of the annual lease value amount is the amount specified in the Annual Lease Value Table (at Reg. Sec. 1.61-21(d)(2)(iii)) using the full value of the demo vehicle, divided by 365, rounding to nearest dollar amounts. To simplify matters, the Revenue Procedure lists the daily inclusion amounts in a table at Question 44.

The employer's determination of the number of days that an employee has the use of a demo vehicle is simple. Absent evidence to the contrary, employees provided the use of a demo vehicle are assumed to have the use of the vehicle for every day (including non-workdays) of the period under consideration.

Records employer is required to maintain to comply with the full inclusion method ... An employer must maintain the following records to satisfy the requirements for the full inclusion method:

1. Adequate records supporting the determination of the value of the demo vehicle provided to the employee. For these purposes, records discussed in the descriptions of deemed reasonable methods (including the *Annual Average Look Back Method)* for determining value will be considered adequate.

2. Evidence that the amount was timely included in the employee's income and wages. For example, copies of wage statements showing inclusion of the amounts no less often than monthly.

Employees are not required to maintain any records under the full inclusion method.

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TABLES

FULL INCLUSION METHOD

DAILY INCLUSION AMOUNTS BASED ON VALUE OF DEMOS

- These are the daily inclusion amounts, effective for years beginning on or after January 1, 2002.
- These amounts must be included in employees' income & wages *no less often than monthly*.
- Corresponding Federal income tax withholding and other applicable employee payroll taxes and matching employer payroll taxes are required.
- Valuation of demonstration auto must be determined under any ***reasonable method***. The ***average annual lookback method*** is considered a reasonable method in this situation.

IF THE APPLICABLE METHOD IS ...

FULL INCLUSION METHOD

THE SIMPLIFIED METHOD FOR INCLUSION OF THE VALUE OF DEMO VEHICLES IF NEITHER THE FULL EXCLUSION NOR THE PARTIAL EXCLUSION METHODS APPLY

(QUESTION 44)

Value of the Demonstration Vehicle	*Daily Inclusion Amount*
$0 - 2,999	$ 3
3,000 - 4,999	$ 4
5,000 - 5,999	$ 5
6,000 - 7,999	$ 6
8,000 - 8,999	$ 7
9,000 - 10,999	$ 8
11,000 - 11,999	$ 9
12,000 - 12,999	$ 10
13,000 - 14,999	$ 11
15,000 - 15,999	$ 12
16,000 - 17,999	$ 13
18,000 - 18,999	$ 14
19,000 - 20,999	$ 15
21,000 - 21,999	$ 16
22,000 - 23,999	$ 17
24,000 - 24,999	$ 18
25,000 - 25,999	$ 19
26,000 - 27,999	$ 20
28,000 - 29,999	$ 21
30,000 - 31,999	$ 23
32,000 - 33,999	$ 24
34,000 - 35,999	$ 25
36,000 - 37,999	$ 27
38,000 - 39,999	$ 28
40,000 - 41,999	$ 29
42,000 - 43,999	$ 31
44,000 - 45,999	$ 32
46,000 - 47,999	$ 34
48,000 - 49,999	$ 35
50,000 - 51,999	$ 36
52,000 - 53,999	$ 38
54,000 -55,999	$ 39
56,000 - 57,999	$ 40
58,000 - 59,999	$ 42

For vehicles with value in excess of $59,999, the dollar inclusion amount is (.25 x value) + $500, divided by 365, rounded to nearest dollar amount.

Source: Reg. Sec. 1.61-21(d)(2)(iii)

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GENERAL RULE ... INCLUSION OF FULL FAIR MARKET VALUE IF OPTIONAL, SIMPLIFIED METHODS 1, 2 OR 3 DO NOT APPLY

Section 7 of Rev. Proc. 2001-56 describes the interaction of the simplified methods with the Section 274 regulations and the application of the general rule when neither of the three foregoing simplified methods apply.

Where demonstrator vehicles are provided by an employer, certain types of written policy statements can be used to implement a policy of no personal use, or no personal use except commuting, of the vehicle. Under Reg. Sec. 1.274-6T, the employee is not required to keep a separate set of records for purposes of the employer's substantiation requirements under Section 274(d) with respect to the use of a vehicle satisfying the written policy statement rules.

Among the requirements under Reg. Sec. 1.274-6T for a policy of no personal use except commuting is that the employer reasonably believe there is no personal use except for de minimis personal use in addition to commuting and that the employee does not use the vehicle for any personal use except for de minimis personal use in addition to commuting. Also among the requirements is that there be evidence that would enable the Commissioner to determine whether the use of the vehicle met the requirements.

