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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. WHERE, OH WHERE, HAVE MY LITTLE PORCs GONE? ... UPDATE ON IRS ATTACK ON PORCs & REPORTABLE TRANSACTIONS. Since our last coverage on the IRS' broadside attack on tax shelters and its impact on dealer reinsurance activity in Notice 2002-70, the Service has not released any further guidance or specifics. But, there has been an enormous concentration of effort within the IRS to try to figure out just exactly what it wants to do about all of this. Our update starts on page 4.

#2. OUTSOURCING ALL OF THE DETAIL WORK OFFERS COST-EFFECTIVE ALTERNATIVE FOR CHANGING ACCOUNTING METHODS FOR FACTORY INCENTIVES & AD FEES. In Update #5 in the December 2002 *DTW*, we overviewed the benefits for dealers who are making changes in accounting methods to reduce inventory costs by Factory incentive payments, trade discounts and advertising charges.

As mentioned there, contending with all the details can become tedious and overwhelming. Not only do year-end invoices for many years have to be analyzed, but other information including various floorplan and other reports must be reviewed in the course of making these determinations.

Complicating matters further, incentive programs vary by manufacturer and, in some cases, by year. And, if the new vehicle inventory is on LIFO, all prior year LIFO layers need to be recomputed to reflect the Section 481(a) adjustments that are required.

For CPAs and dealers wanting to obtain the benefits, but not wanting to do all of the detail work themselves, the opportunity to outsource this work can be irresistible. This includes the detailed invoice analysis for the three prior years, preparation of the Forms 3115, and the LIFO index recalculations. See page 3 for some additional information on this.

WATCHING OUT FOR

#3. TECHNICIAN TOOL REIMBURSEMENT ACCOUNTABLE PLANS ... REQUEST FOR CLARIFICATION OF TAX ISSUES. Here's a new development ... one provider of Section 62(c) accountable plans for technicians has requested that the IRS consider clarifying the answers to some of the underlying tax questions that are involved in determining reimbursement rates. It isn't surprising that different programs have different reimbursement rates, some (considerably) higher than others. And this alters the relative attractiveness of the plan being offered to dealers and their technicians.

This request was made to the IRS for consideration under its IIR (IRS Issue Resolution) Program. A similar request for clarification was made for this

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A Quarterly Update of Essential Tax Information for Dealers and Their CPAs

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issue to be placed on the IRS' Priority Guidance List. See page 6 for details.

#4. *FRONTIER CHEVROLET'S* PAYMENTS FOR NON-COMPETE AGREEMENTS HAVE TO BE STRETCHED OUT OVER 15 YEARS. In the June 2001 *Dealer Tax Watch*, we reported on the defeat that Frontier Chevrolet Co. experienced in the Tax Court. Frontier had argued that it should be allowed to write-off its payments for non-compete agreements over 5 years. The IRS had said that Section 197 required amortization over 15 years, and the Tax Court agreed with the IRS.

Recently, the United States Court of Appeals for the 9th Circuit agreed with the Tax Court in denying the 5-year write-off. However, the Appeals Court seemed to introduce the possibility that the 15-year write-off period might not be required in all cases. For more on this, see page 8.

#5. ONE DEALERSHIP FAMILY'S 10-YEAR WAR WITH THE IRS ... ANOTHER REALLY GOOD CASE STUDY. A year ago, we selected *Metro Leasing & Development Corp.* as a dealer case worthy of special attention. *Metro* is an opportunity to see the mishaps or misadventures that lurk in a situation that could be fairly common. The tax issues were encountered in the context of dealership activities that had resulted from the formation of a real estate holding company controlled by the former dealer.

In this issue of the *DTW*, we are focusing on another interesting series of cases, all involving another extended dealership family who went to court with the IRS over a host of tax issues for over 10 years. In this group of cases, collectively the *"Cordes"* cases, the dealer patriarch really controlled the entities and he was the beneficial owner of all of the stock of all of the entities, even though there seemed to be prior gifts of stock to other family members. Mr. Cordes was taxed big-time on the receipt of constructive dividends. He even ultimately paid the *"F"* penalty.

Our look at the *Cordes* saga begins on page 11.

#6. USED CAR *"DEALER"* NOT ALLOWED TO DEDUCT LOSSES FROM USED CAR ACTIVITY. There was an unusual case reported in May out of the Small Tax Case Division of the Tax Court (*Claude D. Mayo, Sr. v. Commissioner*, T.C. Summary Opinion 2003-51). Mr. Mayo worked for a power company as a lineman and he and his wife were not allowed to deduct net losses attributable to their used car activities in Schedule C of their individual income tax returns for 1995 and 1996.

They had conducted business as "Mayo's Auto Sales" beginning in 1989 or 1990, but this activity had never operated at a profit. In 1993 and 1994, they had reported losses of $14,000 and $16,000, respectively, from their activity. In 1995 and 1996, he had sold 4 automobiles, 2 of which were sold to relatives.

The tax issue was whether Mr. and Mrs. Mayo were allowed by Section 183 (the so-called "hobby loss" rules) to deduct the net losses attributable to their used car activity. The essential test for determining whether an activity is engaged in for profit is whether the taxpayer engages in the activity ***with the primary objective of making a profit.***

The expectation of making a profit must be bona fide. In these determinations, less weight is given to a taxpayer's statement of intentions than to the objective facts.

Reg. Sec. 1.183-2(b) contains a non-exclusive list of factors to be consulted in determining whether an activity is engaged in for profit. In this regard, see page 4 of the September 2002 *Dealer Tax Watch* which discusses the dealer deep-sea fisherman case—*James Peacock v. Comm.* No single factor nor simple numerical majority of factors is controlling.

Although the Mayos claimed that they had maintained books and records, they did not produce any records at trial. They couldn't explain a $16,000 deduction claimed for supplies in 1995, nor a deduction of $22,500 for other expenses in 1996.

The Tax Court Special Trial Judge stated that he was also concerned by the history of losses. He pointed out that "...while a person may start out with a bona fide expectation of profit, there is a time when, in light of recurring losses, the bona fides of that expectation must cease. This is particularly pertinent here where (the taxpayer) could not estimate when the activity might become profitable."

The Judge also said that there was no evidence that the Mayos, despite losses of more than $79,000 from 1993 to 1996, ever sought expert advice concerning the profitability of the venture. Also, there was no evidence that they had altered their method(s) of doing business to cut the stream of losses. Accordingly, the Court agreed with the IRS that Mayos' activity was not operated for profit. Therefore, it held that their net losses from this activity were not deductible.

The Tax Court declined to sustain penalties under Section 6662(a). The IRS had also asserted negligence penalties in this case. The Court pointed out that the taxpayers were not sophisticated in financial matters and that their income tax returns were prepared by a professional tax return preparer. Note: This is the same case as T.C. Summary Opinion 2001-146.

Automotive Trade Discounts

Green FINANCIAL OUTSOURCING SOLUTIONS

Sample CPA - Auto Clients

Thank you for contacting Green Outsourcing regarding Automotive Trade Discount and Advertising Expense adjustments. Frequently asked questions and additional information regarding these adjustments can be found at www.GREENOUTSOURCING.com.

The amounts listed below are actual benefits received by a Sample CPA Client and includes:

- Confidential benefits received by varying Automotive Dealerships.
- Typical "Capped Cost" service fees including LIFO re-calculations.
- Process and steps required to determine the calculation.

DEALERSHIP RESULTS

Individual Dealership Analysis:

Dealership	2001 Inv. At Cost	Actual Benefit	Service Fee**
GA. Dodge Dealer	$ 3,859,641.63	($ 136,540)	$ 5,557.45
CA. Ford Dealer	707,557.55	(19,949)	2,643.70
TX. GM / Nissan / Mazda / VW	8,859,717.25	(154,181)	7,682.00
TX. Dodge / Toyota Dealer	2,093,655.10	(40,603)	3,411.79
CA Ford Dealer	1,681,176.75	(40,545)	3,462.60
TX. Ford Dealer	1,998,496.06	(59,289)	3,953.13
AL. Ford Dealer	3,705,973.87	(116,405)	5,702.50
CA. Ford Dealer	1,465,310.40	(39,735)	3,390.72
NM Pontiac Dealer	1,816,034.86	(22,713)	2,794.95
TX. Dodge Dealer	3,295,663.00	(132,685)	7,160.00

Combined benefit available to clients in fiscal year 2002! **($ 762,645)**

All Dealerships required 2 – 3115's. $1200.00 IRS filing fees apply and are not included in Service fees. One (1) 3115 must be filed by fiscal year end and the other with the return.

**** If the combined benefit is more than the estimated amount, the service fees are capped at the maximum stated price. If the combined benefit is less than the estimate, the fees are adjusted accordingly.**

***** Green Outsourcing utilizes "capped service fees" and NO C.O.D. surprises. All fees are due upon receipt.**

SERVICE INCLUDES:

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- VIN Matching (3 Years).
- Electronic Back-up.
- Bound Documentation
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- FY 2003 YB Adjustment Assistance.
- Advertising Program Confirmation
- Trade Discount Confirmation.
- LIFO recalculation.
- 3115's filed under 97-27.
- 3115's filed under 02-09.
- Current through FY 2002.

PORC UPDATE
... WHAT'S THE IRS (REALLY) UP TO?

PORC UPDATE

The IRS launched its surprise attack on abusinve tax shelters, in which it included dealer reinsurance activity, in Notice 2002-70. See December 2002, *Dealer Tax Watch*. Since then, the IRS has not released any further guidance, clarification or specifics. But, that does not mean that there hasn't been an enormous concentration of effort within the IRS to try to figure out just exactly what it might want to do about all of this.

