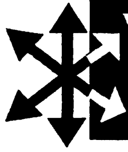
Willard J. De Filipps, CPA, PC
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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. INDEX OF *DTW* ARTICLES THROUGH DEC. 2002 IS NOW AVAILABLE. We have updated and expanded our previous index of all articles appearing in the *Dealer Tax Watch* from our first issue, June, 1994, through December, 2002.

This *Index of Articles* has eight sections. In addition to listing all articles by subject, there are *Finding Lists* for all tax cases, IRS Coordinated Issue Papers, Field Service Advice Memoranda, Letter Rulings (including TAMs), Revenue Rulings, Revenue Procedures and the *Practice Guides* included with various articles. In this revision, we have also added (1) Bibliographies and Lists of Further Suggested References that appeared with various articles and (2) a Contributing Authors List.

You can view and print the entire *Index of Articles* on our web site, www.defilipps.com. A limited number of printed copies is available upon request.

#2. PORCs ... STILL SIZZLING. We received a lot of positive feedback on our coverage of IRS Notice 2002-70 in our last issue. Several readers expressed their appreciation for the disclosure statement pro forma, especially after the message sunk in that dealer PORCs really are under the IRS' magnifying glass.

You may have noticed the article on this subject in the March 31 issue of the *Automotive News* in which it is estimated that several thousand dealers are expected to be affected by the IRS' disclosure requirements. Worse yet, did you see the Feb. 14, 2003 *Wall Street Journal* article on this? What a disaster!

We always encourage input from informed individuals. In this regard, we are pleased to include *An Update on PORCs and IRS Notice 2002-70*, authored by Kevin L. Woodruff, CPA, beginning on page 3.

In his update, Kevin points out that it is the promoters ... almost more than the dealers ... who may be at risk in this whole affair. He concludes that because most dealers and tax professionals incorrectly assume that all PORC reinsurance promotions were properly and similarly structured transactions using conventional insurance techniques, it will be the dealers who will have to learn the hard way that this is simply not the case.

LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients—and, in the process, to help yourself.

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Based in Dallas, Kevin has extensive industry experience and credentials. There is a substantial "cost" in terms of your professional time in trying to understand what is required and how any dealer client with a PORC must respond to these requirements. One place you can go to for in-depth information is the one-day seminars on PORCs and Notice 2002-70 that Kevin will be presenting several times in June. For more information on his seminars, see pages 6-7 and/ or e-mail him at porctaxissues@aol.com.

Please note that as a subscriber to the *Dealer Tax Watch*, Kevin has extended to you a substantially reduced registration fee for his seminar.

#3. REASONABLE COMPENSATION. One case recently came to our attention where dealer compensation was a major issue. But it was not an issue between the IRS and the dealer. It was an issue between the silent partner in a dealership and the dealer who was involved in the active, day-to-day dealership management.

The bottom line was that the Appeals Court found that the dealer's compensation, averaging about 1.6% of sales over a 9-year period, was not excessive. This case involved a Ford dealership in Tennessee, and it is discussed on page 8.

#4. IRS VIEWS DEALER'S ACQUISITION OF A NEW FRANCHISE AS AN "EXPANSION" OF HIS EXISTING BUSINESS. The IRS recently issued a favorable Ruling that could make it easier for dealers who want to realign their dealerships by setting up parent-subsidiary corporate relationships.

Several years ago, the *Dealer Tax Watch* included an extensive analysis of Section 355 and dealer rulings involving tax-free spin-offs and split-offs. Recent Revenue Ruling 2003-18 evidences a taxpayer-friendly attitude towards a dealer who wanted to use a tax-free spin-off transaction to rearrange his ownership interests. For more on this, see page 10.

#5. TWO USED CAR AUTO DEALERS STRIKE OUT WITH THE IRS. In the Tax Court case reported on page 14, two used car dealerships were unsuccessful in defending their accounting practice of writing off losses on repos and in writing down their inventories under the lower-of-cost-or-market method. Note: Both of these are really "timing" issues.

What really hurt the dealers was the fact that they did not have decent records. How could this outcome, the IRS' initial adjustments or the Tax Court's support for them, ever have been in doubt?

#6. BUY-HERE, PAY-HERE DEALERS CONFERENCE COMING IN MAY. Another special conference of interest to dealership niche professionals is the National Convention for Buy-Here, Pay-Here Dealers to be held at Caesars Palace in Las Vegas, May 21-23. This conference is in its 5th year and it is hosted by the National Association of Buy-Here, Pay-Here Dealers (NABD). In one of the sessions, your editor, Will De Filipps, will join Terri Harris, the IRS MVTA, and Ken Shilson discussing all the current tax issues and developments of interest to used car dealers.

Readers of the *Dealer Tax Watch* are familiar with the many contributions that Ken Shilson has made in sharing used car dealer / BHPH information in various articles and in his efforts on behalf of NABD.

NABD has extended to subscribers to the *Dealer Tax Watch*, a substantially reduced registration fee for this conference. See page 17 for more details.

#7. WATCH THOSE GIFT TAX RETURNS. In ILM 200221010, the IRS concluded that the disclosure in a gift tax return of the gifts of interests in a limited liability company was not detailed enough to get around the statue of limitations.

The ILM provides some reassurance that we were not overly cautious in our recommendations in a previous issue of the *Dealer Tax Watch* (March 2000) regarding the need for full and adequate disclosure of gifts in gift tax returns. For more on this ILM, see page 18.

#8. VEHICLE DONATION PROGRAMS: THE WRONG WAY & THE RIGHT WAY. In TAM 200243057, we have the opportunity to see (although not too clearly, because the dealer would not cooperate with the IRS in disclosing all of the facts) just how much trouble one used car salesman got himself--and his family--and a whole bunch of related entities--into when he messed around with trying to set up a Section 501(c)(3) organization.

It would seem that he couldn't have been greedier, or sloppier and that things couldn't have turned out worse, from a tax standpoint.

Standing opposite to this example, for dealers who might want to really benefit charitable organizations by collecting and disposing of used vehicles, Revenue Ruling 2002-67 provides some much-needed guidance. Both the TAM and the Revenue Ruling are discussed in the article beginning on page 21.

#9. WHAT ARE AUTO DEALERS BIGGEST CONCERNS? At the NADA Convention earlier this year in San Francisco, dealers told the Factories their biggest concerns going forward into 2003. These concerns are summarized on pages 26-27. *

AN UPDATE ON PORCs AND IRS NOTICE 2002-70 by Kevin L. Woodruff, CPA

PORCs 2002-70

With the announcement (Notice 2002-70) by the IRS on October 15, 2002 that certain transactions involving producer-owned reinsurance companies (PORCs) may be disallowed – it is now more important than ever for tax professionals to take a closer look at their clients' PORC strategies. According to the Notice, the IRS intends to challenge those PORC transactions it regards as abusive tax avoidance schemes that lack "economic substance" and a "business purpose." If the IRS determines any of these transactions to be abusive, participants in (and promoters of) these schemes will pay a severe financial price.

What is the IRS doing now about the abusive PORC arrangements described in the Notice? It now appears the IRS, with the full support of the Treasury Department, intends to clean-up abusive PORC arrangements and Notice 2002-70 is the first warning shot to abusers. In an April 4, 2003, *New York Times* article, Ms. Pam Olson, Assistant Secretary of Treasury for tax policy said the Treasury has already directed the IRS to aggressively pursue abuses of tax-exempt (i.e. Section 501(c)(15)) insurance companies.

In the article, Ms. Olson stated, "We are in a target-rich zone because we had too many years of no enforcement going on and that is the hole we are trying to dig ourselves out of now." Ms. Olson anticipates considerable activity by the IRS in the tax-exempt insurer area in the very near future.

Are properly structured PORCs okay? In reality, properly structured PORCs are effective tools to manage risk, control costs and create additional profit opportunities (not to mention the "estate planning" possibilities). What's more, the IRS has publicly stated that properly structured reinsurance programs (including PORCs) will be respected as legitimate business activities.

What has the IRS most likely discovered in the tax-exempt 501(c)(15) determination process? In the past, promoters actually used the IRS as a selling point. Promoters told their clients that because PORCs applied for and received favorable determination letters from the IRS' National Office recognizing them as tax-exempt organizations under IRC Section 501(c)(15) their promotions were okay. This representation could only be correct if the information provided to the IRS during the determination process was complete and accurate and consistent with the actual operations of the PORC thereafter.

In some cases, critical documents representing the true contractual and economic relations between the parties may have been withheld from the IRS. In other cases, the parties described in the application may have simply ignored the form of the transaction or, in substance, the actual transactions might not establish *bona fide* insurance relationships. In any case, written determination letters will <u>not</u> provide cover for PORCs who have wrongfully obtained exemption under Section 501(c)(15).

So, what is the problem? Quite simply, certain promoters (with the help of their advisors) have developed and are currently marketing "questionable" reinsurance schemes to dealers. These programs are designed to resemble legitimate insurance arrangements that purportedly "transfer risk" (or shift income) to PORCs (or other similar "shell" insurance companies) that result in significant tax benefits for participants.

However, there are a number of serious questions and concerns about the propriety (i.e., substance) of many of these unconventional tax-motivated "insurance" transactions. For example, several unconventional PORC transactions might allow a critical reviewer to contend that they involve nothing more than a simple sleight-of-hand or "wink and nod" deception.

Which "tax insurance products" are susceptible to abuse? Industry experts now believe that vehicle service contracts represent the largest single category of insurance premium "ceded" to, and reinsured by, auto dealership affiliated PORCs. It is suspected that the majority of abusive tax avoidance transactions with respect to Notice 2002-70 in the auto industry are directly related to the reinsurance of vehicle service contracts and other <u>non-insurance</u> aftermarket financial products. Although these non-insurance financial products are not abusive per se, they can be easily manipulated (and abused) since they are non-regulated transactions.

Are dealers responsible for the abuse? Certainly, some dealers may abuse particular aspects of a specific PORC arrangement–such as, transfer pricing issues (i.e., over-remits) and shareholder loans from their PORC–but none of these could occur without the knowledge of the promoter. As in any related party transaction, PORCs provide the opportunity and fertile ground for self-dealing and some dealers will certainly push the limits, if allowed. While these types of transactional abuses may be disallowed and income reallocated to the appropriate tax-

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 (Continued from page 3)

payer, the entire PORC promotion should not be "doomed" – unless, of course, the underlying program itself is improperly structured.

However, in the case of abuses described in the Notice, the dealer will probably be the unfortunate loser if any PORC promotion is determined to be abusive. In all likelihood, most, if not all of these dealers probably never intended to participate in an improper or abusive PORC insurance arrangement and relied solely on their promoters and service providers to ascertain state insurance regulatory compliance and state and Federal income tax compliance. Unfortunately, some dealers may have bought into PORC arrangements in an attempt to (what they presume is legally) avoid both state and Federal income taxes that, if determined to be an abusive tax shelter, could result in an unintended reallocation or an acceleration of taxable income to the dealer or related party taxpayer.