Generally, in the case of a full-time salesperson, satisfying the requirements of this Regulation would satisfy the requirements for the full exclusion under Rev. Proc. 2001-56. Moreover, in the case of a full-time salesperson, the employer would not be required to include an amount in the income of the salesperson representing the value of commuting.

Splitting hairs over personal use mileage in addition to commuting... For purposes of Reg. Sec. 1.274-6T and Rev. Proc. 2001-56, ***de minimis personal use*** means personal use during the employee's commute and in conjunction with business use. In contrast, the ***limited personal use*** permitted under Section 132(j)(3) and the full exclusion method in Rev. Proc. 2001-56 allow the employee to use the vehicle for personal purposes, even if that use involves a departure from the commuting route.

Thus, if the employee stops on the commuting route for a personal purpose, that use constitutes de minimis personal use. However, if the employee travels to a location that is five miles away from the commuting route for a personal purpose, that use exceeds de minimis personal use even though it may be permitted under the full exclusion method described in this Revenue Procedure.

Evidence establishing that each salesperson's personal use by mileage was calculated no less often than monthly would support an employer's reasonable belief that the vehicle was not used for any personal purpose other than de minimis personal use in addition to commuting.

For that purpose, the out and in records under the simplified full exclusion method would constitute evidence that would enable a determination that the use of the vehicle met the requirements. However, as noted above, the additional average 10 miles per day would not be permitted as de minimis use.

Limited error correction mechanism... Finally, the Revenue Procedure raises the question of what amount is to be included in the income of an employee if the demo vehicle use was not taken into account and included in income for the month in which the use of a demo vehicle was provided.

The Rev. Proc. provides that if the error is identified and corrected during the calendar year the demo vehicle was provided, the amount included in income may be determined under the Revenue Procedure. ***If the error is not corrected during the calendar year in which the demo vehicle is provided, the amount included is determined under general valuation and substantiation rules.***

Example 1. In August, the employer determines that three employees provided the use of demo vehicles without limitations on personal mileage (and for whom amounts were included in income and wages under the partial exclusion method) did not qualify as full-time salespeople since June of that year. Beginning in August, the employer accounts for the use of demo vehicles by these three employees using the full inclusion method.

In addition, no later than December 31, the employer includes an amount in the three employees' income that is the difference between the amount that should have been included in their incomes under the full inclusion method for June and July and the amount actually included under the partial exclusion method. With respect to these employees, the employer satisfies the requirements of identifying and correcting the error during the calendar year.

Example 2. Two years after a demo vehicle was provided to an employee, it is determined that the employee was not a full-time salesperson qualifying for either the full exclusion or for the partial exclusion method. The employer did not include any amount in

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the employee's income with respect to the demo vehicle. The amount required to be included in income and wages for the year the vehicle was provided is the ***full fair market value*** of the demo vehicle. If there are not records substantiating the business use of the demo vehicle, the ***full fair market value*** is included without reduction.

FAIR MARKET VALUE ... TO PURCHASE ... OR TO LEASE THE VEHICLE?

Determining "fair market value"... In referring to the amount to be included in income in Example 2 as "full fair market value," the Service appears to leave open the question of whether that "fair market value" amount is determined as the amount that would be paid to ***purchase*** the particular vehicle or the amount that would be paid to ***lease*** that vehicle.

Regulation Section 1.61-21(d)(5) provides that the "fair market value" of the vehicle to be used in connection with the Annual Lease Value Table "is the amount that an individual would have to pay in an arm's length transaction ***to purchase*** the particular automobile in the jurisdiction in which the vehicle is purchased or leased. ...Any *special relationship* that may exist between the employee and employer must be disregarded. ...Also, the employee's *subjective perception* of the value of the automobile is not relevant to the determination of the automobile's fair market value."

The IRS position where the Annual Lease Value Table amounts are inappropriately applied is usually that, by default, the taxpayer is required to use the general valuation rules of Reg. Sec. 1.61-21 to determine the taxable value of the vehicle use fringe benefit. These general rules require that the fair market value be determined "on the basis of all the facts and circumstances." And, in these particular circumstances, that value equals the amount that an individual would have to pay in an arm's-length transaction ***to lease*** the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use (i.e., a one year period). Reg. Sec. 1.61-21(b)(4).

This was one of the issues in *BMW of North America, Inc. v. U.S.* For more on this see "Demo Valuations Hit Very Hard Again in *BMW of North America, Inc.," Dealer Tax Watch,* March 1999, page 4.

WHAT ADVICE SHOULD CPAs BE GIVING THEIR DEALERS NOW?