It is our understanding that a few major reinsurance providers and at least one of the Big 4 have recommended some minimum disclosure in tax returns in response to the Notice 2002-70 ambiguous "...or similar situation" wording. On the other hand, no doubt there are many others who support the conclusion that disclosures by dealerships and shareholders are not necessary. How far should you go? How far did you go? Should you just have flipped a coin?

AMENDED RETURNS?

Some CPAs told us that they included PORC-related disclosures in the tax returns that they filed. Some did not, but now (that they have had time to catch up on their reading or to do further research), they wish that they had put something in the returns they filed. They now believe that even some minimum ... CYA ... disclosure might have been prudent.

For those *johnnies-come-lately*, perhaps they could consider filing amended tax returns with that minimal attachment. Will that satisfy the disclosure requirements for listed transactions? Why shouldn't it?

If you're considering filing an amended return to make some disclosures, the July 2003 issue of *The Tax Adviser* (which came in shortly before going to the printer) has an article worth your review. See *"Tax Shelter Transactions: To Amend or Not to Amend?"* which begins on page 428.

The authors discuss the technical requirements to be satisfied by a "qualified amended return," and their underlying ramifications. The authors point out, "Absent further IRS clarification of its position on amended returns filed in such situations, many practitioners are uncomfortable in advising clients that an amended return accomplishes anything, other than *possibly* reducing the likelihood that the IRS will seek penalties."

The article also discusses the impact that an amended return may have on the calculation of interest. This is yet another troublesome area.

THINKING THROUGH THE FINAL REGS

Another article published in *The Tax Adviser* addresses some of the issues faced in attempting to comply with the final Regulations. (*"Tax Shelter Final Regs."* by Dan Mendelson and Jim Emilian of PricewaterhouseCoopers, LLP, appearing in *The Tax Adviser*, June 2003, pages 338-344.)

More serious students of these regulations will be interested in the authors' comments on these problem areas ... revised effective dates, participation, penalties, what constitutes a transaction, minimum fee, registration and lack of economic substance. The article also includes a full-page "Final Tax Shelter Quick Reference Guide" as Exhibit 1 and a full-page "Disclosure, Decision Tree" as Exhibit 2.

In their discussion of "what constitutes a transaction," among other aspects, the authors discuss confidential transactions, the presumption of non-confidentiality, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference and documentation retention.

The article concludes ... "The final regulations relieve some of the unwarranted complexity and excessive disclosure contained in the temporary regulations. ... ***No doubt the Service will tire from seeing disclosure of many types of non-consequential transactions ... Documentation retention*** by taxpayers and their advisors as an evidentiary matter ***is the overriding consideration*** and obligation under these regulations ... The regulations may be final, but more changes are just around the corner ..." (Emphasis added.)

THE AICPA WEIGHS IN

The *AICPA Tax Shelter Letter* dated March 24, 2003 to AICPA members is reproduced in full in the May 2003 *AICPA Tax Section Newsletter*. The *Letter* makes reference to "our enforceable *Statement on Standards for Tax Services* (SSTSs) (that) are a clear example" evidencing the AICPA's hard work "for years to help society effectively separate abuse and appropriate tax planning, while consistently supporting "the protection of the public interest and prohibition on the misuse of our tax system."

Gee whiz, makes you wonder if those hard-working members had any spare time left over after marketing all of those shelters that investors are suing them over and that the IRS wants to pin down to specific taxpayers based on lists that are arguably

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confidential. There's something to read about almost daily in the *Wall Street Journal*, *New York Times*, *Washington Post*, etc. Anyway, *you* might find something useful (maybe ironic) in the text of this 2-page *Letter*.

INSIDER INFO

Turning specifically to PORCs and Notice 2002-70, as we said, there's not much new to report in terms of solid pronouncements. However, there were several comments at the Federal Bar Association and IRS Insurance tax seminar in Washington on June 19 that are ominously ambiguous and worth calling to your attention.

As reported in *Tax Notes* (June 30, 2003), the Service is continuing to look with new vigor at many old (presumably thought to be already resolved) issues. One IRS representative indicated that Notice 2002-70 raises questions over whether the contracts are really *insurance* contracts. This, of course, would affect whether a PORC is really an insurance company. Ancillary issues the Service may be taking a more penetrating look at include whether the requisite degree of risk shifting and of risk distribution is present in purported contracts.

Another IRS representative said that although transactions under scrutiny occur in several retail areas, most of the transactions that the IRS had seen involved auto dealers offering repair protection or retailers offering credit life insurance.

These issues are important to the IRS. They are so important to the Service that it has assigned three "issue champions" from different divisions to work as a task force for more fact-finding on the nature of these transactions. They will be looking into various pricing components and the opportunity for taxpayers (read: dealers) to use commissions to divert income.

THE GHOST OF *WILLIAM WRIGHT*

Even more ominous, it was reported that the IRS would be invoking several theories to challenge these transactions. The *William Wright* case has been thrown into the works for good measure, yet another time.

YET A LITTLE MORE

Two peripheral developments, the issuance by the IRS of Notices 2003-34 and 2003-35, were also discussed at the Seminar in Washington.

Trivia: If you're not already familiar with *"stuffing"* a PORC, that means transferring appreciated assets to various (PORCs) entities ... also likely to receive IRS attention.

CONCLUSION

The additional guidance that the IRS said that it might issue within 60 or 90 days after the NADA Convention is nowhere to be seen. Realistically, it is unlikely that anything solid will come out of the IRS before (early) next year. Therefore, if you haven't already filed your PORC-related tax returns, it looks like you now have all of the information you're likely to get to help you decide what, or how, to disclose these activities in those returns.

We've saved the best for last: It appears that the IRS Motor Vehicle Technical Advisor has become a significant contributor to the various IRS task forces at work on all these PORC-related issues. This suggests that PORCs and the dealer transactions that generate them are likely to be well-represented when the IRS gets around to issuing something.

One wonders whether the ***"Eat PORK"*** ads by the Midwest Hog Raisers have been misinterpreted or taken out of their intended context by the IRS.

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May 14, 2003

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Re: IRS Industry Issue Resolution (IIR) Program
Recommended Issue for Consideration

Dear Ms. Blake:

In accordance with Revenue Procedure 2003-36, we submit the following issue for consideration. We believe that this issue is appropriate for the IIR because it potentially impacts almost all automobile dealers.

DESCRIPTION OF ISSUE

Clarification of tax treatment of expenditures incurred for, and related to, tools and equipment provided by (automobile dealership) service technicians in connection with their employment when their employer (automobile dealership) adopts a Section 62(c) accountable plan.

In determining an appropriate reimbursement rate, the answers to several tax questions directly bear on the final calculation. These questions include the proper tax treatment of (1) pre-employment expenditures for tools and equipment, (2) pre-plan adoption expenditures for tools and equipment and (3) prior-year tax treatment of those expenditures by the employee technicians in their previously filed income tax returns. In addition, an integrally-related question is, "To what extent, if any, may anticipated or projected future expenditures for tools and equipment by current technicians be factored into determining a current reimbursement rate?"

DESCRIPTION OF WHY THE ISSUE IS APPROPRIATE TO THE IIR PROGRAM

The Service recognized the prevalence and industry-wide importance of Service Technician Tool Reimbursement programs for auto dealers several years ago. However, at that time (in its Coordinated Issue Paper - June 2000), ***it did not directly address*** the issue we are specifically raising at this time in connection with employer adopted reimbursement plans that satisfy the requirements of Section 62(c) accountable plans.

The Coordinated Issue Paper, which is an IRS internal directive to examining agents in the field, unfortunately dealt with many types of arrangements by lumping them all together. In referring to these arrangements collectively, the CIP stated, "None of the methods, however, are directly correlated with or based exclusively upon the actual expenses paid or incurred by the service technician for tools." This significantly limits the conclusion of the Coordinated Issue Paper that "Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements." Also, it is contrary to many plans in existence under which technicians are currently receiving tool and equipment reimbursements.

There are thousands of automobile dealers, and almost all of them employ service technicians who provide their own tools and equipment as a condition of their employment. Both before and after the issuance of the Coordinated Issue Paper, automobile dealerships have adopted plans more specifically designed and structured to comply with the requirements of Section 62(c). Where these plans differ most significantly is in how, and the extent to which, the third-party administrator determines the reimbursement rate.

(Continued)

Under different interpretations of the same underlying tax questions, the same technician could be reimbursed at a significantly different rate, depending on which third-party administrator the employer has selected to handle the administration of the accountable plan details. Consequently, some portion of the amount being excluded from taxable income by some technicians under these rate computations may be improperly computed. In addition, a corresponding amount of employment taxes is being improperly computed.

EXPLANATION OF THE NEED FOR GUIDANCE

Given the industry-wide status of this issue and the large number of auto dealership employers and employee technicians affected, clarification of these tax questions addressed to the employer-employee taxpaying communities (rather than in the form of an IRS internal directive) is in the best interest of fair, equitable and consistent administration of the income tax and the payroll tax rules and regulations.

Many of the concerns referred to, but not definitively addressed in, the Coordinated Issue Paper are incorporated into this request for guidance, since this request is conditioned upon the existence of an employer accountable plan in place that satisfies all three of the requirements set forth in paragraphs (d), (e), and (f) of Regulation Section 1.62-2:

1. ***Business connection***
2. ***Substantiation***
3. ***Returning amounts in excess of expenses***

The Coordinated Issue Paper states, "If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan." The IIR Guidance herein requested is not for guidance on Section 62(c) plan requirement issues or on subsequent compliance (or lack of compliance) issues or consequences for accountable plans.