This view is further supported by the fact that many dealers are still not even aware of or informed about the Notice and its potential adverse tax consequences. Tax professionals need to alert their dealers to disclosure requirements that must be made in their 2002 Federal income tax returns and related disclosure requirements with the Office of Tax Shelter Analysis in Washington D.C.

Why, then, are promoters most likely to be blamed for abusive arrangements? The simple answer is because promoters designed the structure of all of their dealer-clients' PORC arrangements and then exercised almost complete control over the transactions thereafter. Furthermore, promoters and their advisors should have done the necessary research to insure adequate regulatory and state and Federal income tax compliance.

Like most promotions sold to dealers today, PORC promoters offer a comprehensive pre-packaged turnkey financial arrangement to dealers interested in reinsurance. As such, the PORC promoter will have already structured transactions with each company participating in its reinsurance promotion and will have also made arrangements to provide for all of the necessary on-going support services with respect to the PORC's formation, registration, and license renewal in the foreign domicile and all record keeping, financial statement compilation and preparation of the PORC's annual U.S. Federal income tax return.

The promoter controls almost every detail of the PORC promotion. As such, the auto dealer has almost no input with respect to the participants in a particular PORC promotion. [In most cases, the dealer's CPA does not prepare or review the PORC's tax return nor perform any "due diligence" or investigation before the initial implementation of a particular PORC strategy.]

PORC promoters structure their own reinsurance arrangements and are subject only to the financial restrictions imposed by any authorized commercial insurer involved in the transaction. Therefore, PORC owners must operate within the operating rules, guidelines and procedures established by either the promoter or insurer. Typically, the promoter alone determines the PORC structure and operating framework.

Arguably, if a PORC promotion were found to be abusive by the IRS, it would be because either (1) the original PORC structure and/or operations were unacceptable, or (2) there were subsequent deviations from what was originally presented to the IRS as an acceptable structure.

What has been the promoter's response to the Notice? Initially, the promoters and their legal and tax advisors tried to "educate" the IRS in an attempt to "scuttle" the Notice. In fact, several articles were written arguing that the IRS was either overreacting to a non-existent problem or overstepping its reasonable discretion by arbitrarily subjecting all PORCs (and not just the truly egregious transactions) to the requirements of the Notice.

It appears the promoters' efforts have been unsuccessful because in a March 31, 2003 article in *Automotive News*, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor stated, "I know of no movement [within the IRS] to suspend or revoke it [the Notice]."

Quite simply, the promoters of abusive PORC arrangements have a serious problem. Most likely, unhappy taxpayers in abusive tax shelter promotions will seek to recover damages from promoters, service providers, accountants and lawyers that participated in devising abusive PORC strategies.

What can you now conclude from the Notice? First, it is a questionable practice for promoters of PORC reinsurance arrangements to contend that most auto dealership taxpayers and PORCs do not fall within the intended scope of the Notice. ***Second,*** it seems reckless for promoters to encourage non-compliance with the Notice based upon either the promoter's narrow interpretation of the Notice or an opinion letter concluding that the tax benefits from these types of PORC transactions are allowable.

The primary reason for promoters of PORC programs to be upset with the Notice is that the IRS and others (primarily dealers) will now understand exactly

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how promoters have structured and arranged their respective programs and affairs to accomplish the many tax and non-tax benefits claimed.

In many cases, PORC transactions will be properly structured and respected as legitimate insurance arrangements; however, in many other cases, the promoters will have created nothing more than "illusionary" transactions that fail to achieve "insurance" tax status.

In the short term, the Notice creates a lot of anxiety, concern and confusion for dealers, promoters and all PORC participants. This is because most dealers and tax professionals ***incorrectly assumed*** that all PORC reinsurance promotions were properly and similarly structured transactions using conventional insurance techniques. Unfortunately, dealers may have to learn the hard way this is simply not the case!

One fact still remains consistent in almost every PORC promotion: Participants do not understand (and to date have not concerned themselves with) how their PORC promotions actually work. Right now uncertainty prevails because dealers have little or no clue about the actual operating details of their reinsurance programs.

Consequently, tax professionals must now get much more involved and immediately inquire about the operating structure of their dealer client's reinsurance programs. Further, at a minimum, this would include obtaining copies of all program documents from promoters to support their representations.

It appears the days of those promoters who may be playing "fast and loose" with dealers' reinsurance programs, more specifically the auto dealerships' and PORCs' tax returns, are coming to an end. If the Notice accomplishes its intended purpose of curtailing abusive tax-avoidance schemes, dealers should have more confidence and guidance in properly structured PORC arrangements from both a tax and insurance standpoint.

Legitimate and properly structured PORC programs should continue to grow and prosper while the improper and/or abusive PORC promotions will be eliminated. *

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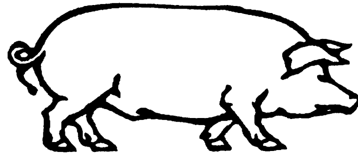
National Auto Dealership Industry Seminar
Insurance Tax Issue:

Producer-Owned Reinsurance Companies (PORCs)
and
IRS Notice 2002-70

Making Sense of the IRS Attack on Certain PORC Reinsurance Schemes



PORCs: The Story of How Pigs Get Fat and Hogs Get Slaughtered!

Presented By: Kevin L. Woodruff, CPA

Benefits from Attending

- **Learn How to Identify Properly Structured PORC Reinsurance Transactions**
- **Learn Different Ways PORC Reinsurance Transactions May Be Improperly Structured Today – Lacking "Economic Substance" and a "Business Purpose"**
- **Learn How Certain Reinsurance Schemes Have Been Designed to Resemble Legitimate Insurance Arrangements that Purportedly "Transfer Risk" (or Shift Income) to PORCs (or Other "Shell" Insurance Companies) Resulting in Significant (and Questionable) Tax Benefits for All Participants**
- **Learn How Vehicle Service Contracts and Other "Non-Insurance" Aftermarket Financial Products Are Manipulated by Promoters to Create the Appearance of "Insurance" and "Risk Transfer" for Tax Purposes**
- **Learn Why U.S. Insurers Are Indifferent Toward Certain "Tax-Motivated" PORC Reinsurance Transactions and Structures**
- **Learn Why State Insurance Regulators Have Never Discovered (Much Less Regulated) These "Tax-Motivated" Reinsurance Transactions**
- **Learn How Foreign "Tax Haven" Domiciles and Their Lax Insurance Laws and Regulations May Have Been Manipulated to Achieve Inappropriate Tax Benefits for Promoters, Auto Dealerships, PORCs and their Respective Owners**
- **Actual Case Study Presentations: Problematic PORC Strategies / Transactions**

A Timely One-Day Seminar Exclusively for Auto Dealership Tax Professionals!

With the announcement (Notice 2002-70) by the IRS on October 15, 2002 that certain transactions and/or arrangements involving PORCs may be disallowed – it is now more important than ever for you to take a closer look at your clients' PORC strategies. In the past, you may have assumed that all of your clients' PORC programs were proper; however, you simply can't afford to do that today! You must now be confident that your auto dealership clients are actually participating in legitimate PORC programs and not taking part in abusive tax shelter schemes.

Unfortunately, you may be like many other tax professionals who are still confused and at a loss as to why the IRS even issued the Notice. If so, this seminar is designed to specifically answer many of your questions and concerns. Nowhere else can you find so much practical, useful and timely information - in one place - and in such a short amount of time.

This seminar is sure to be a sell-out, so register today!   Call (866) 896-6826

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Here's What We've Learned Since the IRS Issued Notice 2002-70

While the IRS has not provided additional guidance to auto dealership taxpayers about specific abuses or transactions that will be attacked, or should be avoided, the IRS has made certain public comments that should help tax professionals protect their clients and begin to focus on the real problem of identifying and stopping egregious PORC transactions and/or arrangements. Here are the facts you should know:

- **The IRS is *NOT* going to suspend or revoke the Notice any time soon.**
- **The IRS currently considers *ALL* PORCs or "substantially similar" (domestic or foreign) insurance arrangements to be listed and reportable transactions. As such, *ALL* "Direct" and "Indirect" participants *MUST* disclose their participation in their 2002 (and subsequent) tax returns and *MUST* also disclose their participation to the Office of Tax Shelter Analysis**
- **The IRS *WILL* respect properly structured reinsurance transactions and/or arrangements (including PORCs) as legitimate business activities.**
- **The *REAL* Problem: The IRS *WILL NOT* respect improperly structured (re)insurance transactions!**

So, do you really know what a properly structured PORC transaction looks like? If not, how can you advise your clients about improperly structured transactions or arrangements? **The simple answer: You can't!**

As your auto dealership clients' most trusted tax adviser, you must be informed!

Important Seminar Information

OBJECTIVE: To provide the basic tools necessary to analyze and evaluate your clients' current PORC arrangements or new PORC strategies in order to differentiate between properly and improperly structured "insurance" transactions.

FORMAT: Classroom lecture with panel discussion (at the conclusion of the session). Attendance will be limited to allow for your active "Q&A" participation throughout the session.

COURSE LEVEL: Basic to Intermediate.

FIELD OF STUDY: Specialized Knowledge & Application - Insurance tax issues affecting the auto dealership industry.

ADVANCE PREPARATION: No advance preparation required – some optional advance reading material provided.

PREREQUISITE: You must be a CPA or attorney representing auto dealership clients – or an owner, financial officer or controller of a dealership – and have a basic working knowledge and understanding of auto dealership accounting, taxation and the proper tax treatment of aftermarket financial products. This seminar is not open to PORC promoters or their advisers.

INSTRUCTOR & COURSE DEVELOPER: Mr. Kevin L. Woodruff developed and will teach this seminar. Mr. Woodruff is a CPA; insurance and tax consultant; and the former President, COO and CEO of First Extended Service Corporation and Vice President of FFG Insurance Company. Mr. Woodruff was responsible for First Extended's dramatic growth into the #2 independent financial services provider in the VSC industry and for building a $120K capitalized offshore (Cayman Island) reinsurance company into a U.S. insurance company rated "A" by A.M. Best and admitted in all 50 states.

DATES, FEE & LOCATION: This one-day seminar will be held in **Dallas, Texas** at the **Northwood Club** and will be offered on three (3) separate dates in June 2003 (specifically **June 4th, 11th and 18th, 2003**). The individual registration fee for the seminar is **$1295 ($995** for subscribers of Willard J. Defilipps' "Dealer Tax Watch") and includes all sessions, materials, refreshments, lunch and post-seminar reception. Registrations for groups of 3 or more may qualify for additional discounts.

RECOMMENDED CPE CREDIT: This seminar is intended to qualify for 8 hours of continuing professional education; however, each State and/or professional association has its own rules and guidelines. A certificate of completion will be issued that you can file, if necessary, with the appropriate educational governing body requesting educational credit.

