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DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH OUT

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

#1. DEALER PORCs ... STILL THE HOTTEST SUBJECT ... *"The Other White Meat."*

Throughout the summer, the IRS has continued gathering more information on PORCs. On August 19, the IRS PORC Task Force held a meeting with various industry professionals, in which, we are told, it made clear that it was still in an information gathering mode and that Notice 2002-70 was not aimed only or specifically at auto dealer PORCs.

Apparently, there are many IRS audits of dealerships going on and one specific area that agents are directed to investigate involves dealer-PORC activities. In addition, we are told that the Service has initiated audits of several promoters. Publicly, IRS representatives have stated that properly structured and implemented PORC programs should not have any problems.

One reader, a CPA, recently called to say that he has a dealer with 3 PORCs that were formed last year. In reviewing the PORC tax returns, he noticed that they did not have any disclosure statements attached. In response to his questioning the Big Four return preparer about their absence, he was told that the decision had been made that disclosure was not necessary because the reinsurance company had reported losses! What do you think about that?

On a related note, we are aware that some advisors have interpreted the Regulations to not require disclosure (even though the taxpayer is subject to Notice 2002-70) if the PORC had filed a tax return on or before February 28, 2000. We need some clarification on this point.

#2. SAFEGUARDING CUSTOMER INFORMATION ... *Not exactly a current dealer tax development, but certainly a current dealer practice development opportunity.* May 23, 2003 was the effective date for the Federal Trade

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Commission's *Standards for Safeguarding Customer Information*. These rules implement the Gramm Leach Bliley Act which requires all "financial institutions" ... and that includes auto dealerships ... to "safeguard customer information" in accordance with its rather general requirements.

Some CPAs have been helping their dealers understand what they are required to do and implementing appropriate procedures. See pages 3-6. If you're not inclined to see this as work your firm wants to venture into, one service provider, The Lauer Group (888-527-1725), offers a comprehensive, dealer-specific turn-key program that does just about everything you can think of at rather reasonable prices.

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

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

see DEALER TAX WATCH OUT, page 2

P.S. If you're a tax advisor, and/or preparing income tax returns, these standards and requirements also apply to you and/or to your Firm.

#3. IRS INTENSIFIES SCRUTINY OF PROPER FORM 8300 CASH TRANSACTION REPORTING & ANTI-MONEY LAUNDERING ACTIVITIES.

Another area that the IRS is heavily emphasizing right now in dealership audits is the proper reporting of cash transactions in excess of \$10,000. In its Fact Sheet (FS- 2003-16) dated August 2003, the IRS said that it has more than 1,000 open audits of the tax returns of new and used car dealers for a variety of issues.

During the past 3 years, the Service "has seen an increase in scams and fraud involving the automotive sales industry. Some scam artists have knowingly assisted narcotics traffickers in laundering their ill-gotten gains, while others submit false loan documents to financial institutions to obtain car loans."

In addition to commenting on Form 8300 and other anti-money laundering initiatives, the Service publicized the success of the U.S. Attorney's Office in achieving a 73% incarceration rate in the eight months ended May 31, 2003.

For more on this, see page 7.

#4. DEALER TAX ISSUES STRIKE OUT. The IRS announced the new issues that it had selected to take on for its Industry Issue Resolution Program in IR-2003-92. Unfortunately, several issues submitted for consideration that involved automobile dealerships were not selected. Included among those not picked up was one specifically involving Section 62(c) accountable plan issues for automobile service and body shop technicians.

In reviewing the published list of submissions not selected, the IRS showed evidence that it had not carefully read the submission (printed in the last issue of the *Dealer Tax Watch*) when it incorrectly described the "submitter's issue description" as "Equipment *Rental* (Automobile Service Technicians)." In fact, nowhere in the submission was there any mention or inference that *rental* arrangements were involved. The entire focus on the request for guidance was addressed to Section 62(c) accountable plan issues.

We had hoped that the IRS powers-that-be would at least have more carefully read and analyzed our submission before dismissing it.

#5. CHANGES IN ACCOUNTING METHOD FOR TRADE DISCOUNTS, FLOORPLAN ASSISTANCE & ADVERTISING FEES. In the last issue of the *Dealer Tax Watch*, Update #2, we commented on another hot topic, namely dealers

who are making changes in their accounting methods by filing Forms 3115 to reduce inventory costs by trade discounts and advertising fees.

There are different opinions out there among CPAs regarding the advisability and/or viability of these changes. Certainly, there is a significant difference in benefit for dealers on LIFO as distinguished from dealers who are not on LIFO.

We have included an outline which treats these auto dealer changes more generally and omits details of the LIFO implications. The outline begins on page 10. A more comprehensive treatment of these changes in method for dealers on LIFO (with related schedules and benefit analyses) appears in the September 2003 issue of the *LIFO Lookout*.

#6. CURRENT TAX DEVELOPMENTS, STRATEGIES AND IRS ACTIVITIES FOR AUTO DEALERS ... Here's a fully developed outline you can use for your own dealer client or staff seminar.

In this issue of the *Dealer Tax Watch*, we've decided to try to do something unique for our readers. One of my ongoing activities involves presenting tax update seminars for auto dealers and for their CPA firms. Beginning on page 16, you'll find the most current outline that I have used for this presentation. Please consider using it as a pro-forma or a head start in your own training and practice development activities. It may be helpful on a stand-alone basis, or as a starting point for developing your own materials for either year-end staff training or client promotional activities. I know that if I were planning to do a staff training session or a dealer seminar on these subjects, I'd love to have somebody else's outline to start out with.

If you want to use it for this purpose, all you need to do is write to us on your letterhead to request our written waiver of our copyright which appears at the bottom of the outline's first page (as well as on the last page of every issue of this publication). We will be glad to provide, via e-mail or hard copy, a master that you can reproduce (with attribution to the *Dealer Tax Watch*) and edit as best suits your needs. There is no charge for any of this service.

On page 17 is the summary of Objectives, etc., that you could modify and use for CPE purposes.

Another use for this outline is simply as a *Practice Guide* by which you can check your staff's familiarity and understanding with these matters.