Rather, the IIR Program Guidance herein requested is on the very important threshold issues that are involved in the technicians' reimbursement rate calculations. Accordingly, our request for guidance under the IIR Program of the tax issues that underlie the reimbursement rate determination has not previously been addressed by the IRS.

Some of these issues/questions are listed in Attachment I.

ESTIMATED NUMBER OF TAXPAYERS AFFECTED BY THE ISSUE

We are unable to provide any statistics on how many automobile dealers may have already adopted reimbursement arrangements which are accountable plans under Section 62(c). It is submitted that clarification of these issues and tax questions will provide more specific guidance to those employers who desire to more accurately and properly compute reimbursement rates under their accountable plan arrangements.

RECOMMENDATION OF HOW THE ISSUE MAY BE RESOLVED

After consideration of a number of tax questions and related issues, it is believed that the ultimate result of IRS consideration could be the issuance of a Revenue Procedure in Question & Answer format.

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* * *

Respectfully Submitted,

/S/ Thomas Lower, II
/S/ Willard J. De Filipps

15 YEAR WRITE-OFF PERIOD FOR DEALER'S PAYMENTS UNDER NON-COMPETE AGREEMENTS ... UPHELD ON APPEAL IN *FRONTIER CHEVROLET CO.*

On May 14, 2001, two cases were reported that involved the application of Section 197 to non-compete agreements given by the sellers in dealership buy-sell transactions. These cases were decided by Tax Court Judge Robert P. Ruwe. One of the cases was *Frontier Chevrolet Co.,* the other case was *Burien Nissan, Inc.*

The second case, *Burien Nissan, Inc. et Al. v. Comm.* (T.C. Memo 2001-116), involved more complicated buy-sell/non-compete agreement fact patterns. It also involved transaction dates which straddled the August, 1993 effective date of Section 197. In *Burien,* the Tax Court required that the amounts paid for the non-compete agreements must be amortization over 15 years ... instead of 5 years. At the present time, any appeal by *Burien Nissan* has not been decided.

In this article, we're only going to deal with *Frontier Chevrolet.*

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

The timing of Frontier's transactions took place before the issuance of regulations under Section 197 specifically addressing how redemption transactions were to be treated. See Reg. Sec. 1.197-2(b)(9) ... proposed January 16, 1997 and adopted by T.D. 8865, January 20, 2000.

On May 28, 2003, the United States Court of Appeals for the Ninth Circuit upheld the decision of the Tax Court.

IN THE TAX COURT

The facts in *Frontier Chevrolet* are set out on the facing page. The question before the Tax Court was whether Frontier Chevrolet must amortize its non-competition agreement payments to Roundtree Automotive and to Mr. Frank Stinson over 15 years pursuant to Section 197. This resulted from the IRS' position that Frontier's redemption of its stock was an "acquisition" of an interest in a trade or business within the meaning of that section.

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

The Tax Court said, "The legislative history of Section 197 contains no evidence that Congress intended a purchase of stock to be excluded from the meaning of the term "acquisition" simply because the purchase occurred in the form of a redemption."

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

The Tax Court said that as a result of the stock sale agreement, Frontier regained possession and control over its stock. Therefore, "On the basis of the plain meaning of the statute," the redemption was an "acquisition" within the meaning of Section 197 because Frontier received 75% of its stock as a result of its transaction with Roundtree Automotive Group. After Frontier redeemed all of the stock held by the Roundtree Automotive Group, Mr. Menholt–formerly a 25% owner–owned 100% of the stock of Frontier.

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

"The legislative history explains that an 'acquisition of stock that is not treated as an asset acquisition' is treated as 'an indirect acquisition of a trade or

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THE FACTS IN FRONTIER CHEVROLET CO.

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

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

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

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

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

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

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

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

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

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

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

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

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

On its Federal income tax returns for the years 1994 through 1996, Frontier amortized the non-competition agreement payments over 15 years. In 1999, Frontier filed a claim for refund for the taxable years 1995 and 1996 on the basis that the non-competition agreement payments should be amortized over 60 months (i.e., the life of the agreement) business.' Thus, the legislative history indicates that an interest in a trade or business includes not only the direct acquisition of the assets of the trade or business but, also the acquisition of stock in a corporation that is engaged in a trade or business."

The Tax Court said that the non-competition agreement was reasonable and necessary to protect the business interest which Frontier Chevrolet was acquiring under the Stock Sale Agreement.

"New" Trade or Business. The Tax Court pointed out that neither the legislative history of the statute–nor the statue itself– contains any indication that an interest in a ***new*** trade or business must be acquired in order for Section 197 to apply.

Therefore, the amortization of the non-compete payments over 15 years, rather than the shorter term of the agreement, was proper.

IN THE APPEALS COURT

The Appeals Court decision is fairly brief (91 AFTR 2d 2003-2338 (CA-9, 2003)). It agrees with the Tax Court that Frontier's redemption was an indirect acquisition of an interest in a trade or business under Section 197. The Appeals Court said Frontier's arguments were incorrect for three reasons.

First, Frontier's argument reads a requirement into Section 197 that taxpayers must acquire an interest in a ***new*** trade or business. The Appeals Court said that Section 197 only requires taxpayers to acquire an interest in **a** trade or business.

The Appeals Court said that, although Frontier continued its same business, acquired no new assets and redeemed its own stock, it acquired an interest in a trade or business because it acquired possession and control over 75% of its own stock. The result of the transaction was to transfer ownership of the company from one owner to another. Mr. Menholt, who before the transaction owned only 25% of the shares, became the sole corporate shareholder after the transaction.

Second, the legislative history of Section 197 makes clear that "an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation engaged in a trade or business. The Appeals Court said that Frontier acquired stock of a corporation engaged in the trade or business of selling new and used vehicles. The result does not change merely because the acquisition of stock took the form of a redemption. "Indeed, the substance of the transaction was to affect a change of ***controlling*** corporate stock ownership." (Emphasis added.)

Third, when Congress passed Section 197, it clearly intended to simplify the resolution of tax controversies related to the amortization of intangibles. Congress provided for this simplification by grouping certain intangibles and by providing ***only*** one period (i.e., of 15 years) for their amortization. The Appeals Court said that Congress further intended to simplify the treatment of intangibles by treating stock acquisitions and stock redemptions similarly.

IS THERE ANY HOPE FOR A SHORTER WRITE-OFF PERIOD?

Are the holdings in *Frontier Chevrolet* applicable across the board in all situations? Or, do the particular facts in Frontier's case suggest that a shorter write-off for a non-compete might be possible in situations where the facts are different?

In a note, the Appeals Court said... "The only issue we address is whether a redemption of 75% of a taxpayer's stock constitutes an indirect acquisition of an interest in a trade or business for purposes of Section 197. We need not, and do not, decide whether ***all*** stock redemptions made in connection with an execution of a covenant not-to-compete constitute an acquisition of an interest in a trade or business within the meaning of Section 197." (Emphasis added.)

As noted above, in *Frontier Chevrolet*, the stock ownership interest acquired was a controlling interest and Mr. Menholt went from a 25% minority interest position before the transaction to a 100% sole ownership, controlling position after the transaction.

What about other fact situations? ... What if the change in stock ownership involved a non-controlling stock interest, yet payments were made to the selling shareholder under a non-compete agreement? Depending on the facts, the amount of stock changing hands might be either (1) an interest of less than 50%, or (2) small enough so that it does not alter the controlling and non-controlling relationships of the other shareholders, but simply changes their absolute percentages.

In fact situations different from *Frontier Chevrolet*, is it possible to argue that related non-compete payments are amortizable over the term of the agreement ... 3 or 5 years ... rather than the 15 years provided in Section 197?

The wording in the Appeals Court's decision seems to leave that door open ... a little ... for that argument.

ONE DEALERSHIP FAMILY'S CONSISTENT LOSSES TO THE IRS IN ITS 10-YEAR WAR OVER CONSTRUCTIVE DIVIDENDS & OTHER QUESTIONABLE TRANSACTIONS

THE *CORDES* SAGA

Last summer, two Memorandum Decisions were decided by the Tax Court involving a dealer, his dealership and several family members and several disputes they had with the IRS over various tax issues. Those cases were just two out of many that have been working their way through the tax courts involving this Oklahoma dealer and his family over the last decade. This article takes a look at the more recently decided cases involving the Cordes family in the context of several other cases that the family disputed in the tax courts.

In several instances, the Tax Court decisions have been appealed. In all instances, they have been upheld at higher levels. The two more recent cases are *June Cordes, Et Al. v. Comm.* (T.C. Memo 2002-124) and *Eddie Cordes, Inc., Et Al. v. Comm.* (T.C. Memo 2002-25).

Together, these cases reflect a somewhat typical situation: The IRS couldn't be sure exactly what happened due to the ambiguity and inconsistency of the recordkeeping, and due to the conflicting and vague oral explanations that it received from the taxpayers. As a result, the Service assessed duplicative deficiencies and left it to the Tax Court to sort it all out and get to the bottom of things.

The *At a Glance* summary of the 5 cases is on pages 12-13. There were actually many more cases involving family members and entities, but they were often simply consolidated as one major case before the Tax Court.

Some CPAs, glancing only at headnotes summarizing these cases, might conclude that the IRS lost heavily in the Tax Court. Deceptive one-liners fostering this impression include ... "Wife Didn't Get Constructive Dividends or Dodge Gift Tax on Stock Transfers" (summarizing T.C. Memo 2002-124) and "Kids Didn't Receive Constructive Dividends from Dad's Corporate Earnings" (summarizing T.C. Memo 2002-125). Although an off-the-cuff reaction to these might be that the Cordes family did not fare too poorly in its disputes with the IRS because they the wife and the kids beat the tax, that reaction really is not correct.