GUARANTEE: During the seminar, if you feel you have not received any practical knowledge or useful and timely information, your fee will be refunded to you less a pro-rated portion of the direct expenses incurred in presenting the seminar.

Here's How to Register – Call or email us today!

Please call or email us and request a registration form (include your name, company, phone number & email):

PORC Advisors * Office / Fax (866) 896-6826 * Email: Porctaxissues@aol.com

Registration material (and additional seminar information) will be forwarded to you as soon as practical. No seminar confirmation will be made until full payment and a completed registration form is received and accepted by us. Don't delay!

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REASONABLE DEALER COMPENSATION ... FROM A DIFFERENT PERSPECTIVE

DEALER COMP

One kind of tax case always receives lots of attention ... and that's a case where the IRS is claiming that a dealer has been paid too much compensation. The fact of the matter is that these cases are few and far between. Recently, the issue of the reasonableness of compensation paid to a dealer came up in a private dispute between the shareholders of a Ford dealership in Tennessee. Although this dispute did not involve the IRS, it did involve three different CPAs. It may be instructive to see how they approached their responsibilities as expert witnesses on both sides of the issue.

This case involved an individual, Mr. Long, who owned several dealerships and who brought in another person, Mr. Langley, to operate an ailing Ford dealership that Mr. Long had the opportunity to purchase. As things turned out, Mr. Long ended up suing Mr. Langley in the Tennessee Courts after 20 years of doing business together.

STOCK OWNERSHIP ISSUE

The case involved two issues. The first issue was whether Mr. Long owned 49% or 50% of the dealership. The flipside of this was whether Mr. Langley owned 51% or 50% of the dealership. Apparently, Mr. Long was initially interested in purchasing the dealership so that he could utilize some of the tax benefits resulting from prior losses sustained by that dealership. The case does not go into which specific sections of the Code were involved. Whether Messrs. Long and Langley owned the stock 50%-50% or 49%-51%, respectively, could make a great deal of difference both in terms of Ford's desire to have a dealer with 51% control, and in IRS Code sections containing 50% stock control requirements.

The Tennessee Lower Court decided that Mr. Long, the silent partner, owned 49% of the stock and that Mr. Langley owned 51% of the stock. The Appeals Court reversed this and held that each party owned 50%. The portion of the case dealing with the stock ownership issue makes very interesting reading. It brings out the effect of subsequent shareholder agreement modifications and shareholder behavior on earlier agreements and "understandings." But, we'll not go into that here.

REASONABLE COMPENSATION ISSUE

The issue we are interested in involved Mr. Long suing Mr. Langley alleging that Mr. Langley had paid himself excessive compensation for managing the dealership for the years 1992 through 2000.

When the dealership was purchased in 1979, it was having serious financial difficulties and its ownership had been changed four or five times previously. At that time, the dealership had 9 employees, and Mr. Langley began with a salary of $276 a week–that's a little over $14,000 per year. This salary remained in effect for more than a decade until the early 1990s. In fact, Mr. Langley's compensation also included some amount of sales commissions, but that component of his compensation is not a matter of record in this case.

At all times, Mr. Long was not actively involved in the operations of the dealership. Mr. Langley worked extensive hours, and it took more than 10 years before the dealership became a profitable business. In 1992, Mr. Langley began paying himself a salary substantially higher than $276 per week. From 1992 through the year 2000, his salary averaged just under $175,000 per year.

Mr. Langley testified that Mr. Long was aware of the increase he had made in his salary because Mr. Long received copies of the dealership's monthly financial statements and copies of the corporate income tax returns. Mr. Langley also testified that he did not know that Mr. Long had a problem with the amount of salary he was drawing until Mr. Long sued him.

ENTER THE CPAs AS EXPERTS

Three different CPAs (firms) were involved in opining on whether or not Mr. Langley's compensation was excessive. The Chancery Court of Gibson County Tennessee appointed a CPA firm as Special Master. This CPA firm issued its report in late November 2000, and it addressed only the years 1992 through 1997.

At the first trial in the Lower Court, a partner in the Firm testified that for the years 1992 through 1997, Mr. Langley's salary (1) averaged $163,218 per year, (2) represented 1.61% of the dealership's average annual sales and (3) was reasonable in the opinion of the Special Master.

In reaching this conclusion, this CPA firm had considered data from six automobile dealerships in West Tennessee and also data from Robert Morris & Associates. The partner testified that he was not aware of any guidelines issued by Ford concerning salaries to be paid by its dealerships, nor did he have any data concerning the average salaries paid to managers of Ford dealerships of comparable size to the dealership in question.

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From 1992 through 1997, the dealership's equity increased by more than $1 million, and during that period, one dividend had been paid in the amount of $40,000 to each shareholder. During these years, the dealership had average annual sales of just in excess of $10 million. For these years, as indicated previously, Mr. Langley's average salary was roughly 1.61% of sales.

In the years 1998 through 2000–years not included in the Special Master's report–the dealership's average annual sales were slightly in excess of $12.5 million, and Mr. Langley's average annual salary of $173,768 was roughly 1.55% of sales.

THE OPPOSING VIEW

Another partner in a large regional dealership accounting firm testified as an expert witness on behalf of Mr. Long. This CPA analyzed the entire period from 1992 through 2000, including the information that was in the Special Master's report. Mr. Long's expert had also utilized the database of information of the National Automobile Dealers Association. In drawing his conclusions, he utilized a sample during this timeframe which ranged from 109 to 170 Ford dealerships of similar size in the geographic region.

Mr. Long's expert witness concluded that there was "a range of overpayment" to Mr. Langley from roughly $750,000 to $975,000. In his opinion, Mr. Langley should have been paid a salary of $50,000 plus 10% of the dealership's net profit.

Both expert witnesses agreed that there are no industry standards by Ford Motor Company for salaries to its managers, nor is there a compiled source of information for salaries paid to them. Mr. Long's expert witness, relying "upon his own experience in the automobile industry," admitted three facts that adversely affected the credibility of his conclusions: (1) he was not aware of Mr. Langley's background, (2) he was not aware of the efforts that Mr. Langley had put into the business and (3) he was not aware of the dividend that had been paid to the shareholders during the years in question.

Still another CPA testified on this matter. This CPA, who testified on behalf of Mr. Langley, had prepared the tax returns for the dealership for a number of years. Although he did not offer an opinion as to the reasonableness of the salary paid to Mr. Langley for the time period in question, he did testify that "during the early years of the business, Langley drew a very minimal salary which was well below what one in his position should earn."

The Chancery Court (i.e., the Lower Court) found that Mr. Long had failed to carry the burden of proof that Mr. Langley had paid himself an excessive salary. The Court of Appeals agreed that Mr. Langley's compensation for the years 1992 through 2000 was reasonable and not excessive.

The Appeals Court had to deal with the technical/procedural problem presented by the fact that the Special Master (i.e. the CPA firm) appointed by the Lower Court had produced a report that analyzed only the years 1992 through 1997, even though three additional years (i.e., 1998 through 2000) were at issue in this case. The Appeals Court said, "Although we do not approve of Langley's unilateral action in setting his salary, nor do we understand why Long did not complain of it until he filed this suit in 1995, nevertheless, we believe that Langley was entitled to this compensation."

In general, the Court's rationale might be lifted from any other case involving the IRS and an auto dealer disputing whether compensation pay was reasonable. When the parties purchased the dealership, it was in financial difficulty, and it remained in that condition for several years. During this timeframe, Mr. Langley worked long hours for little pay. (Note here the element of undercompensation of the dealer in prior years.) By the early 1990s, the dealership had become profitable. From 1992 through 1997, stockholders' equity increased by more than $1 million and the dealer's salary for those years averaged just over $167,000 per year or 1.6% of average annual sales.

The Appeals Court found that the testimony of Mr. Long's expert regarding the alleged range of overcompensation was "a personal opinion and (was) unsupported by any concrete data as to the appropriate salaries for Ford managers." Also, it commented on the major facts or points of information of which Mr. Long's expert witness CPA was unaware. These, of course, could not have been taken into consideration by him in reaching his conclusions.

Although there was the lack of continuity between the years examined by the Special Master and the years in issue in this case, the Appeals Court held that the evidence "does not preponderate against the ... finding that Langley's salary for the years 1998 through 2000 was reasonable." Accordingly, Langley's compensation for all nine years (1992-2000) in question was reasonable and not excessive.

CONCLUSION

It is reassuring to see that when the issue of reasonable compensation is raised by parties other than the IRS, the criterion for reaching a conclusion is about the same as that applied by the Tax Court when the IRS is directly involved in the tax ramifications of the outcome.

IRS TREATS DEALER'S ACQUISITION OF A NEW FRANCHISE AS AN "EXPANSION" OF HIS EXISTING BUSINESS

REV RUL 2003-18 SPIN-OFF

Dealers are great for wanting to "move their dealerships around" like pawns on a chess board. Often, this moving around takes the form of creating new corporate entities and transferring ownership in the old and in the new. In this regard, Section 355 is very important as a means of structuring the corporate realignment in a way that will avoid immediate income tax consequences to both the original corporation and to its shareholders.

Here's the general rule: A corporation that distributes property having fair market value in excess of its adjusted tax basis must ordinarily recognize gain on the distribution of that property as if that property had been sold. The shareholders to whom the property is distributed also are usually taxed on the fair market value of the property received.

Section 355 allows a corporation to carve up or divide its business activities by creating or using an existing subsidiary and to distribute the stock of the subsidiary to its shareholders in a tax-free transaction. Essentially, there are three different ways whereby the shareholders split up their former investment among several different entities, placing some of the corporation's business assets or business functions in separate corporations. These alternative arrangements may take the form of either a (1) spin-off, (2) split-off, or (3) split-up.

A ***spin-off*** involves the distribution of the stock of the controlled corporation (the subsidiary) without requiring the shareholders of the parent corporation to give up or surrender in exchange any shares they hold in the parent corporation as part of the transaction. No stock of the parent corporation is given up by the shareholders who receive a distribution of the new subsidiary's stock. Accordingly, a *spin-off* is a pro-rata distribution by one corporation of the stock of a subsidiary–and that subsidiary may be either an existing subsidiary or a newly-created one.

In Revenue Ruling 2003-18, the IRS adopted a taxpayer-friendly or "favorable" view in interpreting one aspect of how Section 355 was to be applied where an auto dealership wanted to go forward with a spin-off transaction.

FACTS IN REV. RUL. 2003-18

The facts in Revenue Ruling 2003-18 are as follows... An automobile dealership, Corporation D, has been engaged under a dealer franchise in the sale and service of brand X automobiles since Year 1. Just to make things more familiar, let's say that "brand X" equates with Cadillac.

Continuing the facts... For over five years before Year 8, these operations had been carried on in two buildings (L and M) within the same city. In Year 8, the auto dealership D acquired a franchise for the sale and service of brand Y automobiles (let's also say that "brand Y" equates with Subaru). At this time, the dealership purchased the inventories, equipment, and leasehold of a former brand Y (i.e., Subaru) dealer who had operated his business in a building adjoining one of D's buildings (i.e., building L).