In general, the clarifications and introduction of simplified methods for reporting the value of the use of demonstrator vehicles by Rev. Proc. 2001-56 seem reasonable and user-friendly. In particular, the Service is looking for further input from dealers and practitioners on reasonable computation methods for determining the value of demo vehicles and the average annual look back method that it has said it will accept as reasonable.

Also, the Service is interested in receiving comments relative to the provisions in the Revenue Procedure concerning its error correction mechanisms. It would appear unlikely that many dealers will be able to make adjustments or corrections as promptly as in the month following the month in which demo use is not "limited" in the technical sense of that term.

We have included a sample letter on page 3 that may be used in bringing these new developments concerning the valuation of demos to the attention of your dealer clients.

Also, we have reproduced the Model Qualified Written Policy Language that the IRS included in the Revenue Procedure for the full exclusion method (pages 20-21) and for the partial exclusion method (page 22).

FULL EXCLUSION METHOD DEMONSTRATOR VEHICLE POLICY

REV. PROC. 2001-56 ... APPENDIX A

MODEL PLAN FORMAT

(1) This policy statement is designed for use by dealers that wish to adopt the out/in or partial exclusion methods of accounting for use of demonstrator vehicles provided to full-time automobile salespeople. It may also be used to explain the full inclusion method for vehicles provided to employees other than full-time automobile salespeople

*(2) Material in italics explains how to use the policy and should be deleted from the policy provided to employees and maintained by the dealership. Material **in bold** is optional and should be included only if it reflects the choices made by the dealership. Material IN CAPITALS is information that is specific to the dealership -- the dealership should insert the appropriate information.*

(3) Because the optional language in this model provides for specifying the amount included employee income, any dealer adopting that language should review the model annually to determine if inclusion amounts have changed; if the inclusion amounts have changed, the dealer should modify the policy to reflect the change and reissue it to employees provided demonstration automobiles.

MODEL QUALIFIED WRITTEN POLICY FOR FULL EXCLUSION [XYZ Dealership] DEMONSTRATOR VEHICLE POLICY

Full-time automobile salespeople at [INSERT NAME OF DEALERSHIP] **and certain other employees** may be provided with the use of a demonstration vehicle. We want you to understand the restrictions on use of demonstration vehicles and how employees who use demonstration vehicles will be taxed on that use.

RESTRICTIONS ON USE OF DEMONSTRATION VEHICLES

The demonstration vehicle must be available for test drives by customers during the normal working hours of the employee to whom the vehicle is assigned. Personal possessions may not be stored in the vehicle. Any personal possessions must be removed by the beginning of normal working hours.

The demonstrator vehicle is provided so that employees can become familiar with the features of the vehicles we sell. Only the employee to whom the vehicle is assigned may use the vehicle outside of normal working hours. It may not be used by family, friends, or neighbors.

The demonstrator vehicle is part of our inventory and must be available for sale to customers. It may not be used outside the dealership's sales area or for vacation travel.

(Insert any other restrictions the dealership has concerning use or maintenance of the vehicle.)

(Insert the following two paragraphs only if the "out/in" method will be used for full-time automobile salespeople.)

The demonstration vehicle may be used only for tests drives by customers or other dealer business, for a daily commute between the employee's home and the dealership, and for other limited personal use. Personal use is limited to [INSERT NUMBER NO GREATER THAN 10 MULTIPLIED BY THE NUMBER OF DAYS IN THE DETERMINATION PERIOD] miles during each [INSERT LENGTH OF A DETERMINATION PERIOD WHICH IS NOT MORE THAN ONE MONTH]. In order to minimize record keeping, all use during the employee's normal working hours will be treated as business use, and all use outside the employee's normal working hours will be treated as commuting or personal use.

The employee must ensure that mileage on the vehicle at the end of each working day, and at the beginning of the next working day, is properly [recorded] OR [verified] by [INSERT NAME, TITLE, OR JOB DESCRIPTION OF THE PERSON OR PEOPLE RESPONSIBLE FOR RECORDING OR VERIFYING MILEAGE].

(Continued on Page 2 of 2)

FULL EXCLUSION METHOD DEMONSTRATOR VEHICLE POLICY

REV. PROC. 2001-56 ... APPENDIX A

MODEL PLAN FORMAT

(Continued ... Page 2 of 2)

TAX TREATMENT OF USE OF DEMONSTRATOR VEHICLES

(Insert the next paragraph only if the "out/in" method is being used.)