Considering all of the Cordes cases in their entirety, the Cordes family lost consistently across the board. The Tax Court simply held that the IRS could not collect the same amount of tax from more than one family member.

As previous articles in the *Dealer Tax Watch* have pointed out, the area of constructive dividend exposure where there are poorly documented shareholder loans and diversions of corporate funds becomes a real minefield. In the Cordes cases, collectively, the IRS hit the mother lode, and once it got started, it just kept on going. One might loosely refer to all this Cordes family litigation as a "war" with the IRS. Certainly, tremendous amounts of time, effort and expense were involved as these cases moved along.

TWO CORPORATE/DEALERSHIP CASES

Eddie Cordes, Inc. was incorporated in Oklahoma in January 1963 as a Jeep-Eagle dealership. Cordes Finance Corp. was incorporated in January of 1964, and it operated mainly to finance new and used vehicles purchased by customers from the Jeep-Eagle dealership and from other car dealerships owned by Mr. Cordes. In 1997, Cordes Finance Corp. merged into Eddie Cordes, Inc., with the latter surviving as the successor corporation.

Two cases involved major dealership or corporate issues. These two cases are *Cordes Finance Corp. v. Comm.* and *Eddie Cordes, Inc., as Transferee*. The latter case followed the former after the Tax Court issued its judgment against Cordes Finance Corp. when Cordes Finance and Eddie Cordes, Inc. agreed to merge in 1997.

In the June 1997 *Dealer Tax Watch*, we reported in some detail, the Tax Court Memo Decision in *Cordes Finance Corporation*. This was a classic case of the IRS coming in and finding an improper method of accounting for interest income. The Service response was to correct that erroneous method by making a change in accounting method under Section 446.

There was no good defense for Cordes Finance's method of accruing interest income only when a loan was fully paid-off or when it repossessed the vehicle securing the loan. Not satisfied with the Tax Court's holding against it, the Corporation appealed unsuccessfully–see *Dealer Tax Watch*, December 1998, *"IRS Change in Dealer's Interest Income & $300,000 Penalty for Underpayment Upheld by Tenth Circuit Court of Appeals."*

see **THE CORDES FAMILY SAGA**, page 14

AT A GLANCE	***THE CORDES FAMILY ET AL. versus THE IRS*** ***A Decade of Dissent, Dispute & Disastrous Results***
Cordes Finance Corp. *v. Comm.* *(Tax Year 1990)* *(Corporate)*	• Three dealerships in Oklahoma ... fraud & penalties • Taxpayer Lost ... all four issues were decided against the taxpayer ♦ The Company's method of accounting for interest earned on its portfolio of car loans... approximately $3.1 million. ♦ The adjustment required by the IRS to eliminate the discrepancy between the deferred interest income control account balance and the total of the underlying individual loan records... approximately $1.6 million. ♦ The imposition of a fraud penalty because the dealer instructed the bookkeeper to credit a shareholder loan account, rather than a current income account, for amounts (such as bankruptcy receipts, late charge fees and other miscellaneous receipts) that should have been reported as income... approximately $33,000 fraud penalty. ♦ The imposition of the accuracy-related penalty under Section 6662(a) for the substantial understatement of income tax ... approximately $303,000 penalty.
	• Citations: ♦ T.C. Memo 1997-162, Dec. 51975(M) 73 TCM 2493 ... April 1, 1997 ♦ 98-2 U.S.T.C. ¶50824 ♦ SCt - Cert denied April 26, 1999
Eddie Cordes, Inc. *as Transferee* *(1997-1998)* *(Corporate)*	• Taxpayer Lost ♦ Surviving corporation in merger was liable under Sec. 6902 as transferee for liabilities in full, including the deficiency upheld against Cordes Finance Corp. by the Tax Court. ♦ Liability as a transferee in the merger was for the full amount of the deficiency, interest and penalties assessed by the IRS. ♦ The transferee corporation's liability was not limited to the value of the assets that Eddie Cordes, Inc. had received from Cordes Finance Company.
	• Citations: ♦ T.C. Memo 2001-265, Dec. 54508(M) 82 TCM 714 ... October 4, 2001 ♦ U.S. Court of Appeals for the 10th Circuit, Docket #029003 ... Feb. 4, 2003
Edmund & June Cordes *v. Comm.* *(Tax Year 1988)* *(Individual)*	• Taxpayer Lost ♦ Edmund Cordes was taxable on constructive dividends on the amount of $432,000 because he had beneficial ownership of all of the stock of Cordes Finance Corp. in 1988, regardless of whether or not he was a stockholder of record. • Cordes was unable to persuade the Court that amounts paid to him, or on his behalf by the Corporation, were actually repayments by the Corporation of loans that he had made to it in previous years. ♦ "Taxpayer used the Corporation as his own personal deep pocket." ♦ The informality relating to Mr. Cordes' purported loans "goes far beyond what we would expect with respect to transactions of this size." ♦ "The facts belie any intention to create a real debtor-creditor relationship."
	• Citation: ♦ T.C. Memo 1994-377 Dec. 50,026(M) 68 TCM 356 ... August 11, 1994

AT A GLANCE	THE CORDES FAMILY ET AL. versus THE IRS A Decade of Dissent, Dispute & Disastrous Results
June Cordes, et al. v. Comm. *(Tax Years 1989-1993)* *(Individual)*	• Involved ten (10) consolidated tax cases ... two of which involved Cordes Finance Corp. and eight of which involved Mr. Cordes and other family members. ♦ Five cases involved income tax issues and five cases involved gift tax issues. ♦ All cases involved assertion of various penalties. • Edmund Cordes was taxable on constructive dividends because he had beneficial ownership of all of the stock of Cordes Finance Corp. and other dealership entities, regardless of whether or not he was a stockholder of record. • Therefore, his wife (June Cordes) could not also be taxed in a separate return on the constructive dividends that were taxable to her husband. • Consistent with these holdings, his wife was not liable for any gift tax on certain disputed transactions that were purported to be stock transfers.
	• Citation: ♦ T.C. Memo 2002-124 ... May 22, 2002
Eddie Cordes, Inc., et al. v. Comm. *(Tax Years 1994-1995)* *(Individual)*	• Involved six (6) consolidated tax cases ... two of which involved Cordes Finance Corp. and other dealership entities and four of which involved Mr. Cordes and other family members. • Edmund Cordes was taxable on constructive dividends because he had beneficial ownership of all of the stock of Cordes Finance Corp. and other dealership entities, regardless of whether or not he was a stockholder of record. • Therefore, his children could not also be taxed (on constructive dividends) in their income tax returns on the constructive dividends that were taxable to Edmund Cordes in his return. • In addition, Edmund Cordes received self-employment income from interest on notes that had been distributed to him. • Substantial underpayment penalties and fraud penalties were assessed.
	• Citation: ♦ T.C. Memo 2002-125 ... May 22, 2002
Bottom Line	• Over all the years and cases, 19 different disputes ended up before the Tax Court. • The Cordes dealership and financing company entities lost all issues that the IRS raised. • Edmund Cordes, the patriarch, was taxable on very large amounts of constructive dividend income over many years because he was the beneficial owner of all of the stock of various entities, notwithstanding book transfers, etc. • Because the facts were so confusing and poorly documented, the IRS threw all of the family members into the mix and assessed deficiencies against all of them. • As a result of holding Edmund Cordes taxable on constructive dividends, a number of the IRS deficiencies proposed against family members (due to the uncertainty of the fact patterns) were dismissed. These were, by no means, victories for the taxpayers in the overall context of what was happening. • Over multiple years, the IRS successfully asserted penalties for underreporting, inaccuracies and fraud against both Mr. Cordes and his corporations. The aggregate amount of the penalties is astounding.

(Continued from page 11)

Still not content to let matters rest, Cordes Finance Corp. appealed to the Supreme Court, and *certiorari* was denied on April 26, 1999.

The next case involved whether the successor corporation to Cordes Finance Corp. was liable and responsible for all of its predecessor's liabilities and obligations, including the finance company's liabilities to the IRS after it lost in the Tax Court in the 1997 decision. Eddie Cordes, Inc. claimed that after the merger, its liability as a transferee was limited to the value of the assets that it received from Cordes Finance Corporation. Obviously, it was looking for a way to dodge its its liability to the IRS as a transferee.

There were arguments over whether the successor corporation's liability as a transferee was based *in law*, rather than *in equity*. The Court held that Eddie Cordes, Inc.'s transferee liability was that of a transferee ***at law.*** Therefore, its liability was not limited to the value of the assets received. Accordingly, it was liable as transferee for the full amount of the IRS assessment against Cordes Finance Corporation as determined by the Tax Court.

Again, not content to let matters rest, Eddie Cordes, Inc. appealed to the U.S. Court of Appeals for the Tenth Circuit ... where it lost again when the Tax Court's decision was upheld.

CORDES FAMILY CASE I

From the summaries above, it becomes apparent that there was no taking "No," as an answer from the Tax Court. Before turning to the more recent midsummer 2002 Tax Court Memo Decisions, let's look briefly at some earlier tax disputes involving Cordes family members that ended up consolidated as a Tax Court Memo Decision in 1994.