Shortly thereafter, D relocated the inventory of brand X (i.e. the Cadillac operations) from building L to his other building, building M. Thereafter, D used building M exclusively for the sale and service of brand X (i.e., Cadillac) vehicles, and it used building L ***and*** the adjoining leasehold (that had been acquired from the former Subaru dealer) exclusively for the sale and service of brand Y (i.e., Subaru) vehicles.

Finally, in Year 10, D (the now Cadillac-Subaru dealer) transferred all of the assets, including building M, and liabilities of the brand X (Cadillac) automobile dealership to a new corporation, C, in exchange for the stock of C, and it distributed the stock of the new corporation, C, pro rata to its shareholders.

DESIRED TAX-FREE TREATMENT

The dealer wanted to be sure that neither the corporation nor the shareholders would be taxed on the fair market value of the underlying assets in this distribution transaction. The underlying assets, of course, would include the value of the Cadillac franchise (i.e. the goodwill), as well as the physical operating assets.

Significantly, the dealer wanted to be sure of this tax result before undertaking the transaction. He did what was prudent and smart: He requested an advance ruling from the IRS on the tax consequences of the transaction.

Specifically, he asked the IRS to rule on "Whether the acquisition by a dealer engaged in the sale and service of brand X (i.e. Cadillac) automobiles of a franchise to sell and service brand Y (i.e. Subaru) automobiles and the assets to operate the franchise constitutes an ***expansion*** of the brand X (i.e. the

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Cadillac) business ***rather than the acquisition*** of a new or different business under Reg. Sec. 1.355-3(b)(3)(ii)."

ANALYSIS OF SECTION 355

The pertinent part of Section 355(a) provides that a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders in a transaction that will not cause the distributees to recognize gain or loss, provided that, among other requirements:

1. Each of the distributing corporation and controlled corporation is engaged, immediately after the distribution, in the active conduct of a trade or business,

2. Each trade or business has been actively conducted throughout the five-year period ending on the date of the distribution, and

3. Neither trade or business has been acquired in a transaction in which gain or loss was recognized, in whole or in part, within the five-year period.

What is most important in this regard is that in determining whether an active trade or business has been conducted by a corporation throughout the five-year period preceding the distribution, the fact that a trade or business underwent change during the five-year period (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, ***provided***

see **IRS VIEWS ACQUISITION AS AN "EXPANSION"**, page 12

QUALIFYING FOR TAX-FREE TREATMENT UNDER SECTION 355

In order for a spin-off, split-off or split-up to be tax-free under Section 355, it must satisfy several requirements. Some of the requirements are contained in the Code and others result from court decisions.

1. The distributions to shareholders must be "*with respect to their stock*," or the distributions must be made to security holders in exchange for their securities.

2. Immediately before the distribution, *the distributing corporation must control the corporation* whose shares or securities it is distributing. In other words, the parent must have at least 80% of the combined voting power and at least 80% of the total number of shares of all other classes of stock issued by the subsidiary. Usually this is not a problem where a single corporation creates a new subsidiary capitalized solely with common stock.

3. Post-distribution ABC/Active Business Conduct: Immediately after the distribution of stock, both the distributing corporation and the controlled corporation (or corporations) must be engaged in the active conduct of a trade or business. In the split-up situation, the parent corporation does not have to meet this requirement–since it is a holding company that is about to be liquidated–but all of the controlled corporations must be engaged in the active conduct of a trade or business.

4. Pre-distribution: ***5 year ABC/Active Business Conduct: Both the parent and the subsidiary (i.e., the controlled corporation or corporations) must have been engaged in the active conduct of a trade or business throughout the five year period ending on the date of distribution of the stock.*** Further refinements of this five year active conduct of a trade or business requirement provide that (i) the trade or business must not have been acquired within the five year period in a taxable transaction and that (ii) the trade or business must not have been conducted by another corporation, the control of which was acquired during the five year period in a taxable transaction.

5. Typically, the distributing corporation must distribute all of the stock and securities in the controlled corporation. If it does not distribute all the stock, it must distribute enough stock to constitute "control," and it must establish that the distribution of less than all of the stock and/or securities in the controlled corporation was not part of a tax-avoidance plan.

6. There must be an independent *corporate business purpose* for the transactions.

7. The distribution transaction must not be used principally as a *device* for the distribution of earnings and profits. Here, the term *device* is more of a concept than something susceptible to precise definition in a few words or short sentences.

8. There must be a *continuity of proprietary interest* by the parent's shareholders after the distribution so that the transaction is not followed shortly thereafter by a sale.

9. There must be a *continuity of the pre-existing business enterprise* after the division.

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that the changes are not of such a character as to constitute the acquisition of a new or different business. See Reg. Sec. 1.355-3(b)(3)(ii).

In other words, for tax-free treatment you want the previous transaction to be an expansion of the original or existing business, rather than the acquisition of a new business.

In particular, if a corporation engaged in the active conduct of ***one*** trade or business during that five-year period purchased, created, or otherwise acquired ***another*** trade or business ***in the same line of business***, then the acquisition of that other business is ***ordinarily*** treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period.

However, this result will not follow if that purchase, creation, or other acquisition ***effects a change of such character as to constitute the acquisition of a new or different business.*** From this portion of the Regulation, it can be surmised that the IRS' interpretation of any particular set of facts and events might go either way. That's why it is critical to know in advance what the IRS interpretation will be.

In Rev. Rul. 2003-18, the IRS looked to Example (8) of Reg. Sec. 1.355-3(c) for guidance. In this Example, a corporation owned and operated hardware stores in several states for four years before purchasing the assets of a hardware store in another state in which it had not previously conducted business.

Two years after the purchase, the corporation transferred the store in the other state and related business assets to new subsidiary and distributed the stock of that new subsidiary to its shareholders. The Example concludes that the original corporation and its new subsidiary both satisfy the requirements of Section 355(b).

IRS HOLDING & RATIONALE

In Rev. Rul. 2003-18, the IRS stated that it would treat the brand Y (i.e., Subaru) dealership as being in the same line of business as the brand X (i.e., Cadillac) dealership. This meant that although the Cadillac dealer had been in the Subaru business for only 2 years (i.e., from year 8 through year 10) before the distribution, the IRS would not treat that as a violation of the 5-year pre-distribution active business requirement.

As a result, the Cadillac dealership's acquisition of the Subaru franchise and assets only 2 years before the distribution did not (or was held not to) constitute the acquisition of a ***new or different business*** under Reg. Sec. 1.355-3(b)(3)(ii).

Instead, the IRS held that the acquisition of the Subaru franchise constituted an ***expansion*** of the dealership's existing (Cadillac) business. The Service gave three reasons as support for its conclusion:

THREE REASONS

1. The ***product*** of the brand X (Cadillac) automobile dealership ***is similar to*** the product of the brand Y (Subaru) automobile dealership,
2. The ***business activities*** associated with the operation of the brand X (Cadillac) automobile dealership (i.e., sales and service) ***are the same as the business activities*** associated with the operation of the brand Y (Subaru) automobile dealership, and
3. The ***operation*** of the brand Y (Subaru) automobile dealership ***involves the use of the experience and know-how*** that dealership D had developed in the operation of the brand X (Cadillac) automobile dealership.

As a result of this holding, the old dealership and the newly created dealership were each considered to be engaged in the active conduct of a five-year active trade or business immediately after the distribution, thus satisfying the Section 355 issue that had been raised.

Revenue Ruling 2003-18 makes obsolete an older Revenue Ruling (57-190) which previously denied favorable tax-free spin-off treatment to a dealership under a somewhat similar fact pattern. The text of Rev. Rul. 57-190 is on the facing page.

CONCLUSION & CAUTION

For dealers looking to use Section 355 to obtain tax-free results in similar transactions, Revenue Ruling 2003-18 is clearly favorable. Since this is not a Private Letter Ruling (PLR), it should have greater precedential value if the dealer's facts are substantially the same as the facts presented by the dealer in the Revenue Ruling.

However, there could be a problem. Depending on which "brands" are involved, the Internal Revenue Service–if it knew more about the automobile business–might be inclined to look more closely at the similarity (or the lack of similarity) between certain brands. Some might simply generalize and say, "Retailing is retailing," regardless of what kind/"brand" of vehicle is involved. Others observing the industry more closely might contend that there is a world of difference between selling brand X vehicles and selling brand Y vehicles. Not to mention the issue of product differentiation, about which most manufacturers seem to be fanatic.

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The only way for a dealer to be absolutely sure that the holding in this Ruling would apply is for the dealer to request his or her own ruling.

For a discussion of other dealership-related Section 355 rulings, see *Tax-Free Spin-Offs and Split-Offs for Dealerships Over 5 Years Old*, September 1998, *LIFO Lookout.*

SECTION 355 RULING INVOLVING DEALERSHIPS REV. RUL 57-190 MADE OBSOLETE BY REV. RUL. 2003-18

A certain corporation has been engaged under a dealer franchise in the sale and service of brand X automobiles since 1946. For over five years prior to 1954, these operations has been carried on in two buildings (B and C) which the corporation owned and which were located some distance apart in the same city. In 1954 the corporation acquired a franchise for the sale and service of brand Y automobiles and purchased the inventories, equipment, and leasehold of a former brand Y dealer who had been operating in a building adjoining the corporation's building B.

Shortly thereafter, the inventories of brand X automobiles and certain shop equipment located in building B were moved to building C, and from that time all brand X sales and service operations have been conducted from the location in building C. At the same time a portion of the activities of the new dealership were moved into building B, and thereafter building B, together with the adjoining leased building, has been used for connection with the brand Y sales and service operations.

In 1956 and for bona fide business reasons, the corporation transferred all of the assets (including building C) and liabilities of the brand X business to a new corporation in exchange for the stock of the new corporation, and distributed such stock pro rata to its stockholders.

It is contended that, since the corporation had been engaged in the sales and servicing of automobiles in two locations for more than five years, the activities at the two locations constituted separate businesses conducted for over five years.

Held, no gain or loss is recognized to the corporation as a result of the transfer of a portion of its properties to the new corporation in exchange for the stock of the latter, in view of the provisions of section 351 of the Internal Revenue Code of 1954.

However, the distribution of the stock of the new corporation is not within the purview of the non-taxable provisions of section 355 of the Code.

The activities of the brand X business, which formerly were conducted at two locations, were amalgamated into one integrated business in 1954 when the inventories of brand X automobiles located in building B and the shop equipment theretofore used in the X business at that location were moved to building C. This business, which was the one transferred to the new corporation, had been actively conducted throughout the five-year period ending on the date of the distribution of the stock of the new corporation. However, the brand Y business retained by the corporation had not been actively conducted by the corporation for five years within the meaning of section 355(b) of the Code, inasmuch as the brand Y franchise, inventories, equipment, and leasehold were not acquired until 1954.