Any full-time automobile salesperson who meets all of the above requirements, including limiting personal use to [INSERT NUMBER NO GREATER THAN 10 MULTIPLIED BY THE NUMBER OF DAYS IN THE DETERMINATION PERIOD] miles during each [INSERT LENGTH OF A DETERMINATION PERIOD WHICH IS NOT MORE THAN ONE MONTH] will not owe any federal [INSERT STATE OR LOCAL, IF APPROPRIATE] income tax or any Social Security or Medicare tax on the use of the demonstrator vehicle.

Any full-time automobile salesperson who meets all of the above requirements [*insert this material only if the "out/in" method is used* **except for limiting personal use or ensuring that mileage is recorded and verified**] will have **[INSERT APPROPRIATE NUMBER FROM TABLE IN ANSWER 35] dollars per day included in wages for each day on which the salesperson was assigned a demonstrator vehicle. Income tax, Social Security tax, and Medicare tax on this amount will be withheld from other wages owed to the salesperson.**

Any full-time salesperson who is provided with the use of a demonstration vehicle but does not comply with the restrictions on storage of personal possessions, use by people other than the employee, use outside the sales area, and vacation travel during a pay period will have the full value of the use of the demonstrator automobile included in wages for the pay period, resulting in [INSERT APPROPRIATE NUMBER FROM ANNUAL LEASE VALUE TABLE UNDER ANSWER 44] dollars per day included in wages for each day on which the salesperson was assigned a demonstrator vehicle. Income tax, Social Security tax, and Medicare tax on this amount will be withheld from other wages owed to the salesperson

(Insert the following bullet only if demonstration vehicles are provided to employees other than full-time salespeople.)

Any other employee who is provided with use of a demonstration vehicle and meets all of the above requirements [*insert this material only if the "out/in" method is used except for limiting personal use or ensuring that mileage is recorded and verified*] will have:

[INSERT APPROPRIATE NUMBER FROM ANNUAL LEASE VALUE TABLE AT QUESTION AND ANSWER 44] dollars per day included in wages for each day on which the salesperson was assigned a demonstrator vehicle. Income tax, Social Security tax, and Medicare tax on this amount will be withheld from other wages owed to the salesperson.

PARTIAL EXCLUSION METHOD DEMONSTRATOR VEHICLE POLICY

REV. PROC. 2001-56 ... APPENDIX B

MODEL PLAN FORMAT

(1) This policy statement is designed for use by dealers that wish to adopt the partial exclusion methods of accounting for use of demonstrator vehicles provided to full-time automobile salespeople.

*(2) Material in italics explains how to use the policy and should be deleted from the policy provided to employees and maintained by the dealership. Material **in bold** is optional and should be included only if it reflects the choices made by the dealership. Material IN CAPITALS is information that is specific to the dealership -- the dealership should insert the appropriate information.*

(3) Because the language in this model provides for specifying the amount included employee income, any dealer adopting that language should review the model annually to determine if inclusion amounts have changed; if the inclusion amounts have changed, the dealer should modify the policy to reflect the change and reissue it to employees provided demonstration automobiles.

MODEL QUALIFIED WRITTEN POLICY FOR PARTIAL EXCLUSION [XYZ DEALERSHIP] DEMONSTRATOR VEHICLE POLICY

Full-time automobile salespeople at [INSERT NAME OF DEALERSHIP] may be provided with the use of a demonstration vehicle. We want you to understand the restrictions on use of demonstration vehicles and how full-time salespeople who use demonstration vehicles will be taxed on that use.

RESTRICTIONS ON USE OF DEMONSTRATION VEHICLES

The demonstration vehicle must be available for test drives by customers during the normal working hours of the employee to whom the vehicle is assigned. Personal possessions may not be stored in the vehicle. Any personal possessions must be removed by the beginning of normal working hours.

The demonstrator vehicle is provided so that employees can become familiar with the features of the vehicles we sell. Only the employee to whom the vehicle is assigned may use the vehicle outside of normal working hours. It may not be used by family, friends, or neighbors.

The demonstrator vehicle is part of our inventory and must be available for sale to customers. It may not be used for vacation travel.

(Insert any other restrictions the dealership has concerning use or maintenance of the vehicle.)

TAX TREATMENT OF USE OF DEMONSTRATOR VEHICLES

Any full-time automobile salesperson who meets all of the above requirements will have [INSERT APPROPRIATE NUMBER FROM TABLE IN ANSWER 35] dollars per day included in wages for each day on which the salesperson was assigned a demonstrator vehicle. Income tax, Social Security tax, and Medicare tax on this amount will be withheld from other wages owed to the salesperson.