One last thought ... If you are interested in my presenting this seminar to your Firm in-house or as a teleconference, these options are also available. Contact Kristin Lavery in our office in this regard.*



SAFEGUARDING CUSTOMER INFORMATION & SAVING YOUR DEALER FROM THE FTC ... A PRACTICE DEVELOPMENT OPPORTUNITY

Over the summer, some CPA firms have been busy helping dealerships in implementing the Federal Trade Commission's final standards for **safeguarding customer information**. This final Safeguards Rule became effective May 23, 2003.

This should not be confused with the privacy notifications that dealers have already been required to send out. Rather, the Safeguards Rule sets forth the appropriate standards that the FTC has established for "financial institutions" relative to how they must safeguard customer information which they come into contact with and maintain.

Since auto dealerships are considered to be "financial institutions," under the Gramm-Leach-Bliley Financial Modernization Act of 1999, **all of your dealership clients are required to be in compliance with these new Regulations**. And, customer information is defined to include information that is shared with, or handled by, affiliates.

The penalty for noncompliance with the Safeguards Rule could be a fine of \$11,000 per day.

Another disturbing potential could be that if a dealership fails to safeguard its customer information, and as a result, identity theft occurs, the dealership might have its liability compounded.

COMPLIANCE ELEMENTS

The FTC's Safeguards Rule requires a dealership to develop a **written information security plan** that describes its program to protect customer information. The plan must be appropriate to the dealership's size and complexity, the nature and scope of its activities, and the sensitivity of the customer information it handles. As part of its **written plan**, the dealership must address five compliance elements. See the *At A Glance* on pages 4-5.

The FTC has indicated that these requirements are intended to be flexible. Each dealership should implement safeguards appropriate to its own circumstances. For example, some dealerships may choose to describe their safeguards programs in a single document, while others may describe their plans in

see SAFEGUARDING CUSTOMER INFORMATION, page 6

COST-EFFICIENT, TURN-KEY SOLUTIONS

For a CPA firm that lacks the time or expertise to do this itself, and doesn't want another CPA firm providing this service for its clients, using a third-party service provider could be a very cost-efficient alternative.

The Lauer Group, operating out of Ionia, Michigan, has developed a comprehensive *Customer Information / Privacy "SAFEGUARD® Program"* for automobile dealerships.

They will come in, and on a turn-key basis, provide

- 1 a thorough dealer/dealership interview
- 2 an initial risk assessment,
3. a written information security safeguard program,
4. all required documentation,
5. all necessary employee training, including split or duplicate employee training sessions,
6. update training for new employees, and
7. periodic newsletters.

The Lauer Group has provided this service to many dealerships. Its prices are based on the number of dealership employees. For example, for a dealership with up to 15 employees, the initial fee is \$1,500 and the subsequent annual renewal amount is \$750. For a dealership with 16-30 employees, the initial amount is \$1,800 with renewal amount being \$900. For a dealership with approximately 100 employees (91-120), the initial amount is \$3,000 and the annual renewal amount is \$1,500.

For more information, contact Michael F. Lower, President of *The Lauer Group, Inc.*, at 105 Kidd, Street, Ionia, MI 48848, phone: 888-527-1725, fax: 616-527-0808, e-mail: clauer@chartermi.net.



<i>At A Glance</i>	STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION DEALERSHIP REQUIREMENTS FOR COMPLIANCE
Objectives of the Safeguards Rule <i>Sec. 314.3</i>	<ul style="list-style-type: none"> • Dealerships must have administrative, technical and physical safeguards for customer information. ... "Customer Information Security (CIS) Programs" • These rules are intended to result in <i>reasonable</i> policies and procedures ... <ol style="list-style-type: none"> 1. To insure the security and confidentiality of information collected from and about customers 2. To protect against any anticipated threats or hazards to the security or integrity of such information 3. To prevent unauthorized access or use that could result in substantial harm or inconvenience to any customer • Additional responsibilities. A dealership is also responsible for taking steps to ensure that its affiliates and service providers safeguard customer information in their care.
Effective Dates <i>Sec. 314.5</i>	<ul style="list-style-type: none"> • May 23, 2003 ... The date by which dealerships are required to develop, implement and maintain a comprehensive customer information security program. • May 24, 2004 ... <i>Extended date for certain providers.</i> The date by which dealerships are required to have completed contracting with their nonaffiliated third-party service providers for the implementation and maintenance of appropriate customer information safeguards by their service providers. • If the dealership has entered into contracts with service providers after June 24, 2002, the extension of the effective date for service providers is not applicable.
Five Elements Required in Written CIS Programs <i>Sec. 314.4</i>	<ol style="list-style-type: none"> 1. <i>At least one employee must be designated as responsible for coordinating the CIS Program.</i> 2. <i>Identify and assess reasonably foreseeable internal and external risks</i> to the security, confidentiality and integrity of customer information in each relevant area of the dealership's operation, and assess the sufficiency of any safeguards in place to control these risks. 3. <i>Design and implement</i> a safeguards program to control the risks identified and <i>regularly test or otherwise monitor</i> the effectiveness of the safeguards' key controls, systems & procedures. 4. <i>Select and oversee appropriate service providers</i> and require them by contract to implement safeguards. 5. <i>Evaluate and adjust</i> the CIS Program in light of relevant circumstances. These circumstances could include changes in the dealership's business arrangements or operations, or the results of testing and monitoring the CIS program safeguards.
Three Areas of Concentration <i>Sec. 314.4(b)</i>	<ul style="list-style-type: none"> • <i>Employee management and training</i> • <i>Information systems</i> • <i>Managing system failures</i>
Employee Management & Training	<ul style="list-style-type: none"> • Check references prior to hiring employees who will have access to customer information. • Ask every new employee to sign an agreement to follow the dealership's confidentiality and security standards for handling customer information. • Train employees to take basic steps to maintain the security, confidentiality and integrity of customer information. These steps include: <ul style="list-style-type: none"> ♦ Locking rooms and file cabinets where paper records are kept; ♦ Using password-activated screensavers; ♦ Using strong passwords (at least eight characters long); ♦ Changing passwords periodically, and not posting passwords near employees' computers; ♦ Encrypting sensitive customer information when it is transmitted electronically over networks or stored online; ♦ Referring calls or other requests for customer information to designated individuals who have had safeguards training; and ♦ Recognizing any fraudulent attempt to obtain customer information and reporting it to the appropriate law enforcement agencies. • Instruct and regularly remind all employees of the dealership's policy - and the legal requirement - to keep customer information secure and confidential. Provide employees with a detailed description of the kind of customer information you handle (name, address, account number, and any other relevant information) and post reminders about their responsibility for security in areas (such as file rooms) where such information is stored. • Limit access to customer information to employees who have a business reason for seeing it. For example, grant access to customer information files only to employees who respond to customer inquiries, and then only to the extent to which they need access to do their jobs. • Impose disciplinary measures for any breaches.
Suggested Security Precautions	



**STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION
DEALERSHIP REQUIREMENTS FOR COMPLIANCE**

<p>Information Systems</p>	<ul style="list-style-type: none"> • Store records in a secure area. • Make sure only authorized employees have access to the secured records storage area. <ul style="list-style-type: none"> ◆ Store paper records in a room, cabinet, or other container that is locked when unattended; ◆ Ensure that storage areas are protected against destruction and/or potential damage from physical hazards, such as fire or floods; ◆ Store electronic customer information on a secure server that is accessible only with a password - or that has other security protections - and is kept in a physically-secure area; ◆ Don't store sensitive customer data on a machine with an Internet connection; and ◆ Maintain secure backup media and keep archived data secure, for example, by storing off-line or in a physically-secure area. • Provide for secure data transmission (with clear instructions and simple security tools) when customer information is being collected or transmitted. <ul style="list-style-type: none"> • If credit card information or other sensitive financial data is collected, use a Secure Sockets Layer (SSL) or other secure connection so that the information is encrypted in transit. • If information is collected directly from consumers, make secure transmission automatic. • Caution customers against transmitting sensitive data, like account numbers, via electronic mail. • If sensitive data must be transmitted by electronic mail, ensure that such messages are password protected so that only authorized employees have access. • Dispose of customer information in a secure manner. <ul style="list-style-type: none"> ◆ Hire or designate a records retention manager to supervise the disposal of records containing nonpublic personal information; ◆ Shred or recycle customer information recorded on paper and store it in a secure area until a recycling service picks it up; ◆ Erase all data when disposing of computers, diskettes, magnetic tapes, hard drives or any other electronic media that contain customer information; ◆ Effectively destroy the hardware; and ◆ Promptly dispose of outdated customer information. • Use appropriate oversight or audit procedures to detect the improper disclosure or theft. <ul style="list-style-type: none"> ◆ Supplement each customer list with at least one entry (such as an account number or address) that you control, and monitor use of this entry to detect all unauthorized contacts or charges. • Maintain a close inventory of all dealership computers. • See <i>FTC Facts for Business - Security Check: Reducing Risks to your Computer Systems</i> <ul style="list-style-type: none"> ◆ <i>The 20 Most Critical Internet Security Vulnerabilities</i> (www.sans.org/top20) ◆ <i>The 10 Most Critical Web Application Security Vulnerabilities</i> (www.owasp.org)
<p>Suggested Security Precautions</p>	
<p>Managing System Failures</p> <p>Suggested Security Precautions</p>	<ul style="list-style-type: none"> • Maintain up-to-date and appropriate programs and controls. <ul style="list-style-type: none"> ◆ Follow a written contingency plan to address any breaches of physical, administrative or technical safeguards ◆ Check with software vendors regularly to obtain and install patches that resolve software vulnerabilities ◆ Use anti-virus software that updates automatically ◆ Maintain up-to-date firewalls, particularly if broadband Internet access is used or if you allow employees to connect to your network from their homes or other off-site locations ◆ Provide central management of security tools for your employees ◆ Communicate updates about any security risks or breaches to all appropriate employees • Take steps to preserve the security, confidentiality and integrity of customer information in the event of a computer or other technological failure. <ul style="list-style-type: none"> ◆ Back up all customer data regularly and store backed-up materials/data securely off-site • Maintain systems and procedures to ensure that access to nonpublic consumer information is granted only to legitimate and valid users. <ul style="list-style-type: none"> ◆ Use tools like passwords combined with personal identifiers to authenticate the identity of customers and others seeking to do business electronically with your dealership. • Notify customers promptly if their nonpublic personal information is subject to loss, damage or unauthorized access.
<p>Source</p>	<ul style="list-style-type: none"> • <i>FTC Facts for Business - Financial Institutions and Customer Data: Complying with the Safeguards Rule</i>



several different documents (i.e., one to cover an information technology division and another to describe the training program for employees). Similarly, a dealership may decide to designate a single employee to coordinate its safeguards program, or it may divide this responsibility among several employees who will work together.

It is important that the dealership must designate at least one employee as responsible for the overall coordination of the safeguards program. A dealership may, however, delegate the responsibility for developing the other four compliance elements ... and that's what some CPA firms have been busy helping their dealer clients set up and monitor.

A dealership with fewer employees may design and implement a more limited employee training program than a dealership with a large number of employees. And dealerships that do not receive or store any information online may take fewer steps to assess risks to its computers than dealerships that more routinely conduct business online.

The Safeguards Rule requires dealerships to consider all areas of their operation. Three special areas requiring consideration are

- employee management and training,
- information systems and
- managing system failures.

The first area, employee management and training, must take cognizance of the fact that the success or failure of a customer information security program depends largely on the employees who implement it.

In connection with the second area, the term "information systems" includes (1) network and software design and (2) information processing, storage, transmission, retrieval, and disposal.

The area of managing systems failures and effective security management includes the prevention, detection and response to attacks, intrusions or other system failures.

Resources. If you want to dig into all the details yourself, one excellent dealer-specific source is *Dealer Guide to Safeguarding Customer Information*, published by NADA Management Education, Item #L43-M. NADA's web site is www.nada.org.