Therefore, the active business requirements of section 355(b) are not met, and the distributions of the stock of the new corporation constitutes a distribution of property to which section 301 applies.

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BEST AUTO SALES FAILS TO APPLY BEST TAX PRACTICES ... SLOPPY RECORDKEEPING FORFEITS DEDUCTIONS

Two used car dealerships owned by the same dealer in Tampa failed to support their accounting for repossessions and related inventory writedowns in the Tax Court. And, because their adjustments were based on the dealer's unsubstantiated "opinions," the 20% accuracy-related penalties under Section 6662 were also applied.

THE FACTS

The two dealerships were separately operated and specialized in selling used vehicles to high credit risk purchasers. This, of course, meant that the dealerships were involved with the financing of the purchased vehicles at high interest rates over short repayment periods. High interest rates ... roughly 32%. Short repayment periods ... 1 to 2 years. Typically, the terms of the loans were that the purchasers of the autos were obligated to make installment payments to the dealerships on a weekly, biweekly, semimonthly, or monthly basis.

When payments due on the vehicle loans became delinquent, office personnel employed by the dealerships mailed past due notices and demand letters to the debtors/customers requesting that the delinquent amounts due on the loans be paid.

Many debtors/customers failed to make the delinquent payments due on their loans within a few days or weeks after notification. When this happened, the dealerships initiated repossession of the vehicles through a third-party automobile repossession agent. On some occasions, vehicles to be repossessed could not be located, and occasionally the debtors voluntarily returned their vehicles.

More usually, however, after the vehicles were repossessed, the dealerships notified the debtor/customer by mail that the vehicle would be sold unless, within 10 days, the delinquent loan payments were made or the entire loan were fully paid off.

After their second notification, if the debtor/customer were still unable to comply, the dealerships would repurchase the vehicles at what were essentially private sales. The vehicles would then be returned to the dealerships' used vehicle inventories for resale to retail customers or to wholesalers. In this way, many of vehicles were sold, repossessed, placed back into dealerships' inventories, and resold a number of times.

Accounting for repossessions. Upon repossession or return of the vehicles securing the loans, the dealerships would charge off, as business bad debt deductions, all but $100 of the outstanding balance due on the loans. This $100 amount was arbitrary. It was intended to reflect the value, for tax purposes, that the dealerships allocated to each and every repossessed or returned vehicle, regardless of its make, year, and condition.

In connection with delinquent loans for which the underlying collateral (i.e., the vehicle) could not be located by the dealerships' repossession agent, the entire outstanding balance of the loans would be charged off the books as business bad debt deductions.

It is not clear how the dealerships calculated the amount charged off for a particular loan. Upon repossession or return of some vehicles, the amount of the charge-off was calculated in the same manner for book and for tax purposes: i.e., all but $100 of the outstanding balance due on the related loan would be charged off.

In other instances, for book purposes upon repossession the dealerships determined the wholesale book value of the vehicle and charged off only the difference between the loan balance and the wholesale book value. (Do you think this inconsistency in treatment could be related to whether or not the dealership needed more deductions to offset income in their tax returns?)

Year in which bad debt deduction was claimed would vary. Under these circumstances, the dealerships also chose the year in which they claimed the tax deduction. Whether a bad debt deduction relating to a particular loan and repossession was claimed on the dealerships' income tax return for the ***current*** tax year ... or for the ***prior*** tax year ... depended on two factors: (1) when the loan originated and (2) whether the repossession of the vehicle occurred prior to the filing of the tax return for the prior tax year.

With respect to a delinquent loan that had been made in the prior tax year and where the repossession of the vehicle occurred in the current tax year ***but prior to the filing*** of the corporate tax return for the prior tax year, the related bad debt deduction would be claimed on the tax return for the prior tax year.

With respect to a delinquent loan that had been made in the prior tax year and where the repossession of the vehicle occurred in the current tax year ***but after the filing*** of the corporate tax return for the prior tax

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year, the dealerships would claim the related bad debt deduction on the tax return for the current tax year.

For example, for the tax year ending May 31, 1990, ABC Autos, Inc. (ABC), in November of 1990 (before filing its corporate Federal income tax return for its tax year ending May 31, 1990), charged off as bad debts $237,795 in automobile loans that were outstanding as of May 31, 1990, even though the automobiles securing the loans were repossessed between June and November of 1990. In the journal entry made by ABC Autos on November 17, 1990, to reflect the above charge-off, a written notation was made to the effect that the related loans "went bad in June-Nov. '90'."

Inventory writedowns. Also, on ABC's tax returns for its years ending May 31, 1990 and 1992, ABC's year-end total basis in its used vehicle inventory was written down under Reg. Secs. 1.471-2(c) and 1.471-4(c). The dealerships failed to maintain any records to substantiate how these inventory writedowns were calculated.

In its audits, the IRS disagreed with the timing. The IRS disallowed the dealerships' bad debt deductions to the extent that those deductions were based on delinquent loans that were related to vehicles which had been repossessed or returned (or identified as unlocatable) ***after the end of the year*** for which the related bad debt deductions were claimed.

The IRS did, however, allow the total amounts of the claimed bad debt deductions as bad debt deductions for the immediately following year.

The IRS also disallowed the inventory writedowns claimed by one of the dealerships for its 1990 and 1992 tax years. Finally, the IRS assessed accuracy-related penalties under Section 6662(a) against the dealerships.

BAD DEBT DEDUCTION ISSUE

The Tax Court did not devote a great amount of discussion to this issue. It set the background by indicating that the IRS' determination to disallow the deductions under Section 166(a)(2) would not be disturbed unless it were "plainly arbitrary or unreasonable," constituting an abuse of discretion.

The Tax Court said, "Generally, to be entitled to deductions under Section 166(a)(2) for debts claimed to be partially worthless, taxpayers have the burden of proving that, based on all the facts and circumstances, the portion of the debts with respect to which the deductions are claimed became unrecoverable by the end of the year for which the deductions are claimed." (Citations omitted)

It added that the fact that some payments on debts become delinquent, standing alone, does not establish the worthlessness or uncollectibility of the debts or of any portion thereof. A taxpayer's business judgment concerning whether debts in a particular year are partially worthless, if clearly supported by facts, may be sufficient to prove the partial worthlessness of the debts for a particular year. But that was not the case here.

The dealerships had argued that they had established the "sound business judgment" supporting their claimed deductions. They pointed to (1) the loan delinquencies, (2) the vehicle repossessions, and (3) the inherent nature of the loans made to high credit risk customers. The Tax Court did not find this fully persuasive. In fact, the Court said, "We perceive little 'sound business judgment' in petitioners' method of charging off the loans in issue."

The Tax Court concluded that the dealerships' method was "arbitrary and unrelated to the exercise of any meaningful discretion with respect to particular loans." The Court did not believe that, just because the dealerships made loans to "high risk" customers, all of the dealerships' automobile loans to customers whose cars were (eventually) repossessed were inherently worthless from the day the loans originated.

The Court said, "The facts of loan delinquency and automobile repossession in a year, combined with high risk debtors, do not automatically establish the full or partial worthlessness of a loan for the year prior to the year in which the repossession occurred." Accordingly, the Tax Court disallowed the bad debt deductions for the years in which they were claimed.

The Court noted that the taxpayers had made no claim that the deductions should be allowed under the loss provisions of Section 165.

INVENTORY WRITEDOWN ISSUE

The Court did not spend much time in dealing with the inventory writedown issue, either. As accrual-basis taxpayers, the dealerships were required to use a method of accounting for inventory that clearly reflects income. Their inventory should be recorded "in a legible manner, properly computed, summarized, and kept as part of the accounting records." The Court added that where the IRS (Commissioner) determines that a taxpayer's method of accounting for inventory is improper, the taxpayer has a heavy burden of proving that the Commissioner's determination is plainly arbitrary and constitutes an abuse of discretion."

Although the lower of cost or market method is an acceptable method of accounting for inventory, at the end of an inventory period (i.e., as of year-end) the

see **SLOPPY RECORDKEEPING FORFEITS DEDUCTIONS**, page 16

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 (Continued from page 15)

cost of ***each item of inventory is compared to its market value,*** and the lower of the two is recorded as the basis of that item of inventory for tax purposes.

If, as of year-end, the market value of the inventory is lower than its cost, the taxpayer "writes down" the basis of the inventory to the lower market value, thereby reducing gross income.

Reg. Sec. 1.471-2(f)(1) clearly provides that the write-down of inventory from cost to market value ***based on mere estimates*** is not allowable. The Court observed that an official guide for used automobiles may be used to ascertain the market value of used automobile inventory for purposes of determining the lower of cost or market value. *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884, 895 (1973) (citing Rev. Rul. 67-107, 1967-1 C. B. 115).

The Court would not overturn the IRS' disallowance of the dealerships' claimed inventory writedowns "without objective evidence such as books and records to substantiate that item-by-item comparisons of cost to market value were conducted by ABC in the calculation of its year-end inventory writedowns."

The Court said that the testimony of ABC's president (i.e., the dealer) that at year-end he made estimates of the value of the automobiles does not provide a basis on which the claimed inventory writedowns can be allowed in this case.

ACCURACY-RELATED PENALTIES

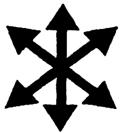
Finally, the Court affirmed the imposition of accuracy-related penalties of 20% on underpayments of tax attributable to negligence or to a disregard of Federal rules or regulations. The Court said simply that for purposes of Section 6662, the term "negligence" constitutes a failure to make a reasonable attempt to comply with the Internal Revenue Code. Furthermore, the term "disregard" includes carelessness, recklessness, and intentional disregard. It added that ***"negligence"*** also ***includes a failure by a taxpayer to keep adequate books and records or to properly substantiate items.*** See Reg. Sec. 1.6662-3(b)(1).

Since the dealerships did not make a good faith attempt to ascertain which loans were worthless at year-end, their failure to maintain records to substantiate their inventory writedowns constituted negligence under Section 6662(a).

These TC Memo cases were decided Dec. 2, 2002 (TCM 2002-297).

THE MORAL OF THE STORY

Dealerships that want to write down their inventories should expect that an IRS agent will look for detailed or itemized listings, vehicle-by-vehicle, comparing actual cost with wholesale costs based on information found in official used vehicle guides. This has long been the position of the IRS, and it is likely to remain so in the foreseeable future.



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INADEQUATE DISCLOSURE OF LLC INTEREST IN GIFT TAX RETURN FAILS TO START STATUTE OF LIMITATIONS ... ILM 200221010

FORM 709 LLCs

In the March 2000 *Dealer Tax Watch*, we described how much detail should be disclosed in gift tax returns in order to start the running of the statute of limitations. Unless gifts are ***adequately disclosed*** in the gift tax return filed, the IRS literally can come in at any time to assess additional tax, reduce available unified credit amounts and/or revalue prior gifts for estate and/or gift tax purposes. The IRS can do this even as late as when the donor dies many years later and his estate tax return is filed.