In *Edmund J. Cordes and June Cordes v. Comm.* (T. C. Memo 1994-377), the basic tax issues were whether Edmund J. Cordes' withdrawal of corporate funds in the amount of roughly $291,000 from Cordes Finance Corp. constituted constructed dividends to him and whether the Company's payment of another $141,000 of his personal expenses should also be treated as constructive dividends to him.

Not surprisingly, the IRS also asserted penalties under Section 6653(a)(1) for negligence or disregard of rules or regulations and under Section 6661 for substantial understatement of income tax.

During 1988, Mr. Cordes owned directly or indirectly all of the stock of Cordes Finance Corporation and four other auto dealerships. At issue was the real status of one account, No. 312. This account was considered by Mr. Cordes to be a "holding account" or an account in the nature of a "shareholder loan account." There was no real documentation to support inflows of money into the account and there were no written agreements or notes evidencing any loans by Mr. Cordes or his wife either to Cordes Finance Corp. or to the other corporations he controlled.

At trial, Mr. Cordes' testimony was unclear in many respects. In his Petitioner's brief, he attempted to disavow stock ownership in Cordes Finance Corp. with respect to the constructive dividend issue. He testified that he and his wife began transferring their stock in that corporation to their children in 1963. He did not recall when the last stock transfer occurred; he could only recall that the children had held the stock for a long time.

In his reply brief, Mr. Cordes had contended that the stock of Cordes Finance Corp. had been transferred to his children in 1971. Mr. Cordes argued that no adverse inference should be drawn from his failure to produce the stock ledgers to support his position. ***He claimed that he would have offered the stock ledgers into evidence, had he "known or had reason to know that ... anyone in IRS questioned the stock ownership" of Cordes Finance Corp.***

The Court stated, "It is the Petitioner himself who has belatedly injected the issue of stock ownership of Cordes Finance Corp." The Court then said that it would not consider issues that were raised for the first time on trial or on brief. Going further, the Court stated, "Even if the stock ledger showed that Petitioner was no longer a stockholder of record of Cordes Finance Corp. during 1988, record ownership of stock, standing alone, is not determinative of who is required to include any dividends attributable to such stock in gross income. ***Rather, beneficial ownership is the controlling factor.***"

The Court then provided these further insights: "This Court must consider not only whether there was a passage of bare legal title, but whether there was a retention or disposition of the benefits and burdens of the incidents of ownership." The Court said that it would consider whether, while the legal ownership or title of the property may have passed, the actual benefits or control associated with stock ownership had remained with the original owner or transferor.

The Court pointed out other cases where a taxpayer's total control over a corporation and the use of corporate funds to satisfy personal debts had resulted in constructive dividend treatment, even though those individuals did not hold legal title to the corporation's stock at the time of the advances. The Court held specifically in the case of Mr. Cordes that "Whether or not Petitioner (i.e., Mr. Cordes) was a stockholder of record, ***Petitioner had beneficial*** →

ownership of all of the stock of Cordes Finance Corp. in 1988." It then went on to find that Mr. Cordes received constructive dividends because he had received economic benefits from payments made on his behalf by Cordes Finance Corp. without any expectation of repayment.

Then, Mr. Cordes tried to throw in a new argument. He did not suggest that the 1988 distributions themselves (i.e., the payment of his personal expenses and the payment of money to others at his direction) constituted loans to him rather than dividends. Mr. Cordes claimed that these 1988 distributions were instead "repayments by the Corporation of loans he had made to the Corporation some time in the past."

Accepting Mr. Cordes' assertions at face value, the Court said, "While the transactions we must examine are remote in time from the 1988 transactions, we apply the same factors in determining the existence of a bona fide indebtedness between Cordes Finance Corp. and Petitioner." The factors to be considered include:

- The extent to which the shareholder controls the corporation.
- The earnings and dividend history of the corporation.
- The magnitude of the advances and whether a ceiling existed to limit the amount the corporation advanced.
- Whether or not security was given for the loan.
- Whether there was a set maturity date.
- Whether the corporation ever undertook to force repayment.
- Whether the shareholder was in a position to repay the advances.
- Whether there was any indication the shareholder attempted to repay the advances.

After considering these factors, the Court said that it found no objective evidence of the existence of any such loans.

It added that Mr. Cordes' "mere statement" that he considered the distributions to be repayments of loans is not sufficient to show that the intrinsic economic nature of the transactions themselves is that of debt rather than of a constructive dividend.... "Petitioner's mere declaration of intention does not create a loan and is not determinative without further evidence substantiating the existence of bona fide loans."

The Court did not find Mr. Cordes' testimony credible (especially in light of the absence of any documentation), particularly in regard to purported sources of funds that would have been deposited into the account No. 312. For example, Mr. Cordes had testified that about $1 million deposited into that account was the result of sales of Italian silk stockings that he had "liberated" from a German warehouse at the end of World War II. Furthermore, the balance sheets included in the Corporate income tax returns (Schedules L) did not show the existence of any such loans by Mr. Cordes to the Corporation.

The Tax Court concluded that the informality relating to Mr. Cordes' purported loans to Cordes Finance Corp. "...goes far beyond what we would expect with respect to transactions of this size." There was no documentation of the loans to Cordes Finance Corp. to support Mr. Cordes' contention that the 1988 distributions were intended to be repayments of these purported loans. While the loans were purportedly documented by "receipts" or "cancelled checks," no receipts or cancelled checks were produced. There was no security for the loans, no set maturity date and no efforts by the Corporation to enforce repayments.

The Court concluded that Mr. Cordes "simply used the Corporation as his own personal deep-pocket." It said that he failed to carry his burden of proving that he was entitled to the funds distributed to him, or paid on his behalf, as repayment of loans. Accordingly, since the facts belied any intention to create a real debtor-creditor relationship, Mr. Cordes was taxable on constructive dividends on the total amount of $432,000.

In addition, Mr. Cordes was liable for both of the additional penalties asserted by the IRS.

CORDES FAMILY CASE II

As many know, once the IRS gets into a dealership, it often stays around for quite a while. The case discussed above involved the patriarch of the Cordes family and the tax year 1988. We now move on to another series of cases involving Cordes family members.

In *June Cordes, Et Al., v. Comm.* (T.C. Memo 2002-124, May 22, 2002), there were 10 cases ... two of which involved Cordes Finance Corp. and eight of which involved Mr. Cordes and other family members over a span of years going as far back as 1983 and then forward through 1994.

Five of these cases involved income tax issues. The other five involved gift tax issues. In all of the cases, the IRS asserted various penalties.

These cases involved big bucks: The total dollars in deficiencies and penalties at the corporate level for the years 1991 through 1993 were slightly in excess

see **THE CORDES FAMILY SAGA,** page 16

of $2 million in tax deficiencies and $440,000 in penalties. At the individual level, for the years 1983 through 1984, the income tax deficiencies assessed were roughly $640,000 and the corresponding penalties roughly $330,000 ... not to mention the gift tax deficiencies for the years 1983 though 1994 which topped-out at little more than $3.1 million.

The reason the proposed deficiencies were so high was because the IRS was initially unable to determine which individuals should be treated as being in receipt of constructive dividends. Therefore, to protect the Government's interest, the Commissioner determined that each of the individual taxpayers had received all of the constructive dividends in full. The Service conceded that, if the Tax Court were ultimately to find that Mr. Cordes–the patriarch–was the beneficial owner of all of the stock of the dealership and the finance companies, then his wife and his children would not be liable for tax on the receipt of the underlying constructive dividends.

By the time they finally reached the Tax Court, many issues had been settled or conceded by the parties, or were deemed to be conceded by the Tax Court. Left for the Tax Court to decide was:

1. Whether the IRS Commissioner abused his discretion in determining that interest charged for 1992 and 1993 on loans between Edmund J. Cordes and Cordes Finance Corp. was unreasonable and excessive. Also, whether the Commissioner abused his discretion in recharacterizing the amounts transferred to reflect and arm's-length rate of interest under Section 482.

2. Whether Edmund Cordes' wife (June Cordes), in 1989 through 1991, and Mr. and Mrs. Cordes, together in 1992 and 1993, received constructive dividends from Cordes Finance Corp. resulting in additional taxable income.

3. Whether Cordes Finance Corp. was liable for a civil fraud penalty under Section 6663 for 1991.

4. Whether Mr. and Mrs. Cordes had made completed gifts of stock in family-owned and closely-held corporations for Federal gift tax purposes.

The Tax Court held that the Commissioner did not abuse his discretion in dealing with the Cordeses. It found that the IRS properly treated the amount of "excess" interest paid to the Cordeses as constructive dividends. With respect to other questionable transactions, Mr. and Mrs. Cordes were also found to have received constructive dividends during the years 1989 through 1993.

As to the gift tax issues, the Cordeses did not make completed gifts. Edmund Cordes was the beneficial owner of the Corporate stock. And, yes, the Tax Court held that Cordes Finance Corp. was liable for a civil fraud penalty.

SUMMARY OF THE FACTS IN CORDES FAMILY CASE II

As mentioned in connection with the corporate cases (on page 11), Eddie Cordes, Inc., was incorporated in Oklahoma in 1963, as a Jeep-Eagle dealer and eventually it obtained a Dodge franchise. Edmund Cordes, Inc. (known as Cordes Dodge, Inc., until February 16, 1989), was incorporated in Oklahoma in 1967, as an authorized dealership for Dodge vehicles. John Cordes, Inc., was incorporated in Oklahoma in 1983, as an authorized dealership for Chevrolet, Oldsmobile, Pontiac, and General Motors vehicles.

The Tax Court collectively referred to the three dealerships (i.e., Edmund Cordes, Inc., John Cordes, Inc., and Eddie Cordes, Inc.) as the Cordes family dealerships. Cordes Finance Corp. operated mainly to finance new and used vehicles purchased by customers from the Cordes family dealerships.