In addition, the Federal Trade Commission's web site (www.ftc.gov) provides full texts of all relevant law, Regulations, and several "FTC Facts for Business" discussions which can be downloaded in .pdf format. Especially useful is *FTC Facts for Business ... Financial Institutions and Customer Data: Complying with the Safeguards Rule*. The full document is available (in .pdf format) at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_register &docid=02-12952-filed.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_register&docid=02-12952-filed.pdf).

Suggestion. If you're not sure where to start with this, here's a suggestion. Go to the FTC web site and pull off the document (four pages) mentioned above. This is written in plain English. Send it to your dealer client, with a cover letter, asking the dealer if he has heard about this and/or wants to talk to you about helping him get started. *

IRS ACTIVITIES & "SUCCESS" RATES ... IRS FACT SHEET 2003-16

	FY 2000-2002 Totals	FY 2002 (10/01- 5/31)	FY 2003 (10/01- 5/31)
Initiations	219	54	65*
Prosecution recommendations	146	22	35
Indictment/information filed	145	19	38
Convictions	136	29	18
Sentenced	155	34	22
Incarceration rate	78.9%	61.8%	72.7%
Avg. months to serve (w/prison)	37	38	55
Avg. months to serve (all sent)	32	24	40

* **How to Interpret Criminal Investigation Data.** Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year. Therefore, in fiscal year 2004, the data should reflect an increase in convictions and sentenced due to the fiscal year 2003 increase in case initiations, prosecution recommendations and indictments.



CASH TRANSACTIONS & MONEY LAUNDERING

... IRS EMPHASIZES IMPORTANCE OF PROPER BEHAVIOR & FORM 8300 REPORTING

Trivia point: The USA Patriot Act of 2001 stands for the law signed October 26, 2001 entitled *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act* ... hence **U-S-A-P-A-T-R-I-O-T Act**. Now let's get down to business.

IRS Fact Sheet 2003-16, concerning the automotive sales industry, was released in August. Reading between the lines, the message is obvious ... There will always be plenty for CPAs to do when they visit their dealers and do compliance checks to see if they are properly handling their cash reporting and filing requirements.

CLAMPING DOWN ... MORE ENFORCEMENT

The IRS, special agents of the IRS Criminal Investigation Division and the Department of Justice have been actively—and successfully—prosecuting numerous individuals involved in the automotive sales industry. Four areas being targeted are: (1) tax evasion, (2) employment tax fraud, (3) money laundering conspiracies and (4) violations of the Bank Secrecy Act.

Front page information included the statement, ***"The IRS has more than 1,000 open audits of the tax returns of new and used car dealers for a variety of issues."***

The Fact Sheet indicated that in the past 3½ years, the IRS has initiated over 280 investigations in the sales sector of the industry. More than 40 (15%) of those cases involve violations of the currency reporting Form 8300 filing requirements.

The Fact Sheet added, "For the first half of fiscal year 2003, the United States Attorney's Office has filed indictments or informations on twice as many individuals for the same time period as fiscal year 2002, and the average sentence has jumped from 38 months to 55 months." For more details, see the bottom of page 6.

FORM 8300 OVERVIEW

Auto dealers are required to file Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, with the IRS when they receive more than \$10,000 in cash in one transaction (or in two or more related transactions).

Form 8300 is an information return that assists the government in its anti-money laundering efforts

and it must be filed not later than 15 days after the date the reportable cash transaction occurred.

In FS-2003-16, the IRS indicated that it had come across a scheme regarding the Form 8300 that describes a "dumping clause" or an "IRS Form 8300 Exemption Certification." Apparently, it had been asserted that an exemption certificate could be filled out by the potential client to exclude the business from filing the required Forms 8300. According to the IRS, "There is no such clause or certificate."

Normally, when the Form 8300 is filed, a correlating Form 4789, Currency Transaction Report, is filed by a financial institution when the same cash is deposited with the financial institution.

For example, if an automotive dealer receives a cash payment of over \$10,000 for a vehicle, the dealer must file a Form 8300 with the IRS. When the dealer deposits that cash into a financial institution, the financial institution is also required to report the \$10,000 or over cash transaction to the IRS by filing a Currency Transaction Report, Form 4789.

DO FORM 8300 & FORM 4789 DETAILS AGREE?

Effective January 1, 2002, the "old" Form 8300 became a combined IRS Form 8300-FinCEN Form 8300. The "FinCEN" stands for *Financial Crimes Enforcement Network*. This is the Bureau within the Treasury that is responsible for issuing regulations to implement certain provisions of the USA Patriot Act of 2001.

Section 365 of the Patriot Act requires that businesses that receive more than \$10,000 in cash in a single transaction, or in two or more related transactions, must file a report with the Financial Crimes Enforcement Network (FinCEN).

This requirement is imposed in addition to the other requirement for filing Form 8300 with the IRS under the same circumstances. To simplify taxpayer compliance burdens, both Form 8300 filing requirements can be met by filing the newer "joint" IRS / FinCEN Form 8300. If after January 1, 2002, a dealership was not aware of this requirement and if it filed *only* Form 8300, it will not be in compliance with the FinCEN reporting requirement with respect to those transactions.

The IRS has indicated that it often finds a discrepancy between the filings of Forms 8300 for cash

see **CASH TRANSACTIONS**, page 8

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sales and the filings of Forms 4789 for currency deposits. That discrepancy is often an indication of a possible violation of the currency reporting laws.

This suggests that CPAs can provide a beneficial service to their dealers by reviewing not just the 8300s that are filed, but also the 4789s that are required.

MONEY LAUNDERING

Section 352 of the Patriot Act addresses Anti-Money Laundering Programs (AMLPs). This Section requires auto dealerships ... which are considered under this law to be *financial institutions* ... to establish AMLPs which contain, at a minimum, the following four elements:

1. The development of internal policies, procedures and internal controls
2. The designation of an employee to act as a Compliance Officer
3. An ongoing training program for employees
4. An independent audit function

Although this requirement for AMLPs to be in place became effective October 24, 2002, NADA has indicated that automobile dealers are presently exempt from these requirements. However, that exemption cannot be expected to remain on the books for long.