If anything, that article made it clear that it is not possible to keep a low profile on certain valuation issues and still have enjoy the benefit of protection by the running of the statute of limitations.

A recent IRS Legal Memorandum, ILM 200221010, illustrates a case in point. This ILM involved two Code Sections that operate to hold open the period of limitations to allow the IRS to assess gift tax deficiencies.

Not "adequately disclosed." The first is Section 6501(c)(9) which provides an extension of the general 3-year period of limitations in the case of gift tax on certain gifts not shown on a Form 709 gift tax return. In general, if a taxpayer does not disclose a gift in a manner adequate to apprise the IRS of the nature and the amount of the gift, the period of limitations is held open ***indefinitely*** in accordance with Section 6501(c)(9).

Substantial omission. The second Code Section involved is 6501(e)(2). This provides another exception to the general 3-year period of limitations. This exception applies in the case of a gift tax return which has a substantial omission. A substantial omission occurs where the taxpayer omits from the total amount of gifts made during the period for which the gift tax return was filed an amount which exceeds 25% of the total amount of gifts stated on the return. In this case, the taxpayer's period of limitations is not held open indefinitely; instead, it is held open for "only" six years.

FACTS IN THE RULING

"ABC, LLC" was formed in 1997 as a limited liability company under Delaware law. For Federal income tax purposes, it elected to be treated as a partnership. At the time of formation, the individual taxpayer in this ruling was a member in "ABC, LLC" and held a 1% interest. Through a series of transactions not relevant to the determination of the issues in this case, the taxpayer acquired an additional 19% interest in "ABC, LLC." As a result, the taxpayer's entire 20% interest in "ABC, LLC" was composed of Class B units.

On April 7, 1997, the individual made gifts of the 19% interest in "ABC, LLC" to a generation-skipping trust. On that same day, the taxpayer gifted the remaining 1% interest in "ABC, LLC" to a family trust.

The taxpayer and his spouse (elected to) split the value of both gifts in accordance with Section 2513. The taxpayer filed his gift tax return (Form 709) on October 9, 1998 and attached the following description of the gifts: ***"Class B units in 'ABC, LLC.' Units acquired on 4/6/97 for $200,000 cash."***

In addition, the taxpayer indicated on Form 709 that the gifts were made on 4/7/97 with a value on that date of $200,000 and an adjusted basis of $200,000. The taxpayer's Form 709 was due on April 15, 1998 and, as indicated above, the return was filed on October 9, 1998. Therefore, the gift tax return was not timely filed (since there is no mention of the taxpayer requesting or receiving extensions of time to file).

The examining agent took the position that the taxpayer's transfers to the two trusts at the time of the transfers had a fair market value of $14 million. As a result, the agent would propose an adjustment for the 1997 tax year for the deficiency in gift tax.

In this regard, the examining agent asked the National Tax Office whether the Service may rely on either of the two exceptions in order to assess a deficiency more than three years after the gift tax return was filed.

ANALYSIS OF SECTION 6501

In general, Section 6501 provides that, tax must be assessed within three years after the return was filed, whether or not such return was filed on or after the date prescribed. As an exception, Section 6501(c)(9) extends the period of limitations ***indefinitely*** if a gift of property, the value of which is required to be shown on a gift tax return, is not shown on such return. This exception does not apply, however, "to any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item."

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To obtain the benefit of this exception, the Service must show that: (1) the value of the gift was required to be shown on a gift tax return; and (2) the gift was not disclosed in the gift tax return or in any statement attached to the return in a manner sufficient to apprise the Service of the nature of the gift.

As previously noted, another exception, Section 6501(e)(2), extends the period of limitations to six years under certain circumstances involving the omission of gift amounts in excess of 25% of the total amount of gifts reported on the return.

In determining the items omitted from the total gifts, there shall not be taken into account any item which is omitted from the total gifts stated in the return "if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Service of the nature and amount of such item."

When determining whether a 25% omission exists, Reg. Sec. 301.6501(e)-1(b)(2) provides that any increases in the valuation of assets disclosed on the gift tax return are not taken into account. Thus, to obtain the benefit of the exception in Section 6501(e)(2), the IRS must show three elements... ***First,*** the omitted items were properly includible in total gifts for the calendar year. ***Second,*** the omitted items comprised more than 25% of the total gifts shown on the return. ***Third,*** the information on the gift tax return or on any statement attached to the return was not sufficient to apprise the Service of the nature and amount of the omitted item.

Neither the Code nor the Regulations provide guidance on what is meant by the phrase "a manner adequate to apprise the Service of the nature and amount of such item." Moreover, there are no gift tax cases interpreting the adequate disclosure standards that apply to either exception.

However, Section 6501(e)(1) provides a similar exception to the period of limitations for a substantial omission of items in the income tax context and it contains identical language regarding adequate disclosure. The National Office reviewer concluded that it could use the income tax cases construing the adequate disclosure standard in the context of a substantial omission of items as guidance for determining whether there has been adequate disclosure for purposes of these gift tax provisions.

HOW MUCH DISCLOSURE IS ENOUGH?

A clue, a hint, a whiff or what? The discussion in the ILM addressing the question *How much disclosure is enough?* is very interesting. Here it is in its entirety:

"The disclosure required to trigger Section 6501(e)(1) and avoid application of the extended period of limitations has been held to require production of a "clue" with respect to the omission of income. *University County Club, Inc. v. Commissioner*, 64 T.C. 460, 470 (1975). ***'[T]his does not mean simply a clue which would be sufficient to intrigue a Sherlock Holmes.*** But neither does it mean a detailed revelation of each and every underlying fact.' *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971).

"The disclosure must be sufficiently detailed that a decision whether to select the return for audit may be a reasonably informed one. *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) (citation omitted). Moreover, the 6-year period of limitations applies where there is either a complete omission of an item of the requisite amount or misstating of the nature of an item. *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968). In either situation, the Service is at a disadvantage in detecting errors and consequently needs more time to uncover those errors. *Id.*"

APPLICATION TO RULING FACTS

The National Office observed that the Regulations that correspond with Section 6501(c)(9) contain detailed guidance on what constitutes adequate disclosure of transfers of property reported as gifts. It added that Reg. Sec. 301.6501(c)-1(e) sets detailed guidelines for a transfer of property subject to the special valuation rules of Section 2701 or Section 2702, and that Reg. Sec. 301.6501(c)-1(f) provides detailed guidelines for gifts made after December 31, 1996 not adequately disclosed on a return filed after December 3, 1999.

Based on the facts submitted for review, the ILM author could not determine whether the taxpayer's transfers of interests in "ABC, LLC" were subject to the special valuation rules of Sections 2701 or 2702. As a result, a determination could not be made as to whether the adequate disclosure standard of Reg. Sec. 301.6501(c)-1(e) is applicable in this case.

The reviewer addressed the overlapping, but not conflicting, regulations that might apply depending on certain circumstances. In this context, the reviewer concluded that regardless of which regulation might apply, ***"a gift tax return (or statement attached thereto) should contain, at a minimum, a description of the transferred property, the identity of the transferor and each transferee, the relationship between those parties, and a description of the method used to determine the value of the gift.*** In addition, for a transfer of property in trust, the gift tax return should contain a description of the terms of the trust."

see **INADEQUATE DISCLOSURE OF LLC INTEREST**, page 20

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Furthermore, the Service has previously ruled in Rev. Proc. 2000-34 that the period of limitations on assessment with respect to a gift tax return does not begin to run where a donor files a gift tax return but fails to adequately disclose a gift because the information required under Reg. Sec. 301.6501(c)-1(f)(2) for the gift was not submitted with the return.

REPORTING GIFTS OF LLC INTERESTS

The National Office said ... "While there are no examples in the Treasury Regulations or the Instructions to Form 709 pertaining to ownership interests in a limited liability company, we believe information similar to that required for a gift of stock should be contained on the gift tax return."

In this regard, Reg. Sec. 25.6019-4 provides that the description of stocks shall include the number of shares gifted, whether common or preferred, and, if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold.

Applying these requirements, the ILM concluded that ***the description of a gift of an interest in an LLC should include the number of units in the limited liability company, the class type, and the percentage of ownership interest that the gift represents.***

As a result, the ILM concluded that the taxpayer did not include an adequate description of the gifts to the two trusts. In particular, the taxpayer did not identify the number of units in "ABC, LLC" being transferred, the percentage of ownership interest that those units represented, or the nature of Class B interests.

The taxpayer had only identified the name of the limited liability company, the purported value and the fact that the units were Class B units. ***This limited information did not allow the Commissioner to make a reasonably informed decision whether to select the return for audit.***

The ILM added, "Nor do we believe that the taxpayer may legitimately argue that the absence of detailed information on the return should itself have given the Commissioner a *clue* to look for the missing information. We believe that in enacting Section 6501(c)(9), Congress intended that taxpayers should fully disclose the nature of their gifts on the return or attachments thereto–not simply leave a trail of questions for the Commissioner to pursue. Therefore, we conclude that the taxpayer did not adequately disclose the nature of the gifts. Consequently, the period of limitations on assessment with respect to the taxpayer's gift tax return remains open."

In finally addressing the question of whether Section 6501(e)(2) applies in this case, the National Office observed that the total amount of gifts stated on the taxpayer's return was $200,000. In order to apply the 6-year period of limitations on assessment to the taxpayer's return, the Service must prove that items properly includible in total gifts for that calendar year in excess of $50,000 were omitted. (25% of $200,000 = $50,000.)

The taxpayer's gift tax return disclosed Class B units in a limited liability company, and the fair market value of the Class B units at the time the gifts were made was $14 million. Because the fair market value of the Class B units is in excess of 25% of the total gifts stated on the taxpayer's return, the ILM concluded that there had been a substantial omission of items within the meaning of Section 6501(e)(2). Therefore, the Federal gift tax due on the transfers can be assessed at any time on or before October 9, 2004.

CONCLUSION

CPAs who have prepared gift tax returns reporting gifts of interests in entities such as LLCs should review the disclosures of those gifts in light of the holding in this ILM. ✻

DID YOU DISCLOSE?

If you prepared a gift tax return for a dealer who gifted interests in an LLC, there could be (big) problems if you didn't include in the description the following three (3) elements:

1. the number of units in the LLC that were gifted,
2. the class type of units in the LLC that were gifted, and
3. the percentage of ownership in the LLC that the gifted interest represents.

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USED CAR DEALER'S NOT-SO-CHARITABLE CAR DONATION ARRANGEMENT BACKFIRES WITH PENALTIES GALORE ... TAM 200243057

Every year, newspapers and magazines are full of tax reducing ideas and tips that invariably mention the possibility of giving your automobile to a charitable organization and taking a tax deduction for the value of your vehicle. Last year, in particular, several arrangements reported in the press almost seemed to border on the outrageous.