Any full-time salesperson who is provided with the use of a demonstration vehicle but does not comply with the restrictions on storage of personal possessions, use by people other than the employee, and vacation travel during a pay period will have the full value of the use of the demonstrator automobile included in wages for the pay period, resulting in [INSERT APPROPRIATE NUMBER FROM ANNUAL LEASE VALUE TABLE UNDER ANSWER 44] dollars per day included in wages for each day on which the salesperson was assigned a demonstrator vehicle. Income tax, Social Security tax, and Medicare tax on this amount will be withheld from other wages owed to the salesperson.

SECTION 62(c) ACCOUNTABLE PLAN APPEALS COURT REVERSES SUMMARY JUDGMENT AS TO PENALTY ASSESSMENTS, BUT UPHOLDS DENIAL OF PLAN BENEFITS

In the March 2000 *DTW*, we discussed two developments that indicated that the IRS was starting to look more carefully at the requirements for accountable plans under Section 62(c).

Specifically, we indicated that the requirement that reimbursements under an accountable plan must have a true business connection is far more difficult to comply with than some may have previously thought.

One of the developments we mentioned at that time was a District Court decision involving a delivery business and the interpretation of the same Section 62(c) accountable plan rules to its "reimbursement" payments. That case was *Shotgun Delivery, Inc.*, involving over $450,000 in Federal employment taxes, interest and penalties.

In that case, the United States District Court, Northern District of California, upheld the IRS' strict interpretation of the "business connection" requirement. The Court also imposed penalties on the delivery courier service even though it tried to argue that it had relied on its accountant for advice in connection with setting up the plan.

Although this case did not involve an automobile dealer, or service technician rental plans, the similarities between it and our concerns for dealerships makes a recent development in this case noteworthy.

Shotgun Delivery appealed the District Court's holding that summary judgment in its case was appropriate. The Ninth Circuit Court of Appeals granted it some relief when, on October 16, 2001, the Appeals Court held that whether Shotgun Delivery had reasonably relied on its accountant's advice in setting up the plan (and therefore should not be subject to penalties) was an issue that should have gone to trial.

In *Shotgun Delivery, Inc. v. U.S.* (88 AFTR 2d, ¶ 2001-5418), the focus of the inquiry of the Appeals Court was "whether, viewing the evidence in the light most favorable to Shotgun (the non-moving party), any genuine issues of material fact remain in dispute."

The District Court concluded that Shotgun had failed to establish an adequate business connection for its reimbursement payments, and that conclusion was agreed to by the Appeals Court. Shotgun appealed its liability for penalties on the ground that it had reasonably relied on the advice of its outside accountant, Robert Borelli. The Appeals Court said: "In general, 'when an accountant...advises a taxpayer on a matter of tax law, such as whether liability exists, it is reasonable for the taxpayer to rely on that advice.'" (Citations omitted.)

It added, "Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place."

The Appeals Court said the record amply supported the conclusion that the reimbursement plan Shotgun adopted was formulated based on Mr. Borelli's professional advice. Although the District Court criticized Shotgun's implementation of the plan for deviating from Mr. Borelli's recommendations, Shotgun had offered evidence to the District Court that such deviations were inadvertent.

The Appeals Court said that under its holding, Mr. Borelli's plan was just as flawed as that which Shotgun actually implemented. It said, "The District Court's criticism that 'Shotgun failed to consult Borelli subsequent to instituting their plan to ensure proper compliance,' is misplaced for the same reason. Drawing all possible inferences in Shotgun's favor, a finder of fact could find that Shotgun's reliance was reasonable and that penalties were not warranted."

Therefore, the Appeals Court reversed the District Court's summary judgment as to penalties, meaning that that issue should have gone to trial.

It will be interesting to follow this case further if the penalty issue actually proceeds to trial.

DEALERS CAN'T HAVE FAST WRITE-OFF OF PREMIUMS PAID FOR VEHICLE SERVICE CONTRACT INSURANCE ... APPEALS COURT UPHOLDS TAX COURT IN *BOB WONDRIES MOTORS, INC.*

In the June 2000 *Dealer Tax Watch*, we analyzed the Tax Court's decision in *Toyota Town, Inc.* (T.C. Memo 2000-40). In this case, the holding was that a group of auto dealerships could not, by creative accounting, get around the requirements of the Rev. Procs. 92-97 and 92-98 which effectively combine to provide dealers selling vehicle service contracts with significant tax relief.

The taxpayers in this case decided not to accept the Tax Court's holding in *Toyota Town, Inc.* and took the case up to the Ninth Circuit Court of Appeals. In that venue, the case was *Bob Wondries Motors, Inc. d/b/a Wondries Ford.* If anything, the fact that this case in the Tax Court was given the status of a Memorandum decision, rather than that of a regular decision, might have provided some insight on the taxpayers' chances at Appeal. In any event, on October 23, 2001 the Appeals Court filed its decision upholding the IRS and the Tax Court.