For some of the "highlights" of what the IRS has come across and successfully prosecuted, see below. *

Allstate Auto Sales West, Inc. ... Cleveland & Parma, Ohio

On Aug. 6, 2003, Harry F. Zanko, owner of Ohio-based Allstate Auto Sales West, Inc., was sentenced to four years probation, with the first twelve months in electronically monitored home confinement, for attempting to evade his income taxes for 1996.

Zanko acknowledged that he diverted receipts and funds for his personal use consisting of: (1) currency payments by customers, (2) four check payments from customers, and (3) various checks written on the corporate checking account, which he recorded on the corporate disbursements records as being for business purposes. Zanko attempted to evade income taxes of approximately \$249,669 for the years 1996 through 1998, by willfully understating his income for those years by approximately \$1,151,636 on his personal income tax returns and amended 1996 return.

According to court documents, Zanko's source of income from 1996 through 1998 was from owning and operating used car lots, initially with a partner in Cleveland, Ohio, under the name of Allstate Auto Sales. Then in 1998 he moved to a new location in Parma, Ohio, where he operated a dealership alone under the name of Allstate Auto Sales West, Inc.

As a condition of his probation Zanko was also ordered to perform 300 hours of community service, refrain from gambling and attending gambling establishments, attend mental health counseling for his gambling addiction, follow doctor's instructions regarding his treatment of diabetes, and cooperate with the IRS in determination and payment of his civil tax liabilities.

Raley-Vaughan Motor Company, Inc. ... Rogersville, Tennessee

On April 7, 2003, four family members who operated an automobile dealership in Rogersville, Tenn. were sentenced to prison terms ranging from 22 to 30 months for conspiring to commit various schemes to fraudulently obtain money, according to court documents. The family ran the Raley-Vaughan Motor Company, Inc. (RVMC) with Terry Vaughan as Vice President and general manager. His mother was Secretary/Treasurer and a co-owner, and his father was President and a co-owner. In addition, his sister was employed by the dealership handling accounting, sales and other duties.

During the course of the conspiracy, the Vaughan family, through RVMC, (1) fraudulently obtained money, funds and credit by making false applications, installment contracts, promissory notes and other documents to banks and lending institutions; (2) engaged in a scheme to defraud General Motors Acceptance Corporation (GMAC); (3) deposited non-sufficient funds to RVMC accounts to fraudulently inflate the balances, and (4) used the money unlawfully obtained from banks, lending institutions and GMAC to promote the fraudulent schemes.

Terry E. Vaughan was sentenced to a prison term of 30 months. The other Kelso family members were each sentenced to prison terms of 22 months. All prison terms are to be followed by 36-months of supervised release. The four were ordered to pay restitution totaling \$572,250.

Car Outlet ... Blue Springs, Missouri

On Nov. 15, 2002, Andrew S. Holloway, owner of Car Outlet in Blue Springs, Mo. was sentenced to 30 months in prison for laundering the proceeds of another person's cocaine trafficking, according to court records. In August 2002, Holloway pleaded guilty to charges that he conducted a financial transaction that involved the proceeds of an unlawful activity, knowing that the transaction was designed to avoid a federal transaction-reporting requirement.

According to court records, Holloway sold a 1999 Chevy Tahoe to a cocaine dealer for \$21,000, which he knew represented the proceeds from unlawful drug sales. The dealer admitted that he assisted the cocaine dealer in concealing his use of substantial amounts of cash. This assistance was provided by creating false sales documents which understated the purchase price of the vehicle. Those false sales documents were created to avoid filing Form 8300 with the IRS and to conceal the method of payment.





IRS Form **8300**
(Rev. December 2001)
OMB No. 1545-0092
Department of the Treasury
Internal Revenue Service

Report of Cash Payments Over \$10,000 Received in a Trade or Business

▶ See instructions for definition of cash.
▶ Use this form for transactions occurring after December 31, 2001. Do not use prior versions after this date.
For Privacy Act and Paperwork Reduction Act Notice, see page 4.

FinCEN Form **8300**
(December 2001)
OMB No. 1506-0018
Department of the Treasury
Financial Crimes
Enforcement Network

1 Check appropriate box(es) if: a Amends prior report b Suspicious transaction.

Part I Identity of Individual From Whom the Cash Was Received

2 If more than one individual is involved, check here and see instructions

3 Last name _____ 4 First name _____ 5 M.I. _____ 6 Taxpayer identification number _____

7 Address (number, street, and apt. or suite no.) _____ 8 Date of birth (see instructions) M M D D Y Y Y Y _____

9 City _____ 10 State _____ 11 ZIP code _____ 12 Country (if not U.S.) _____ 13 Occupation, profession, or business _____

14 Document used to verify identity: a Describe identification ▶ _____ b Issued by _____ c Number _____

Part II Person on Whose Behalf This Transaction Was Conducted

15 If this transaction was conducted on behalf of more than one person, check here and see instructions

16 Individual's last name or Organization's name _____ 17 First name _____ 18 M.I. _____ 19 Taxpayer identification number _____

20 Doing business as (DBA) name (see instructions) _____ Employer identification number _____

21 Address (number, street, and apt. or suite no.) _____ 22 Occupation, profession, or business _____

23 City _____ 24 State _____ 25 ZIP code _____ 26 Country (if not U.S.) _____

27 Alien identification: a Describe identification ▶ _____ b Issued by _____ c Number _____

Part III Description of Transaction and Method of Payment

28 Date cash received M M D D Y Y Y Y _____ 29 Total cash received \$ _____ .00 30 If cash was received in more than one payment, check here 31 Total price if different from item 29 \$ _____ .00

32 Amount of cash received (in U.S. dollar equivalent) (must equal item 29) (see instructions):
 a U.S. currency \$ _____ .00 (Amount in \$100 bills or higher \$ _____ .00)
 b Foreign currency \$ _____ .00 (Country ▶ _____)
 c Cashier's check(s) \$ _____ .00 Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶ _____
 d Money order(s) \$ _____ .00
 e Bank draft(s) \$ _____ .00
 f Traveler's check(s) \$ _____ .00