Each dealership was subject to a franchise agreement with the vehicle manufacturer whose cars it sold. Each franchise agreement identified an individual as the franchise holder and bound that individual to specific restrictions. The two common relevant restrictions required the franchise holder (1) to maintain direct ownership of a certain minimum percentage of stock of that Cordes family dealership and (2) to maintain active operational control of the respective Cordes family dealership. The franchise holder had to be both the principal owner and the principal operator of the Cordes family dealership involved.

Throughout almost the entire period, Mr. Cordes was the franchise holder for each Cordes family dealership. At times, John Cordes, Jean Ann Richard, and Eddy Ben Cordes were the franchise holders or principal owners, at least nominally (sometimes in conflict with the relevant franchise agreement), of John Cordes, Inc., Edmund Cordes, Inc., and Eddie Cordes, Inc. From time to time, legal title to the stock in the Cordes family dealerships would change hands among members of the Cordes family.

Each member of the Cordes family played a role in the Cordes corporations, but no one played a more substantial role than Mr. Cordes. Mr. Cordes served as president of each of the Cordes corporations and controlled every aspect of the day-to-day operations. No other family member questioned his dominance or attempted to exercise any

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control over any corporate decision, regardless of his or her ostensible stock ownership in that corporation.

None of the Cordes corporations held shareholder meetings. Instead, Mr. Cordes directed his corporate attorney to draft meeting minutes, which he brought home for Mrs. Cordes and their children, as appropriate, to sign. Similar sequences of events occurred for each other document Mr. Cordes required Mrs. Cordes and their children to sign. Mr. Cordes prepared, or directed the preparation of, retained, and maintained all corporate minutes, records, stock certificates, and other corporate documents.

Mr. Cordes decided who would hold legal title to each of the shares of stock in each of the Cordes corporations. He believed he had the power to revoke those holdings if the shareholder did not follow his directions, or for any other reason, by virtue of his original capitalization of the Cordes corporations. The other members of the Cordes family acknowledged Mr. Cordes' complete control. In many cases, they did not know how many shares were titled in their names, if any, or whether they were officers in any of the Cordes corporations.

Mr. Cordes controlled and executed all external dealings of the corporations. Banks dealt solely with him and held him liable on all corporate debts, even though they occasionally required other members of the Cordes family to sign certain documents as a formality.

The Cordes corporations' accounting firm dealt only with Mr. Cordes. Mr. Cordes had sole control over the occurrence, timing, amount, and recipient of corporate payments for noncorporate reasons, and he occasionally made below-market loans to and from the corporations to suit his own purposes.

Mrs. Cordes and Jean Ann Richard each served as officers or directors of each of the Cordes corporations. However, they did not participate in any of the Cordes corporations' day-to-day operations or business decisions. Neither of them had any knowledge of any financial transactions, stock-related or otherwise. Jean Ann Richard treated the Cordes corporations as belonging exclusively to Mr. Cordes, no matter the amount of shares that may have been titled in her name.

John Cordes served as an officer of Cordes Finance Corp., but his only operational involvement with the Cordes corporations was the occasional execution of vehicle repossessions in Texas. He otherwise was unaware of any corporate transactions. Eddy Ben Cordes served as an officer of Cordes Finance Corp. and as the full-time sales manager of Eddie Cordes, Inc. He had no decision-making ability, but he placed orders for acquisitions of new cars.

The Cordes family occasionally discussed the Cordes corporations' business and financial matters in informal settings, including at the Cordeses' kitchen table.

INCOME TAX CASES

In the income tax cases, the IRS was dealing with a myriad of transactions. At the same time, it was receiving little cooperation from the taxpayer in understanding the underlying facts and events. Accordingly, the Service threw a very broad net over the whole area. It took the position that Cordes Finance Corp. had dealt with the Cordeses in at least three ways, each of which resulted in the family members receiving constructive dividends. The three charges the Service raised were that (1) Cordes Finance Corp. transferred funds to the Cordeses, (2) the Cordeses had diverted funds from Cordes Finance Corp., and (3) funds were otherwise appropriated from Cordes Finance Corp. for the Cordeses' benefit.

The IRS raised questions concerning the withdrawal of Corporate funds for distribution to friends and family in the years 1989 through 1993 in the aggregate amounts of $315,700, $290,659, $900,511, $170,000 and $250,000, respectively. No less than 10 different individuals or corporations were identified as recipients or beneficiaries of these withdrawals or distributions. In addition, there were issues regarding loans and loan interest allocation during many of these years.

For the three years 1989 through 1991, Mr. Cordes had caused Cordes Finance Corp. to pay certain family personal expenses in various amounts aggregating over $380,000. In addition to the payment of personal expenses by Cordes Finance Corp., the Service charged that Mr. Cordes also diverted from the Company for his and his wife's personal use, amounts representing collections on debts that the Company had previously written-off as bad debts in an amount in excess of $150,000.

The last income tax issue involved the tax consequences and ramifications of purchase by Mr. Cordes from Cordes Finance Corp. of various notes representing funds that the Corporation in prior years had loaned to various family members for the purchase of residences and other real estate. Mr. Cordes had purchased these notes from Cordes Finance Corp. at less than fair market value, and the tax issues involved whether, and to what extent, Mrs. Cordes might have taxable income from constructive dividends stemming from Mr. Cordes' purchase of these notes for amounts less than their fair market value.

see **THE CORDES FAMILY SAGA**, page 18

(Continued from page 17)

INCOME TAX ISSUES
... WHAT THE TAX COURT SAID

The Tax Court held that the Commissioner was correct in reallocating loan interest income. As to various constructive dividend issues, the fact that Mrs. Cordes had filed separate income tax returns for some of the years complicated the Tax Court's overall analysis. The Court did refer to the prior case that it had decided involving Mr. Cordes.

In referring to its decision in *Cordes v. Comm.* (T.C. Memo. 1994-377), the Tax Court said that it held that Mr. Cordes received constructive dividends even if he did not hold legal title to any shares, because he had exercised full control over Cordes Finance Corp. in the taxable year at issue, 1988.

In 1988, the taxable year immediately preceding the years involved in the current consolidated cases, Mr. Cordes had caused Cordes Finance Corp. to make distributions to him, to friends and family, and to his personal creditors. He controlled the timing, amount, and uses of those funds. Because Mr. Cordes had total control over Cordes Finance Corp. and used the corporate funds for personal reasons, the Tax Court concluded that "whether or not petitioner [Mr. Cordes] was a stockholder of record, petitioner had beneficial ownership of all of the stock of Cordes Finance Corp. in 1988." By virtue of his beneficial ownership, the Tax Court had held Mr. Cordes had received constructive dividends in 1988 and was required to include those dividends in his gross income.

The Court added that "Mr. Cordes' relationship to Cordes Finance Corp. did not change from 1988 to 1989, or during any of the other taxable years before us; in the taxable years 1989 through 1993, Mr. Cordes remained in complete control of Cordes Finance Corp. and remained the beneficial owner of the shares of stock therein.

"Mr. Cordes' actions with respect to Cordes Finance Corp. exceeded the level of control normally conferred upon corporate officers. He made every corporate decision without conferring with the shareholders of record. ***Any purported shareholder meeting was an invention of his design***; he made all shareholder decisions and instructed the legal titleholders merely where to sign the corporate minutes, loan arrangements, stock certificates, and so forth. The legal titleholders complied with his every instruction.

"His actions were that of an owner and sole shareholder. He viewed the Cordes corporations as his own and used them to make generous loans and gifts to family and friends, and to satisfy personal obligations and desires. He made loans to third parties of Cordes Finance Corp. funds and then unilaterally forgave those loans. Mr. Cordes controlled the timing, amount, and use of the distributions and transactions. ... His control was unmitigated. ... Taken together, the facts and circumstances reveal that Mr. Cordes was Cordes Finance Corp.'s sole beneficial owner during the taxable years at issue; Mrs. Cordes' status as a shareholder was in name only."

The Court concluded that, in the years in which she filed separate income tax returns (1989, 1990, and 1991), Mrs. Cordes did not receive constructive dividends from Cordes Finance Corp. Because beneficial ownership is the controlling factor in deciding who is required to include dividends in gross income, the Tax Court held that with respect to those taxable years, Mrs. Cordes was ***not*** a beneficial owner or shareholder of Cordes Finance Corp. for Federal income tax purposes. The Tax Court declined to consider whether Mr. Cordes received constructive dividends as a shareholder for those taxable years, because he was not a party to those years.

However, the Cordeses had filed joint income tax returns for 1992 and 1993. And, for those years there remained the plethora of tax issues involving withdrawals of Corporate funds for distribution to friends and family, diversion of Corporate income and loan interest allocation.

The Court concluded that the Cordeses had not introduced any evidence that Cordes Finance Corp. had not received any benefit from these transfers. Therefore it held Mr. Cordes to be the beneficial owner of the all of the Corporation's stock. As a result, he received constructive dividends with respect to these items in the amounts determined by the IRS. In addition, to the extent that excess interest had been paid by the finance corporation to Mr. Cordes, those excess amounts also were constructive dividends to him.

Last, but not least, the Tax Court upheld a civil fraud penalty against the finance corporation for 1991.

GIFT TAX ISSUES

In the gift tax cases, the IRS took the position that members of the Cordes family had transferred shares among themselves without properly reporting those transfers or paying gift tax where it was due. The recitation of facts is extremely detailed and involves the transfer of shares in all three dealerships as well as in Cordes Finance Corporation. In all cases, none of the stock transfers were made for any consider-

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ation. Some of the family members had filed Forms 709 (Gift Tax Returns), and others had not.