In the interest of fair disclosure, it might be appropriate to repeat the warning that introduced the discussion of this case in the June 2000 *Tax Watch*. In that article, we said, "This article could put you to sleep quickly. If you stay awake and read it, it could bore you to tears unless you're really a serious student of dealer/obligor VSCs." Similarly, if your reaction on seeing the title of this article was something along the lines of ... "That's not really news, I knew that all along...," you can probably stop reading right here, right now.

For the benefit of those wishing more detail, we have included a summary of the facts on the facing page and will, but briefly, follow through with the basics.

CAN'T USE THE SAME "AS IF" ASSUMPTION FOR EXPENSES THAT IS REQUIRED TO BE USED FOR INCOME

What the Wondries/Toyota Town dealerships attempted to do was to write-off the insurance premium costs as if each insurance contract had been paid for on the first day of the taxable year in which the extended warranty agreement had been sold.

Revenue Procedure 92-98 (superceded in 1997 in all material respects by Revenue Procedure 97-38) treats the proceeds from the sale of extended warranty agreements as if they had been received on the first day of the taxable year in which the warranty agreement was sold for purposes of computing the amount of income required to be included each year in connection with those sales.

Apparently, these dealers believed that it should be equally appropriate for the corresponding deduction for insurance premium costs to use the same *"as if"* or *"deemed"* date as the beginning of the year for convenience or practicality purposes.

Therefore, they took deductions for the amounts paid to Western General for the assumption for the vehicle service contract liabilities by capitalizing such amounts and amortizing them in a manner which departed from the method required by Revenue Procedure 92-97.

The taxpayers computed their amortization deductions using an accounting convention under which the premium payment and policy inception were deemed to have occurred on the first day of the taxable year in which the policy was purchased, irrespective of the actual date of payment and policy inception.

The Tax Court said, "This methodology, which resembled the convention prescribed in Rev. Proc. 92-98 for the recognition of income from the qualified advanced payment amount resulted in Petitioners' taking amortization deductions in the first taxable year of a policy's inception equal to a full year's worth of amortization, without regard to the actual date of payment and policy inception.

"In effect, this increase in the first year's amortization deduction caused it, as well as each ensuing years' deduction, to match the ratable portion of the deferred EWA (extended warranty agreement) income required to be included pursuant to the terms of Revenue Procedure 92-98.

"As a result, the 'net' income recognized by Petitioners consisted only of the excess of the aggregate EWA prices charged to the Petitioners' customers over the aggregate premiums paid by Petitioners to Western General in the year of inception of an EWA, plus the imputed income represented by the interest-equivalent factor in each of the years of the contract term."

see **DEALERS CAN'T HAVE FAST VSC WRITE-OFF**, page 26

THE FACTS

Bob Wondries Motors, Inc. d/b/a Wondries Ford v. Comm. (82 AFTR 2d, ¶ 2001-5449) Toyota Town, Inc. (T.C. Memo 2000-40)

This case involves several dealerships and various individual shareholders of dealerships being operated as S-corporations. The years involved were taxable years ending in 1991, 1992 and 1993. These years bridged the introduction of Revenue Procedure 92-97 and 92-98 and the SWIM (Service Warranty Income Method) and its correlative adjustments.

The dealer was the primary obligor in the sale of extended warranty agreements (which the Court referred to as EWAs). Each EWA or VSC (vehicle service contract) expressly provided that it was a service contract between the dealer and the vehicle purchaser and it described the dealer as acting as a principal (and not as an agent) on behalf of any insurer.

The dealer did have an arrangement with Western General Insurance Company, an unrelated entity. Under this arrangement, the dealer purchased (for a single lump sum payment with respect to each vehicle service contract) coverage under which Western General agreed to issue and maintain individual insurance policy coverage at the dealer's expense which would insure a dealer for covered cost of repairs and/or replacements incurred by the dealer and covered under the extended service warranty agreement.

The dealerships elected to report their income under the Service Warranty Income Method provided in Revenue Procedure 92-98. This election allowed them to defer the recognition of a portion of the advance payment over the life of the service warranty obligation. Under the Rev. Proc., the amounts that were treated as qualified advance payments were spread over the life of the contracts, along with the appropriate non-deductible imputed interest amount. For purposes of computing the deferral period and the "interest equivalent" imputed income, all advance payments for service warranty contracts sold during the taxable year were effectively treated as if they were entered into, and payments were received, on the first taxable day of the year.