33 Type of transaction f Debt obligations paid g Exchange of cash
 a Personal property purchased h Escrow or trust funds
 b Real property purchased i Bail received by court clerks
 c Personal services provided j Other (specify) ▶ _____
 d Business services provided
 e Intangible property purchased

34 Specific description of property or service shown in 33. (Give serial or registration number, address, docket number, etc.) ▶ _____

Part IV Business That Received Cash

35 Name of business that received cash _____ 36 Employer identification number _____

37 Address (number, street, and apt. or suite no.) _____ Social security number _____

38 City _____ 39 State _____ 40 ZIP code _____ 41 Nature of your business _____

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Signature ▶ _____ Authorized official _____ Title ▶ _____

43 Date of signature M M D D Y Y Y Y _____ 44 Type or print name of contact person _____ 45 Contact telephone number _____

Form **4789**
(Rev. June 1998)
Department of the Treasury
Internal Revenue Service

Currency Transaction Report

▶ Use this 1998 revision effective June 1, 1998.
▶ For Paperwork Reduction Act Notice, see page 3. ▶ Please type or print.
(Complete all parts that apply—See instructions)

OMB No. 1506-0004

1 Check all box(es) that apply:
 a Amends prior report b Multiple persons c Multiple transactions

Part I Person(s) Involved in Transaction(s)

Section A—Person(s) on Whose Behalf Transaction(s) Is Conducted

2 Individual's last name or Organization's name _____ 3 First name _____ 4 M.I. _____

5 Doing business as (DBA) _____ 6 SSN or EIN _____

7 Address (number, street, and apt. or suite no.) _____ 8 Date of birth M M D D Y Y Y Y _____

9 City _____ 10 State _____ 11 ZIP code _____ 12 Country (if not U.S.) _____ 13 Occupation, profession, or business _____

14 If an individual, describe method used to verify identity:
 a Driver's license/State I.D. b Passport c Alien registration d Other _____
 e Issued by: _____ f Number: _____

Section B—Individual(s) Conducting Transaction(s) (if other than above).
 If Section B is left blank or incomplete, check the box(es) below to indicate the reason(s):
 a Armored Car Service b Mail Deposit or Shipment c Night Deposit or Automated Teller Machine (ATM)
 d Multiple Transactions e Conducted On Own Behalf

15 Individual's last name _____ 16 First name _____ 17 M.I. _____

18 Address (number, street, and apt. or suite no.) _____ 19 SSN _____

20 City _____ 21 State _____ 22 ZIP code _____ 23 Country (if not U.S.) _____ 24 Date of birth M M D D Y Y Y Y _____

25 If an individual, describe method used to verify identity:
 a Driver's license/State I.D. b Passport c Alien registration d Other _____
 e Issued by: _____ f Number: _____

Part II Amount and Type of Transaction(s). Check all boxes that apply.

26 Cash In \$ _____ .00 27 Cash Out \$ _____ .00 28 Date of Transaction M M D D Y Y Y Y _____

29 Foreign Currency _____ (Country) _____ 30 Wire Transfer(s) 31 Negotiable Instrument(s) Purchased

32 Negotiable Instrument(s) Cashed 33 Currency Exchange(s) 34 Deposit(s)/Withdrawal(s)

35 Account Number(s) Affected (if any): _____ 36 Other (specify) _____

Part III Financial Institution Where Transaction(s) Takes Place

37 Name of financial institution _____ Enter Federal Regulator or BSA Examiner code number from the instructions here. ▶ []

38 Address (number, street, and apt. or suite no.) _____ 39 SSN or EIN _____

40 City _____ 41 State _____ 42 ZIP code _____ 43 MICR No. _____

44 Title of approving official _____ 45 Signature of approving official _____ 46 Date of signature M M D D Y Y Y Y _____

47 Type or print preparer's name _____ 48 Type or print name of person to contact _____ 49 Telephone number _____

AUTO DEALER CHANGES IN ACCOUNTING METHOD
FOR TRADE DISCOUNTS,
FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

WILLARD J. DE FILIPPS, CPA

Page 1 of 6

I. Currently Still a (Somewhat) Controversial Hot Topic ... and Planning and/or Marketing Opportunity

- A. Discussed at last year's AICPA conference ... by both Terri Harris of the IRS and by Les Schneider ... and throughout the year in various CPA/dealer-oriented publications and meetings
- B. Many dealers have already made the changes, ... many of them made these CAMs years ago
- C. Two different CAMs and filing procedures
 1. ***Trade discounts (floorplan assistance payments)*** ... automatic permission, simplified 3115 filing procedures and the payment of a user fee is not required ... Rev. Proc. 2002-9
 2. ***Advertising fees and expenses*** ... not automatic IRS permission, more complicated 3115 filing procedures (including filing before year-end) and requires payment of user fee ... recently changed to \$1,500 ... Rev. Proc. 2002-19 (formerly Rev. Proc. 97-27)
- D. Separates CPA firms that are more aggressively marketing to dealers ... from more passive CPA firms that are not growth/marketing oriented (i.e., these firms respond to pressure coming from dealers who are returning from presentations to their 20 groups and other meetings where they heard about these new ideas from other CPA speakers)
- E. Also separates CPA firms (with dealer clients) who better understand the dealership specifics from those firms that do not
- F. By demonstrating competence in this planning area, CPA firm secures a "foot in the door" for prospective clients ... also increases a sense of client loyalty

II. Divided Opinions ... Different Schools of Thought

- A. Deep analytical approaches with differing weight assigned to different factors
- B. ***Typical negative reactions include:*** "It's just a timing difference." ... "Not really worth it." ... "My dealers don't see the benefit." ... Maybe that's because they really didn't see the numbers!
- C. Huge difference between benefits for dealers using LIFO vs. dealers who are not on LIFO (i.e., dealers using FIFO - or more accurately, specific identification)
- D. Yes, it is a timing difference, but ... Why should the dealer prepay his/her taxes?
- E. ***Query:*** If LIFO (depending on inflation, over which dealer has no control) is attractive, why shouldn't trade discount and ad fees CAMs (depending on the continuation of Factory programs, over which dealer has no control) also be attractive?