In connection with the gift tax issues, the Tax Court said, "The evidence in this case resoundingly demonstrates that Mr. Cordes' control over the Cordes family dealerships remained unimpaired and was so complete that he could do anything he wanted with the Cordes family dealerships regardless of which family member held legal title to the shares of stock.

"While the record in this case contains several examples of Mr. Cordes' taking inconsistent positions with the Internal Revenue Service and with others regarding the ownership of the Cordes family dealerships, we simply cannot ignore the overwhelming weight of the evidence establishing that no member of the Cordes family other than Mr. Cordes held any beneficial ownership interest in the Cordes family dealerships. The family members knew it, corporate employees knew it, and, despite Respondent's position in these consolidated cases, Respondent knew it (having taken such a position in related cases).

"Mr. Cordes' absolute control over all aspects of the Cordes family dealerships–stock, financial, and operational–was such that we must conclude he was the beneficial owner of all of the Cordes family dealerships.

"Because Mr. Cordes owned all beneficial interest in the Cordes family dealerships during the taxable years at issue, all of the disputed transfers were solely of legal title. Because such transfers of legal title are not subject to the gift tax, we must hold for petitioners (i.e., various Cordes family members other than Mr. Cordes) with respect to the gift tax cases involving stock in the Cordes family dealerships."

Accordingly, since Mr. Edmund Cordes was taxable on the receipt of constructive dividends because he had beneficial ownership of all of the stock of all of the entities ... regardless of whether or not he was a stockholder of record ... his wife was not liable for any gift tax on these transactions that were purported to be stock transfers.

CORDES FAMILY CASE III

The second mid-summer 2002 Cordes family case for discussion is *Eddie Cordes, Inc., Et Al., v. Comm.* (T.C. Memo 2002-125, May 22, 2002). Not surprisingly, this case also involved a myriad of stock ownership and related constructive dividend issues. However, this time the children of Edmund and June Cordes are more involved. This Tax Court decision involved six (6) consolidated tax cases ... two of which involved Cordes Finance Corp. and the other dealership, and four of which involved Mr. Cordes and other family members.

In many respects, this case is simply a continuation of T.C. Memo 2002-124 (discussed above). It, too, ultimately ends badly for Edmund Cordes with the Tax Court upholding significant fraud penalties against him, along with other lesser penalties.

The years at issue in the cases consolidated in this Tax Court Memo Decision are basically 1994 and 1995. The year 1992 is also involved in the dealership dispute. Separate Notices of Deficiency had been issued to Eddie Cordes, Inc., to Edmund and June Cordes, and to three of their married children. The IRS had determined that constructive dividends totaling $4.5 million in 1994 and $2.5 million in 1995 had been paid, and it wasn't sure how much of each amount was actually paid to the Cordes family members.

Because the IRS was not able to determine which individual taxpayers received each alleged constructive dividend, the IRS again determined that each family member received the full amount of the constructive dividend. As a result, once the Tax Court determined who was the proper party to be taxed, the other taxpayers were relieved of their alleged tax deficiency which had been set up in order to protect the Government's interest.

At the corporate level, the deficiencies assessed were roughly $1.2 million of which $850,000 was the tax deficiency and $350,000 related to fraud and other penalties. At the individual level, for the years 1994 and 1995, the deficiencies aggregated roughly $11.4 million, plus $2 million more for various penalties and another $1 million for fraud.

Remembering that the companion mid-summer 2002 case involved issues of whether or not completed gifts of stock had been made, one can appreciate the complexity and difficulty that had to be dealt with in developing an appropriate statement of facts in this case. Accordingly, several of the determinations in this case, TCM 2002-125, were contingent on what were determined to be the facts in TCM 2002-124.

In TCM 2002-124, some of the findings of the Tax Court as to stock ownership were crucial: During the taxable years at issue, members of the Cordes family held legal title to all the shares of stock in Cordes Finance Corp. and Eddie Cordes Inc. On January 1, 1994, Jean Ann Richard and John Cordes each held legal title to 33.3% of the shares of stock in Cordes Finance Corp., and June J. Cordes (Mrs. Cordes) held legal title to the remaining 33.4% of the shares of stock in Cordes Finance Corp.

On January 14, 1994, Mrs. Cordes transferred her legal title to Eddy Ben Cordes. No further transfers of stock in Cordes Finance Corp. took place during the years involved in (i.e., in TCM 2002-125).

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At all times during those years, Eddy Ben Cordes held legal title to 100% of the shares of stock in Eddie Cordes Inc.

The Tax Court included the following in its findings of fact in TCM 2002-125:

"Mr. Cordes exercised complete control over Cordes Finance Corp. and Eddie Cordes Inc. (the Corporations) during the taxable years at issue. Mr. Cordes controlled all of the Corporations' operations and made all decisions pertaining to the timing, amount, and character of the distributions at issue herein. All Corporate decisions that would typically be made by shareholders–including who would hold legal title to the shares of stock in the corporations, and for how long–were made by Mr. Cordes. The record owners had no knowledge of the Corporations' day-to-day operations, did not authorize or disapprove of any of the distributions at issue, and, in many cases, were not aware of those distributions."

With regard to numerous transactions, all having a constructive dividend denominator, the IRS concluded that during the years 1994 and 1995 combined, one or more of the individual taxpayers had received constructive dividends aggregating more than $7 million.

Some of these amounts were attributable to the diversion of checks from unidentified loans, the diversion of tag refunds, excess payoffs, distributions to family members, the bargain sale of notes and the diversion of checks from bad debt recoveries, unbooked finance company income and other "unexplained sources of funds." For a sense of what the IRS came up with and possibly what was going on, see the table on the facing page.

From all of this, the Tax Court had to decide:

1. Whether any of the individuals had received constructive dividends from either Cordes Finance Corp. and/or from Eddie Cordes, Inc., in the years 1994 and/or 1995 ... and, if so, in what amounts.

2. Whether interest earned on certain notes in 1994 and in 1995 was properly included in the taxable income of Cordes Finance Corp. or in Edmund J. Cordes' taxable income. A related question was: If the interest were properly includable in Mr. Cordes' income, whether that interest should be treated as income from self-employment.

3. Whether Cordes Finance Corp. could deduct repossession costs in 1994 and 1995 from income.

4. Whether accuracy-related penalties should be imposed.

5. Whether Cordes Finance Corp. and Mr. Cordes were liable for fraud penalties for 1994 and 1995.

The Opinion portion of the case is quite lengthy. In summary, the primary argument of the IRS was that Mr. Cordes should be taxable on all of the alleged constructive dividends, rather than any of the other shareholders. It took this position because Mr. Cordes was the beneficial owner of all of the stock of all of the Corporations.

The alternative position of the IRS was that if Mr. Cordes were not taxable on all of the constructive dividends, then each of the other individual Cordes family members should be taxable on receipt of constructive dividends in amounts proportionate to his or her record ownership.

Mr. Cordes' opposing argument was ironic. He argued that although he completely controlled Cordes Finance Corp. and Eddie Cordes Inc., he could not held to have received constructive dividends because he did not hold stock in those corporations in the taxable at issue. In response to the IRS's alternative argument, Mr. Cordes contended that because he completely controlled Cordes Finance Corp. and Eddie Cordes Inc., and the record owners (i.e., the other individual Cordes family members') had no knowledge of, did not authorize, or did not actually benefit from the transactions, they received no constructive dividends. (Is there a better word than *ironic* to describe this argument?)

The Tax Court commented as follows ... "This is not the first time Mr. Cordes and his family have appeared before us, nor is it the first time that Mr. Cordes and his family have presented us with ***a mishmash of arguments apparently designed to escape the consequences of the tax laws***. [*Cordes v. Comm.*, T.C. Memo. 2002-124; *Cordes v. Comm.*, T.C. Memo. 1994-377] For the reasons discussed below, we conclude that, in the taxable years before us, Cordes Finance Corp. and Eddie Cordes Inc. conferred certain economic benefits on Mr. Cordes as beneficial owner of all the stock in those corporations, without expectation of repayment, and that Mr. Cordes has income from constructive dividends."

The "reasons discussed below" to which the Tax Court referred related to the fact that it was clear that Mr. Cordes was the beneficial owner of all of the Corporate stock and that the Corporations had conferred economic benefits on him, as beneficial owner directly and/or indirectly. At one point, in connection with certain loan accounts, the Tax Court observed, "Those loan accounts were established to account for the $1,600,000 that was distributed in effect to Mr. Cordes and returned to Cordes Finance Corp. until Mr. Cordes determined what to do with the funds. ***The loan accounts operated in substance as savings***

EDMUND CORDES, ET AL. - EDDIE CORDES, INC.
CONSTRUCTIVE DIVIDENDS ... $7 MILLION

	1994	*1995*	*Combined*
Eddie Cordes, Inc. ... Sources of Distributions			
Diversion of Checks from Unidentified Loans	$ 88,225	$ 16,000	$ 104,225
Diversion of Tag Refunds	57,609	55,088	112,697
Excess Payoffs	3,826	28,514	32,340
Cash Distributions to Mr. Cordes.	-	600,000	600,000
Total from Eddie Cordes, Inc.	$ 149,660	$ 699,602	$ 849,262
Cordes Finance Corporation ... Sources of Distributions			
Cash Distributions to John Cordes	$ 800,000	$ -	$ 800,000
Cash Distributions to Jean Ann Richard	800,000	120,000	920,000
Cash Distributions to Mrs. Cordes	484,651	400,000	884,651
Sale of 1994 and 1995 Notes	1,733,608	1,073,608	2,807,216
Diversion of Checks from Bad Debts	12,282	-	12,282
Diversion of Unbooked Cordes Finance Corp. Income	71,910	-	71,910
Unexplained Source of Funds	405,724	211,612	617,336
Total from Cordes Finance Corporation	$ 4,308,175	$ 1,805,220	$ 6,113,395
Total Constructive Dividends	**$ 4,457,835**	**$ 2,504,822**	**$ 6,962,657**

Note: Totals may not add due to rounding.

accounts from which Mr. Cordes distributed funds to his family members at will."