One recent Technical Advice Memo dealt with the efforts of one very aggressive family of used car dealers who attempted to act as the "in-betweens" for individuals who wanted to donate their vehicles to charity and the charitable organizations that were so anxious to receive these gifts. The IRS did not deal too kindly with the dealers.

TAM 200243057 showed just how much trouble could be stirred up if one attempted to set up these arrangements and forgot that it was the charities that were supposed to benefit from these car donations.

In this case, a used car salesman created an exempt organization to allow individuals to donate their used cars for tax deductions while choosing the charity that would ultimately benefit from the donation. If the donors did not designate a charity, the proceeds were to go into a general fund. The general funds, after expenses, were then distributed to various charities and social service organizations within the community.

The charitable organization filed for, and received from the IRS, tax-exempt status under Section 501(c)(3). The dealer and certain of his family members were employed by the exempt organization in various official capacities. They received substantial benefits in many forms, including the use of employer-provided vehicles.

The Articles of Incorporation of the organization stated that "no part of the net earnings of the Corporation shall inure to the benefit of, or be distributable, to its members, Trustees, Officers, or other private persons, except that the Corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in this Article."

The 501(c)(3) exempt organization operated on the same premises (i.e., at the same location) as a used car lot owned by the son of the founder of the exempt organization. The exempt organization used this lot to sell vehicles that had been donated to it. These vehicles were sold alongside other vehicles that were offered for sale on that lot by the founder's son as part of his own dealership used car inventory.

The Board of Directors of the exempt organization consisted of the founder (a used car salesman) his wife, his father-in-law and a CPA. At first, the founder was the President, Executive Director and in control of the organization's activities. The only non-family member Director was the CPA, and this CPA resigned shortly after the organization had been created.

When the IRS agent secured a copy of the CPA's resignation letter, it stated that the 13 checks that the CPA had reviewed were enough to cause the organization to lose its tax-exempt status under 501(c)(3). Apparently, even after the CPA had explained to the founder that no part of the exempt organization's revenues could or should inure to any private shareholder or individual, the founder continued with the same pattern of conduct.

It is evident from the text of the TAM that the dealer and other employees of the charitable organization were uncooperative in providing the examining agent with many facts and background information.

As the "success" of the used vehicle donation program increased, its expansion involved the need for more land on which to house the vehicles and the willingness of other organizations to become involved with the program. By the year 2000, the charitable organization had expanded to a second city, it operated two auctions a week and it had hired a Director of Development whose sole purpose was to develop partnerships with charities, enabling those charities to generate monies not normally available to them.

Since 2000, the Section 501(c)(3) organization splits all partnership donations and charities designated by donor on a 50-50% split, with the 501(c)(3) exempt organization absorbing all of the costs for towing, reconditioning, auction fees, advertising, detailing and costs of pamphlets or other written material that explain and describe the car donation program.

THREE PROBLEM AREAS

Essentially, the used car dealer's car donation program (with its related structuring) went wrong in

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three areas. ***First,*** the Service found that it provided misleading information that lead to the overstatement of tax deductions claimed by individuals who contributed their vehicles "to charity." The IRS agent's findings disclosed that the individual donors took charitable deductions greater than the fair market value of the vehicles donated.

During the years 1998, 1999 and part of 2000, the charitable organization had provided the individual donors with only the retail *Kelley Blue Book* value, in writing, along with a signed Form 8283. The charitable organization did not provide the donors with any information concerning the loan or trade-in value, even though some of the vehicles were not able to be driven and were sold for scrap.

Second, the Service imposed significant penalties under Section 4958 on the organization and on the individuals involved because they participated in "excess benefit transactions." These are transactions which provide "excess benefits" to individuals involved with the exempt organization beyond what they should have ordinarily received. These penalties were imposed because of the "sporadic, haphazard and informal" nature of many purported loan transactions, repayment transactions, towing fee arrangements, and other business-related transactions.

Third and finally, the individual who created the charitable organization was found to be the promoter of an abusive tax shelter under Section 6700. However, the National Office recommended that he instead be pursued under Section 6701 which provides penalties on persons who aid and abet the understatement of a tax liability.

Excise penalty taxes applied by the IRS. Section 4958(a)(1) imposes on the participation of any organization manager, a tax equal to 25% of the excess benefit (the "first tier tax"). This tax must be paid by any disqualified person with respect to such transaction. Section 4958(a)(2) imposes on each excess benefit transaction a tax equal to 10% of the excess benefit unless the participation is not willful and is due to reasonable cause. Finally, Section 4958(b) provides that where an initial tax is imposed, but the excess benefit involved in such transaction is not corrected within the taxable period, a tax equal to 200% of the excess benefit involved is imposed and must be paid by any disqualified person.

These penalty provisions are not to be taken lightly, and the IRS sought to apply them wherever possible to the dealer's used car donation program activities.

An "excess benefit transaction" is defined as any transaction in which an economic benefit is provided directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The Code provides that if more than one person is liable for any Section 4958 penalty tax, a number of other persons may be jointly and severally liable for that tax. The Regulations provide that the value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances (i.e., reasonable compensation). The standards under Section 162 apply in determining the reasonableness of compensation, which take into account all economic benefits provided by the organization in exchange for the performance of services. This includes all forms of cash and noncash compensation, such as salary and severance payments; the payment of liability insurance premiums for a disqualified person; and all other compensatory benefits, whether or not included in gross income for income tax purposes, including taxable and nontaxable fringe benefits.

Given the complexity of the fact pattern, the apparent difficulty the IRS had in getting all of the facts, and the complexity of the Code Sections involved, only a brief summary of the issues and holdings is provided below. In these comments, "B" refers to the individual who formed the Section 501(c)(3) exempt organization.

Issue 1. B, the used car salesman, and founder, former President, Executive Director of the 501(c)(3) exempt organization, was held to be an I.R.C. "disqualified person" in the years 1998 and forward.

Issue 2. B was held to be an "organization manager" with respect to the charitable organization in 1998 and years forward.

Issue 3. All of the salary paid to B in 1999 "must presumptively be treated as a Section 4958 excess benefit" payment to B. The TAM does allow, however, that if credible, probative evidence can be provided of any time that B spent in 1999 administering a charitable program of the organization, and of the value of such services, then it is possible that such value might be used to reduce the amount of the excess benefit.

Issue 4. All of the payment of backpay from 1998 and severance pay paid in 2000 to B by the exempt organization constituted a Section 4958 excess benefit transaction to B.

Issue 5. The payments by the organization purporting to be repayments of undocumented loans

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by B are Section 4958 excess benefits to B unless B can provide credible, probative evidence to explain the many inconsistencies in the current information. These inconsistencies included disclosures on Forms 990, inadequate loan documentation and inadequate journal entry explanations.

Issue 6. Payments to a towing company owned by the founder's son in excess of fair market value constituted excess benefits to the Founder (B), to his son and to the towing company his son owned.

The TAM states that the fact that the father, B caused the exempt organization to directly transfer the funds to the company his son owned cannot eliminate the father's excess benefit liability. Both the father and his son have joint and several liability for the Section 4958 excise taxes on these excess benefits. The examining agent was directed to determine the exact amount of the excess benefit, based on the extent to which the payments exceed the fair market value of the services rendered or property transferred.

Issue 7. The value of lease payments made by the exempt organization for an auto furnished to B was not substantiated as compensation and was held to be an automatic excess benefit subject to Section 4958 excise taxes.

Issue 8. The value of automobiles that the 501(c)(3) organization furnished to the founder's wife, his son and his daughter constituted excess benefits to B, the founder. These three individuals were also "disqualified persons" and were jointly and severally liable for Section 4958 sanctions on these excess benefits.

Issue 9. Other payments by the exempt organization to B, alleged to be loan payments to B, constituted Section 4958 excess benefits to B. The examining agent was given discretion to adjust all or part of the excess benefit transaction if B could provide "credible, probative evidence" to explain many of the underlying in consistencies.

Issue 10. Similarly, payments by the exempt organization to a corporation owned by the founder, alleged to be loan repayments, constituted Section 4958 excess benefits to B.

Issue 11. Payments by the exempt organization for rent on property leased and used by the founder and by the founder's son's corporation constituted excess benefits to B to the extent of the rental value of space not actually occupied by the exempt organization.

Issue 12. Payments by the exempt organization for life insurance premiums for a number of employees, including some family members, were Section 4958 excess benefits to B.

Issue 13. The Service held that penalties should be assessed against B under Section 6684 because these excess benefit transactions were not due to reasonable cause and the failure was a willful and flagrant act. Under Section 6684, the penalty amount is equal to the amount of such tax. The TAM states that after being counseled by his CPA/co-director, B had continued to engage in the activities that caused excess benefit transactions.

Issue 14. B was held to be subject to the organization manager tax under Section 4958.

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ISSUE 16 ... FALSE, FRAUDULENT & GROSS VALUATION MISSTATEMENTS

"...[T]he major thrust of the promotional literature prepared by (the exempt organization) under B's supervision was that donors would obtain a substantial Section 170 charitable deduction for the value of the donated vehicle. ***B was an experienced used car dealer, and well knew the approximate value of used automobiles.***

"Ignoring this knowledge, B instead sent to each donor the *Kelley Blue Book* retail value of the donor's automobile, together with a copy of the IRS Form 8283 used by donors to claim charitable contributions for the value of donated automobiles. He made no attempt to provide donors with the more relevant, and much lower, *Kelley* wholesale or salvage value of the donated automobile.

"He provided this information even though he knew that many of the donated vehicles could only be sold for salvage or scrap.

"As a direct result of this misleading information, several donors claimed greatly overstated valuations in taking Section 170 deductions for their vehicle donations. Under these circumstances, B's actions satisfied ... [the necessary technical language/requirements for the penalties to be imposed.] Therefore, B participated in making false, fraudulent, and gross valuation misstatements under Section 6701."

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Issue 15. Although B was held to be a promoter of an abusive tax shelter under Section 6700, the TAM recommended that he be subject instead to the penalties provided under Section 6701. This recommendation was made because Sections 6700 and 6701 are mutually exclusive and B's actions more easily satisfy the elements needed to impose the Section 6701 penalties.

Issue 16. B did participate in making false, fraudulent and gross valuation misstatements under Section 6701. In this respect, the TAM considered B's activities as President, Executive Director and day-to-day manager of his 501(c)(3) organization.

Under Section 6701, a penalty of $1,000 with respect to each person to whom B provided a false valuation should be imposed. The penalty applies to each false valuation, regardless of whether it was or was not used to claim an overvalued deduction.

From the foregoing summaries, one gets a sense of the wide range of questionable transactions and self-dealing activities, and the quagmire of Code Sections that ensnared the dealer in this TAM who tried to set up a "fast and loose" used car donation program.

In essence, TAM 200243057 is a case study in what ***not*** to do.

HOW TO DO IT: RR 2002-67

In Revenue Ruling 2002-67 (2002-47 I.R.B. 873), the IRS provided guidance on how a car dealer can set up a car donation program that will not run into the problems that befell the dealer in TAM 200243057.