(Continued)



AUTO DEALER 3115 CAMs FOR TRADE DISCOUNTS,

FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

Page 2 of 6

III. The Technicalities ... Common to All Dealerships ... Whether Using LIFO or Not

A. Cash Discounts

1. A cash discount is a reduction allowed by the seller in the invoice or purchase price that is granted for payment within a prescribed time period (i.e., 2/10 net/30)
2. For tax purposes, cash discounts can be accounted for under one of two methods. Taxpayer may elect/choose to use either method, but accounting method used for discounts must be followed consistently from year-to-year.
 - a. Gross invoice method ... Price of item purchased includes cash discount allowed
 - b. Net invoice method ... Price of item purchased does not include cash discount
3. Proposed Coordinated Issue Paper on Treatment of *Cash* Discounts issued April, 2003 by IRS ISP

B. Trade Discounts

1. A trade discount is a reduction allowed by the seller in the invoice or purchase price that is allowed or granted regardless of when the payment is made
2. Generally, trade discounts are allowed for volume or quantity purchases
3. The taxpayer *must* reduce the cost of inventory by a trade (or quantity) discount
 - a. Reg. Sec. 471-3(b)
 - b. Revenue Ruling 84-481 ... 1984-1 CB 130
 - c. IRS Pub. 538: *Accounting Periods and Methods* ... March 2003
4. *Exception...* Consistently following an erroneous method of accounting constitutes a method of accounting for the improper treatment, which cannot be changed without first securing permission from the IRS

C. Form 3115 Filing Required

1. A change in the method of accounting for discounts (trade discounts or cash discounts) and/or advertising fees and expenses requires permission from the IRS
2. In certain cases, IRS permission to change may be granted automatically if IRS notification procedures are followed.
3. See I(C) ... *Two different CAMs and filing procedures* on page 1 of outline
4. When these CAMs occur, corresponding adjustments are required
 - a. *Section 481(a) adjustment...* An adjustment under Section 481(a) is required to compute the effect as if the change in method had been used in valuing prior years inventories ... The simplified cut-off method is not allowed for this inventory change
 - b. *Section 263A corresponding adjustment...* If this CAM is made, it is necessary to compute the corresponding change in inventory capitalized costs under Section 263A, and this change becomes a (small) component of the Section 481(a) adjustment

D. Floorplan Assistance Payments as Trade Discounts

1. Manufacturers' programs are different in terms of when dealers become entitled to these *cost reductions*
2. Watch your terminology ... these discounts are not "*earned*" ... if the dealer had to do anything to earn the discount, that would disqualify it from being treated as a trade discount

(Continued)



AUTO DEALER 3115 CAMs FOR TRADE DISCOUNTS,

FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

Page 3 of 6

III. The Technicalities ... Common to All Dealerships ... Whether Using LIFO or Not (Continued)

D. Floorplan Assistance Payments as Trade Discounts (Continued)

3. Timing of when trade discounts are allowed ... and the "all events" test
 - a. Some discounts attach at the time when the vehicle is purchased
 - b. Some discounts attach at the time when the vehicle is sold ... or, if sooner, after the passage of 45 or 90 days from the date of purchase. In this case...
 - (1) *If the vehicle is not sold as of the end of the year (or if the specified passage of time has not elapsed), the dealer's reduction in cost for the discount has to be deferred to the succeeding year ...* Note: This has to be considered in computing the Section 481(a) adjustment, as well as at the end of each succeeding year
 - (2) The receipt of the discount in the following year will affect that year's computation of the cost of goods sold, and thus, reflects a shift of income via the valuation of the ending inventory between years
 - (3) This consequence is sometimes loosely referred as the "deferred income" or "earning" of a discount
4. The IRS considers the floorplan assistance programs offered by the manufacturers to be trade discounts within the technical meaning of that term
 - a. Some CPAs prefer the interpretation that these payments are reductions of interest expense (PPC)
5. Second factor complicating program analysis is wide variety of different manufacturers' plans
 - a. *Different programs have been put in place at different times over the years and have been in effect for different time durations*
 - b. Vehicles (goods) in ending inventory may have been acquired at different times and subject to the terms of different programs
6. **Reminder:** For these trade discounts, the reduction of acquisition cost by the amount of the trade discount is *mandatory*. These trade discounts should be distinguished from *cash discounts* for which a taxpayer has a choice of methods of accounting to record the acquisition cost of the item either gross or net of the cash discount

E. Advertising Fees and Expenses

1. Involve the technical requirements for satisfying the "all events" test before a deduction may be taken
2. IRS will not allow CAM for *national* advertising expenses
3. IRS will allow CAM for *local* advertising expenses
4. Manufacturers have various plans and programs related to advertising and some are administered through dealer advertising associations ... placement of charges on dealer invoice for advertising, actual placement of advertising before or after year end, rebates of unused amounts, etc., all tends vary by manufacturer
5. Need to distinguish (4) from advertising allowances granted by some manufacturers

(Continued)



AUTO DEALER 3115 CAMs FOR TRADE DISCOUNTS,

FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

Page 4 of 6

III. *The Technicalities ... Common to All Dealerships ... Whether Using LIFO or Not (Continued)*

F. *Invoice-By-Invoice Analysis Required*

1. Determination of trade discounts, advertising fees & expenses etc. ... Amounts must be determined based upon an invoice-by-invoice analysis (analogous from proposed CIP April, 2003)
2. It appears the IRS will not accept any other generalized calculations or estimates with no underlying detail computations
3. Query: Where LIFO is used, is there any conflict/contradiction with the dollar-value LIFO concept?
4. CPAs who attempt to make these determinations generally will not have a comprehensive database of manufacturer programs (varying terms, durations, etc.)
 - a. Reliance only on invoices will not result in an accurate determination
 - b. Availability of outsourcing services to do this work
 - c. As the IRS Motor Vehicle Technical Advisor said last year at the 2002 AICPA Auto Dealership Conference, this CAM requires a facts and circumstances analysis which takes into account the fact that the manufacturers' programs are constantly changing
 - d. See *V. Issues / Perils for CPA Firms Undertaking the "Doing It Yourself" Approach*