In order to result in proper tax symmetry, the Court said, "Because we have already held that Mr. Cordes must report the $1,600,000 recorded in the loan accounts as constructive dividends, we hold that the distributions from the loan accounts ... (i.e., distributions of various amounts to various other family members) ... do not constitute additional constructive dividends from Cordes Finance Corp. to Mr. Cordes." In other words, in "fairness" to Mr. Cordes, he shouldn't be taxed on money as it went into the account and on that money again as it came out of the account.

Perhaps more troublesome to the Tax Court were the tax issues related to the bargain sale of notes by the finance corporation to Mr. Cordes in 1994 and 1995 at prices below their fair market values. The Service alleged that the discount at which the notes were sold constituted dividend income as well.

In this regard, the Tax Court said, "...What is more relevant is that Cordes Finance Corp. treated the notes as satisfied and completely removed the

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records from its computer and files, going so far as to claim deductions for bad debts. Mr. Cordes added the records to his files and treated them as outstanding debts owed to him. Moreover, any payments delivered to Cordes Finance Corp. were promptly forwarded to Mr. Cordes. Although Cordes Finance Corp.'s employees occasionally collected the payments from the borrowers, recorded them in Mr. Cordes' records, and issued receipts for those payments, they did so on behalf of Mr. Cordes."

Mr. Cordes had argued that he "merely held the payments 'in escrow,' ultimately delivering them to Cordes Finance Corp." The Tax Court said that it presumed that Mr. Cordes' argument was that because he had never deposited the payments in his own account, he did not have dominion or control over the funds; and the funds, therefore, were not income to him.

However, Mr. Cordes received payments on notes he had already purchased from Cordes Finance Corp. and exchanged them for more of Cordes Finance Corp.'s notes, which he then also owned. That Mr. Cordes did not first deposit the payments received in a personal account before purchasing additional notes was irrelevant. The Court found that Mr. Cordes had full control over the payments, that he owned the notes in question, and that the differences between the prices paid for the notes and the fair market values of the notes were constructive dividends to him.

In short, Edmund Cordes was taxable on all of the constructive dividends because he had beneficial ownership of all of the stock of Cordes Finance Corp. and other dealership entities, regardless of whether or not he was a stockholder of record. Therefore, his children could not also be taxed (on constructive dividends) in their income tax returns on amounts that were already taxable to Edmund Cordes in his income tax return. On a related point, Edmund Cordes also received *self-employment* income from interest on notes that had been distributed to him.

Accuracy-related penalties due to substantial understatement of income under Section 6662(a) and (b)(2) were imposed. Furthermore, accuracy-related penalties due to negligence or disregard of rules or regulations under Section 6662(c) also were imposed. Finally, fraud penalties were imposed on Cordes Finance Corporation to the extent of 75% of the portion of its underpayment which was attributable to fraud, and its entire underpayment of $555,000 was attributable to fraud.

The Service and the Tax Court weren't done yet. The remaining issue for the Tax Court was whether Mr. Cordes intended to evade taxes known to be owing by conduct intended to conceal, mislead or otherwise prevent the collection of taxes.

The Court started by considering the various indicia or "badges" of fraudulent behavior. In this regard, circumstantial evidence which may give rise to a finding of fraudulent intent includes: (1) Understatement of income; (2) inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent explanations of behavior; (5) concealment of assets; (6) failure to cooperate with tax authorities; (7) filing false documents; (8) failure to make estimated tax payments; (9) dealing in cash; (10) engaging in illegal activity; and (11) attempting to conceal illegal activity. These "badges of fraud" are nonexclusive. The taxpayer's background and the context of the events in question may be considered as circumstantial evidence of fraud.

The Court concluded that the Commissioner "clearly and convincingly [has] shown that Mr. Cordes intended to evade tax known to be owing by concealing, misleading, and otherwise preventing the collection of taxes." See facing page for more on this.

The Tax Court held that Mr. Cordes had not reasonably relied, in good faith, on his accountant and/or on the Revenue Agent. It said that the facts that Mr. Cordes had presented did not allow it to find that Mr. Cordes had reasonably relied on professional advice in good faith. Mr. Cordes did not show that he ever requested, received, or relied on any advice with regard to the transactions at issue. Therefore, Mr. Cordes was liable for the fraud penalty for 1994 and 1995.

LESSONS FROM THE CORDES CASES

One can't help but conclude that over all the years and all the cases involving the 19 different disputes that ended up before the Tax Court (with some going even higher), the Cordes entities lost substantially all issues to the IRS. In the Cordes family situation, a very muddled history of "gifts" of stock and corporate distributions resulted in significant tax deficiencies, an assortment of penalties and even the successful prosecution of fraud charges.

Edmund Cordes, the patriarch, was taxable on very large amounts of constructive dividend income over many years. This happened because he was held to be the beneficial owner of all of the stock of various entities, notwithstanding book transfers, etc. Because the facts were so confusing and poorly documented, the IRS threw all of the family members into the mix and assessed deficiencies against all of them. Then the Tax Court sorted it all out.

As a result of holding that Mr. Edmund Cordes was taxable on constructive dividends, a number of →

ACTIONS & BEHAVIOR = TAX FRAUD

The Tax Court relied on the following facts in reaching its conclusion...

1. ***Mr. Cordes consistently over a period of several years substantially understated his income by not reporting the constructive dividends or interest income earned.*** ... While this consistent underreporting alone is not enough to establish fraud, other badges of fraud are present here that make it clear that Mr. Cordes' behavior was fraudulent.

2. ***Mr. Cordes provided false documents to the Revenue Agent.*** Mr. Cordes, in an effort to prove there were no personal ledger cards in excess of those already produced, provided the Revenue Agent with documents that purported to show that the transferred notes were properly removed from Cordes Finance Corp.'s books and were not personally owned by Mr. Cordes.

   Those documents consisted of purported lien releases, each dated to coincide with the date the note was removed from Cordes Finance Corp.'s records. The Oklahoma Tax Commission's records, however, evidenced that the liens were actually released on later dates, indicating that those notes were outstanding beyond the date that Cordes Finance Corp. had removed them from its records. Mr. Cordes did not deny that the Oklahoma Tax Commission's records were accurate. ***It appears that Mr. Cordes, or someone acting on Mr. Cordes' behalf, falsified many of those records, intending to deceive the Revenue Agent,*** with the goal of evading taxes known to be owed. This is yet another strong indication of fraud.

3. ***Mr. Cordes repeatedly failed to cooperate with tax authorities.*** Regarding Mr. Cordes' 1994 taxable year, the Revenue Agent assigned to the case, Ken McGee, requested from Mr. Cordes and Cordes Finance Corp., which Mr. Cordes controlled, documents (such as the loan ledger cards) which relate to the constructive dividends and the interest income.

   Mr. Cordes refused to provide the Revenue Agent with Cordes Finance Corp.'s books or records, refused to comply with a subsequent summons for the same books and records, and only complied with a second-chance letter to provide those documents approximately 4 months after the initial summons.

   The Revenue Agent issued two additional document requests after reviewing the initial documents, but Mr. Cordes specifically refused to provide any additional information. The Revenue Agent then issued a summons for those documents, as well as a summons for the books and records containing information regarding Mr. Cordes' 1995 taxable year; those summonses were issued to Eddy Ben Cordes, president of Cordes Finance Corp., as well as to Bill Burns, Viola Burns, and Michael Heinz (other administrative personnel).

   The Revenue Agent also issued a summons to Mr. Cordes to produce his personal ledger cards. Mr. Cordes denied he had those cards and refused to comply with the summons, although Mr. Burns and Mrs. Burns had informed the Revenue Agent that Mr. Cordes did keep those cards. Eventually, Mr. Cordes produced 108 ledger cards in partial compliance with a judge's order. The Revenue Agent was later able to obtain more ledger cards from Mr. Cordes but cumulatively obtained cards pertaining to fewer than 200 of the 1,168 notes Mr. Cordes had purchased from Cordes Finance Corp.

   Mr. Cordes' repeated refusals to cooperate with the Revenue Agent and his concealment of documents strongly indicate that Mr. Cordes' behavior was fraudulent.

The *Cordes* Family Saga

(Continued)

the IRS deficiencies proposed against other family members (due to the uncertainty of the fact patterns) were dismissed. There were, by no means, any victories for any of the taxpayers in the overall context of what was happening.

These cases illustrate, once again, the likelihood that the IRS will prevail when it comes across ambiguous and poorly documented stock ownership situations. In addition, the specter of constructive dividend taxation is always present when dealers and/or other family members indiscriminately draw money out of their corporations without proper documentation.

One final reminder: For more information on what the *IRS Audit Guide* tells agents to look for in shareholder loan situations, see the *Dealer Tax Watch*, June 2001. There you will find a full write-up of the *IRS Audit Guide*, including 12 critical or key factors, a checklist for identifying problem areas and a listing of some of the disguised dividends that could be lurking in related party transactions.

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