This assumption that all contracts were treated as if they were entered into on the first day of the taxable year was simply a convenience to make the computations less complicated. Otherwise, specific identification of the starting date of each contract and its applicable amortization period would have been required.

The Tax Court was aware that Revenue Procedure 92-98 allowing dealers to use the SWIM method attached further conditions to the use of that favorable election. One of these conditions was that the SWIM method was not available to a dealer unless the dealer used the proper method of accounting for amounts paid or incurred for insurance costs that covered the dealer's risks under the service warranty contracts.

Revenue Procedure 92-97, in addressing the accounting for insurance costs, provides that the lump sum amounts paid in advance for multi-year insurance policies...to insure a consumer durable goods seller's obligations to customers under multiple warranty contracts sold to them...must be capitalized and pro-rated or amortized over the life of the insurance policy.

The dealerships took deductions for the amounts paid to Western General by capitalizing the payments and amortizing them, using an accounting convention under which the premium payment and policy inception were deemed to have occurred on the first day of the taxable year in which the policy was obtained, without regard to the actual date of payment and policy inception. This accounting treatment caused the first year's amortization deduction, as well as each succeeding year's amortization deduction, to match the ratable portion of the deferred EWA income required to be included pursuant to the terms of Rev. Proc. 92-98.

As a result, the net income recognized by dealerships consisted only of the excess of the aggregate EWA prices charged to their customers over the aggregate premiums they paid to Western General in the year of inception, plus the imputed income represented by the interest-equivalent factor in each of the years of the contract term.

The Commissioner determined that the dealerships incorrectly computed their deduction for insurance costs in the year a policy was purchased by taking a full year's worth of amortization rather than amortization measured from the actual date of the policy's inception and payment of the premium.

The issue involved was whether the dealerships could deduct insurance premium expense incurred in connection with the sales of extended warranty agreements under the convention that they had initially adopted, or whether those insurance premium expenditures had to be amortized ratably over the years in issue.

In *Toyota Town, Inc.* (T.C. Memo 2000-40), the Tax Court held that the IRS was right and that ratable amortization was proper. The dealerships appealed the decision of the Tax Court.

In *Bob Wondries Motors, Inc.*, the United States Court of Appeals for the 9th Circuit affirmed the IRS and the Tax Court.

(Continued from page 24)

The Appeals Court said, "The Commissioner administratively established in Rev. Proc. 92-98 a method of accounting for certain prepaid services income of accrual basis taxpayers engaged in the sale of multi-year service warranty contracts for which third-party insurance is obtained. Taxpayers ***elected*** this method, which permits deferral of a portion of the prepaid service income equal to the amount which is paid over to a third party to assume the risk under the warranty contracts. Having done so, taxpayers could not ignore Rev. Proc. 92-98's prescribed method of accounting for the insurance expense associated with the warranty contracts set out in Rev. Proc. 92-97. Rev. Proc. 92-97 requires taxpayers to take a proportionate deduction in the year the policy was sold."

The Appeals Court agreed with the Tax Court that dealerships could not avail themselves of the benefits of deferral provided by Rev. Proc. 92-98 without adhering to its conditions as well.

THE COMMISSIONER WAS REASONABLE... THERE WAS NO ABUSE OF DISCRETION

The dealerships had argued unsuccessfully in the Tax Court that the Commissioner had abused his discretion in requiring them to change their method of accounting for expensing insurance costs.

The Tax Court had said the dealers were wrong for at least two reasons. First, it was not an abuse of discretion by the Commissioner to establish ***reasonable*** conditions on the use of an accounting method that has been established administratively. Second, the dealers would not be entitled to use the premium amortization method they were using because it was in direct violation of the Regulations.

The dealerships' claims for a full year's amortization in the first year that a multi-year insurance policy was acquired or placed in service, without regard to the determination of when during the year the policy was in fact placed in service, directly convenes the rule in Reg. Sec. 1.167(a)-10(b). That rule allows only a "proportionate part of one year's depreciation" in the first and last years of a period of service.

The Tax Court overruled the dealers' contentions stating that a method of accounting that is "plainly inconsistent" with valid regulations does not clearly reflect income within the meaning of Section 446(b).

The Appeals Court, citing *Thor Power Tool v. Comm.* to the effect that "there is no dispute that the Commissioner has broad discretion in determining whether a chosen accounting method clearly reflects income," added the following in upholding the Tax Court:

"The effect is not to force a change from an accounting method which clearly reflects income to an alternate method that does not, as taxpayers contend. They (i.e., the dealerships) could instead have chosen to include the entire proceeds from EWA sales in income in the year of receipt. They submit that it is unfair to treat the recognition of service warranty income and the corresponding deduction inconsistently, and to apply an accounting method that fails to match income with expenses.