The facts in the Revenue Ruling are fairly simple. They involve a charitable organization described in Section 170(c)(2) that is located in, and conducts its activities in, the same state as a for-profit entity (i.e., a dealership). Pursuant to a written agreement, the charitable organization and the dealership establish an ***agency relationship*** that is valid under the applicable law of their state.

The agreement provides that the dealership, acting as the authorized agent of the charitable organization, will administer a fund-raising program for that organization in exchange for a fee. The dealership's activities under the agreement are subject to review and approval of the charitable organization.

The agreement provides that the dealership will act on the organization's behalf to

DEALERSHIP RESPONSIBILITIES

1. solicit donations of used cars,
2. accept, process, and sell the cars,
3. transfer the proceeds of the sales to the organization, less its own fee, and
4. provide each donor with substantiation of that donor's contribution, including an acknowledgment that contains the information required by Section 170(f)(8)(B).

The Ruling holds that for purposes of Section 170, an individual donor's transfer of a car/vehicle to the authorized agent of a charity may be treated as a transfer to the charity. The Ruling states that the determination of whether an agency relationship exists is based on the requirements of state law. Accordingly, it cautions that not all contractual relationships will result in agency relationships under state law. It would appear that if a charity does not retain the right to control the processor, the necessary agency relationship will not be established.

Revenue Ruling 2002-67 also holds that the contemporaneous written acknowledgment required by Section 170(f)(8) may be provided to the donor by the charity's authorized agent.

HOW DONATED VEHICLES SHOULD BE VALUED

Obviously, a primary concern of the IRS is that taxpayers claim appropriate, and not excessive, deductions for the vehicles they donate to charity. Accordingly, Rev. Rul. 2002-67 discusses two different fact patterns. In one case, the vehicle donated is in ***average*** condition; in the other, the vehicle donated is in ***poor*** condition.

Vehicle in average condition. The first situation is described in the Ruling as follows... To assist a charitable organization in furthering its charitable purposes, an individual (donor D) who itemizes Federal income tax deductions, transfers a used car to an entity/dealership, as the charitable organization's authorized agent. The individual, D, does not receive anything of value in exchange for the car.

D consults an established used car pricing guide, which lists $4,500 as the current sales price for a car of the same make, model, and year as D's car and sold in D's area, if the car is in excellent condition. The guide lists $3,000 as the current sales price for such a car if it is in average condition. The guide does not provide a sales price for a car that is in poor condition.

The guide states that a car is in ***excellent*** condition if it has no defects; it is in ***average*** condition if it has some defects, but is safe to drive; and it is in ***poor*** condition if it needs substantial mechanical or body

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repairs, or is unsafe to drive. D's car is in average condition.

The Ruling states that one method of determining fair market value of a donated car is by reference to an established used car pricing guide. However, ***a used car pricing guide establishes fair market value only if the guide lists the sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition, as the donated car.***

Applying this generalization to D's vehicle in average condition, the established used car pricing guide lists $3,000 as the current sales price for a car that is the same make, model, and year as D's car, sold in the same area, and in the same condition (i.e., average). Therefore, the fair market value of D's car, and the amount treated as a charitable contribution under Section 170, is $3,000.

The Revenue Ruling adds that the individual donor "also could have determined the value of the car by *any other reasonable method."*

Vehicle in poor condition. The second fact pattern described in the Revenue Ruling involves the same individual, except that the car he is going to donate to charity is in ***poor*** condition.

The Ruling states that the established used car pricing guide does not list a sales price for a car of the same make, model, and year as D's car, sold in the same area, and in the same condition (i.e., in poor condition).

Because the guide does not provide a value for a car in poor condition, the guide does not establish the fair market value of D's car. ***Therefore, D must establish the fair market value of the car using some other method that is reasonable under the circumstances.***

Although the Ruling specifically directs one to see Publication 561, *Determining the Value of Donated Property*, that will produce no meaningful answer to a valuation question like this.

Query: Is it possible that asking a few used car dealers what they would pay for a car in that (poor) condition would establish a fair market value that could be used for tax purposes? If it would, or if that would be appropriate, this information should be obtained in writing.

CONCLUSION

It's quite possible that some CPAs have been asked by their auto dealer clients about how they might help organized charities by participating in a valid car donation program. TAM 200243057 indicates how they should ***not*** attempt to do it.

On the other hand, Revenue Ruling 2002-67 provides appropriate guidelines a dealer should follow if he or she is going to set up a program and provide information to the donors on the value of donated vehicles that they will use in their income tax returns.

For further information for dealers who want to set up these programs, see *Vehicle Donation Programs: Finally, IRS Guidance on How to Do Them Right*, in the *Journal of Taxation*, April 2003. This article also discussed Letter Rulings 200235005 and 200230007 where third-party vehicle processors (not necessarily car dealers) are involved as the gift facilitators. ✱

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TOP ISSUES & DEALER CONCERNS *FROM DEALER MAKE MEETINGS* *AT NADA CONVENTION ... SAN FRANCISCO ... JAN. - FEB., 2003*	
ACURA	1. Introduce new nameplates. 2. Get more product at dealerships. 3. Become more competitive.
AUDI	1. Focus on profitability. 2. Launch the A8 successfully. 3. Press for continued quality improvement of vehicles.
BMW	1. Maintain dealer profitability. 2. Achieve higher volume. 3. Upgrade dealerships.
BUICK	1. Get new product for Buick. 2. Launch the Rainier sport-utility successfully. 3. Move Buick upscale.
CADILLAC	Not Reported
CHEVROLET	1. Increase market share. 2. Have flawless new-product launches. 3. Continue to improve local marketing groups; get them in more of the top 50 markets.
CHRYSLER-JEEP	1. Give dealers new products, including a large and small sport-utility, an entry level Jeep and an entry level Chrysler car. 2. Price product right and competitively before incentives so dealer margins and profits don't suffer. 3. Keep improving quality.
DODGE	1. Get new products - a small sport-utility, a new small car, a 4500 pick-up, a 5500 pick-up and a large sport utility. 2. Get back from the Chrysler group the $50 per vehicle sold that funds the Dealer Advertising Association. 3. Set reasonable monthly/quarterly dealer sales goals.
FORD	1. Improve vehicle quality. 2. Get sufficient product. 3. Rework Blue Oval program.
HONDA	1. Analyze the direction of the economy. 2. Get dealers to sign new dealer agreement. 3. Get customers to buy into customer loyalty initiative.
HUMMER	1. Continue good customer service. 2. Build the dealer network. 3. Promote the brand.
HYUNDAI	1. Bring a minivan to the market - fast - and accelerate all future products. 2. Increase marketing, advertising and incentive support. 3. Improve product flow and mix from Korea.
INFINITI	1. Increase dealer profitability. 2. Keep up the emphasis on future product. 3. Strengthen the used-car certification program.
ISUZU	1. Get new products. 2. Adjust business operations until the new products come out. 3. Focus on the good news coming up, not the negative news.
JAGUAR	1. Keep Jaguar's competitive position in the luxury segment. 2. Build product quality and parts availability. 3. Get continuity and stability in the management ranks.
KIA	1. Reassure customers about quality. 2. Get a pick-up. 3. Build stand-alone stores.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION ... SAN FRANCISCO ... JAN. - FEB., 2003	
LAND ROVER	1. Boost communication. 2. Improve product and parts availability. 3. Preserve the brand image.
LEXUS	1. Make all-wheel-drive available on all Lexus vehicles. 2. Shorten product cycles. 3. Deal with the uncertainties about the economy.
LINCOLN MERCURY	1. Rework dealership certification program. 2. Accelerate future product. 3. Increase dealership profitability.
MAZDA	1. Gain profitability. 2. Increase Mazda-only locations. 3. Keep products coming.
MERCEDES-BENZ	1. Maintain dealer profitability. 2. Introduce Maybach in April. 3. Get all dealers to sell used cars.
MITSUBISHI	1. Improve relationship with customers. 2. Launch new vehicles successfully. 3. Continue sales growth in new segments .
NISSAN	1. Increase dealer profitability. 2. Increase return on sales. 3. Increase sales per outlet.
OLDSMOBILE	• None provided.
PONTIAC-GMC	1. Continue to get product. 2. Continue advertising and promotion. 3. Maintain profitability.
PORSCHE	1. Launch the Cayenne successfully. 2. Maintain dealers' profit margins. 3. Regain Boxster momentum through more advertising.
SAAB	1. Find out what products are coming and when. 2. Build the brand. 3. Get more dealer participation and communication.
SATURN	1. Get more Vue sport-utilities. 2. Build the Ion into a segment leader. 3. Create a better awareness for the mid-sized L series.
SUBARU	1. Cut Baja sticker. 2. Get more turbos. 3. Develop multipassenger hybrid.
SUZUKI	1. Get more product. 2. Market vehicles efficiently. 3. Deal with the economy.
TOYOTA	1. Get larger product allocations. 2. Develop Signature program. 3. Improve low CSI scores.
VOLKSWAGEN	1. Resolve lingering quality issues. 2. Push for fresh product; shorter product cycles. 3. Launch the Touareg sport-utility successfully.
VOLVO	1. Maintain profitability. 2. Restore brand advertising budget. 3. Build a stable relationship with the Factory.

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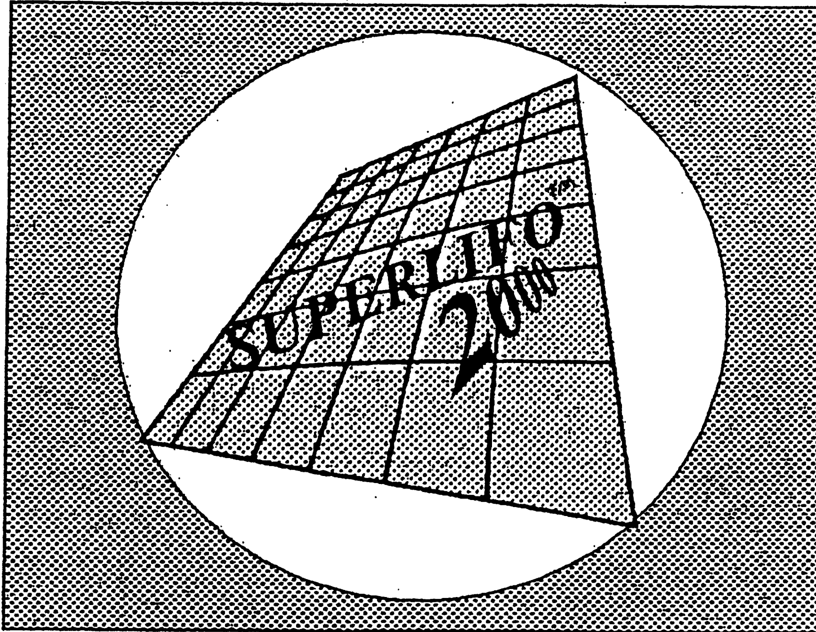

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