"Yet matching of income and related expense does not necessarily result in a clear reflection of income for tax purposes. "[A] taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of 'generally accepted commercial accounting principles'" (citing *Thor Power Tool, Co.*, and *American Automobile Association v. United States*).

"Further, as the Tax Court noted, without the benefit of Rev. Proc. 92-98, taxpayers would have been obliged to recognize the qualified advance payment to the third-party insurer in the year of receipt. This would yield an even greater mismatch of extended warranty income and associated insurance expense. Put differently, we are not persuaded that it is arbitrary or unlawful for the Commissioner to allow taxpayers favorable deferral of income, as Rev. Proc. 92-98 does, without at the same time accelerating deductions more than they already are."

Although there is considerably more discussion on the matter of "reasonable administrative conditions," in the June 2000 *DTW* article, there is no reason to repeat all of that here.

THE LIMITED EXCEPTION IN *RAMEAU JOHNSON* DID NOT APPLY

The taxpayers in *Wondries/Toyota Town* tried to fit their situation within the narrow exception that the Appeals Court allowed in the *Rameau Johnson* appeal. (See *Selected Articles*.)

However, the Appeals Court agreed with the Tax Court that facts in the *Wondries/Toyota Town* case do not fall within the exception language allowed by the Court of Appeals for the Eighth Circuit when it upheld the Tax Court's holding in *Rameau Johnson* that the cost of insurance premiums was required to be capitalized and amortized over the life of the insurance coverage.

The taxpayers in *Wondries/Toyota Town* had stipulated that all of the amounts it paid that were in dispute were paid for ***insurance costs***. In contrast, the reversal of a part of *Rameau Johnson* by the Court of Appeals was only with respect to certain ***fees paid***

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for administrative services provided by an administrator unrelated to the insurer, and that holding was that such fees were deductible in the year of payment.

Therefore, the fact that insurance costs, rather than fees paid for administrative services were involved, distinguished the *Wondries/Toyota Town* situation from that at issue in *Rameau Johnson.*

The Appeals Court rejected the dealers' arguments that certain other issues (1) should have been heard (but, they were not heard because they had not been properly raised in the petitions filed); and/or (2) had been adequately raised in their trial memorandum (but, they were not heard because the dealers' own stipulations contradicted their arguments on these points).

THE MORAL OF THE STORY

The moral of story for the Wondries/Toyota Town dealerships was reaffirmed by the Ninth Circuit. Taxpayers can't expect to have it both ways: They can't expect the benefit of a tax deferral under the SWIM method while at the same time accelerating deductions of the write-off of the cost of the insurance premium paid to protect themselves against loss on those policies.

SELECTED DEALER TAX WATCH ARTICLES ON VSCs

*Dealers Can't Have Fast Write-Off of Premiums Paid for Vehicle Service Contract Insurance ... IRS Prevails Again in **Toyota Town, Inc. et al. v. Comm.*** June, 2000. pg. 14.

Dealer Off-Shore Reinsurance Arrangements Get Some Favorable Guidance From Three Recently Published IRS Documents: LTR 199924001, FSA 1999-953 & ITA 199932007. September, 1999. pg. 17.

Appeals Court Upholds Immediate Tax on Rameau Johnson's Service Contract Sales, But Allows Immediate Deduction for Matching Costs. September, 1999. pg. 6.

*Issues & Holdings in **Rameau Johnson.*** September, 1999. pg. 7.

VSCs, Dealer Obligors & the Service Warranty Income Method (SWIM). September, 1999. pg. 10.

How the SWIM Method Works: Rev. Proc. 97-38. September, 1999. pg. 12.

Checklist for VSC Issues & Problem Areas. September, 1999. pg. 14.

PORCs: More Attractive After TRA '97. March, 1998. pg. 16.

VSCs, Rev. Procs. 97-37 & 38, and the SWIM Method . September, 1997. pg. 6.

*Advances from Offshore PORC to Dealer Are Taxable Dividends - **Wm. F. McCurley.*** September, 1997. pg. 30.

*Dealers Using Escrow Funds for VSCs Can't Avoid Full Tax on Proceeds in Year of Sale...**Rameau Johnson.*** September, 1997. pg. 15.

*What the Tax Court Said in **Rameau Johnson.*** September, 1997. pg. 23.

***Hinshaw's, Inc.** - Tax Treatment of VSCs ... LTR 9417028.* September, 1994. pg. 22.

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