G. *Year-End Reconciliations of Carrying Values Net of Trade Discounts, etc., with Inventory at Cost (Including Trade Discounts, etc.)*

1. The IRS will allow year-end reconciliations to the net-of-discount results if the reconciling amounts are based upon detailed invoice-by-invoice determinations
2. There should be no violation of the LIFO conformity requirement if one method is used for financial statement purposes, while a different method is used for tax purposes ... different cost determinations under Section 263A are allowable
3. GAAP considerations ... Most dealerships reflect the CAMs for both book and tax purposes

H. *Invoice-By-Invoice Analysis Must Be Made Each Year.*

1. These CAMs involve a continuing responsibility or requirement to track the qualification status and reduction amounts that are attributable to each vehicle in inventory at the end of each succeeding year

IV. *LIFO Dealerships ... Summary of Special Benefits & Implications*

A. *Huge benefit for LIFO inventories* ... the Section 481(a) adjustment that is required to be computed to implement this change in accounting method will be a **negative** Section 481(a) adjustment

1. Entire deduction (100%) is allowable in the year of change
2. This benefit does not turn over and is not recovered in the following year. It remains locked into the valuation of the LIFO layers, and remains until they are invaded

B. *Three-year (weighted) average factor* must be computed and applied to LIFO valuation of the ending inventory for the year before the year of change

C. *Cumulative indexes are required to be rebased or restated* to 1.0000 as of beginning-of-year of change in order to have the proper correspondence with carrying inventory at cost, net of trade discounts, etc.

(Continued)



AUTO DEALER 3115 CAMs FOR TRADE DISCOUNTS,

FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

Page 5 of 6

V. Issues / Perils for CPA Firms Undertaking the "Doing It Yourself" Approach

- A. Manufacturers have a wide variety of programs in place. Analysis must be made on a case-by-case basis
1. Terri Harris, IRS Motor Vehicle Technical Advisor has emphasized this in numerous public remarks at conferences
 2. Natural reaction when this CAM opportunity is discussed with the dealer is for the dealer to assume that the CPA is able to make the analysis, and that the CPA has all of the necessary information if he has the prior year invoices
 3. More often than not, both assumptions are incorrect
 4. However, some CPA firms don't want to admit to their dealer clients that they don't know what this is all about or that they don't have the ability to do the necessary detailed analysis
- B. Some CPA firms making the change for their dealers just bluff their way through it by using oversimplified routines instead of doing the necessary detailed analysis
1. Extensive database is required
 2. Not all items shown on the invoice are what they appear to be ... (Toyota might be the exception here)
 3. Some dealers don't get all of the benefit that they are entitled to because their CPAs oversimplified (and/or inaccurate) analysis is not thorough enough
 4. Another myth: "It's already on the invoice."
 - a. If you rely on what's stated on the invoice, your calculation is likely to be incorrect
 - b. Example: In the case of a large dealer who could not provide supporting invoices (the vehicle detail was taken from the inventory register and from other Factory documents), the dealer received a \$2.2 million benefit ...
 - (1) Because no Ford invoice information is correct, only half of GM invoice information is correct, and all of the Chrysler information was omitted at the dealer's request (because he was being paid under-the-table) ... The only useful piece of information from the invoices are the VINs
- C. Need to be careful with trade vehicles because in some instances the trade discount monies follow the vehicle, but in other instances, they do not
- D. **Example:** In one instance involving a Chrysler dealer where a CPA "did it himself with spreadsheets prepared from invoice information."
1. In this case, both DAA (Dealer Advertising Association expense, local - not national) and PPA (labeled Prepaid Advertising, but in reality a *trade* discount) were claimed as advertising expenses. This treatment is obviously incorrect, as separate 3115s are required, one for trade discounts and one for ad fees
 2. Furthermore, in his analysis, the CPA missed all of the finance credits (which also should have been included as part of the trade discount CAM)
 3. What do you think was the CPA's reaction when this was pointed out to him?

(Continued)



AUTO DEALER 3115 CAMs FOR TRADE DISCOUNTS,
FLOORPLAN ASSISTANCE, ADVERTISING FEES & EXPENSES

Page 6 of 6

VI. Evaluating and Estimating the Benefits

- A. Ballpark estimate ... differs depending on whether or not dealer is on LIFO
- B. Again, different schools of thought, approaches and “different strokes for different folks”
- C. Cost effectiveness benefit analysis for CAMs (changes in accounting methods) needs to consider all elements

VII. Recommendations & Suggestions

- A. **Where do you stand ... and why?** Regardless of how you feel about the treatment of advertising fees, CPAs should read the Regulations and determine their Firm’s position, liability and/or responsibility for not changing to the correct method/treatment for trade discounts ... It is clear that it is incorrect to include trade discounts as inventory costs
- B. **Acquired new clients.** Every time you acquire a new dealer client, if changes in accounting method for trade discounts and/or advertising fees have not been made, inquire why and document the reasons
- C. **Need for lead time.** If you are going to discuss the possibility of making these changes in accounting method with dealers, it is advisable to have these discussions at least 6 to 8 weeks before year-end. This much lead time is needed in order to allow enough time to determine costs and projected benefits and to incorporate the anticipated results into other year-end planning for the dealer
 - 1. Fairly accurate preliminary estimates of the benefits can be made ... but the detail 3-year analysis takes some time
- D. **Consider using a specialized service to do the detailed analysis**
 - 1. Obtain a preliminary, but somewhat tailor-made estimate of the possible benefits
 - 2. Negotiating the cost of outsourced services
 - a. There is a wide disparity in cost of services offered to do detailed invoice analysis, etc.
 - b. Where possible, to avoid fee surprises, try to secure “capped cost protection”
 - c. Often, the preparation of the necessary 3115s, LIFO layer restructuring and calculation of Section 481(a) adjustment will be included as part of the overall services provided ... thus making the CAM activity a simple “turn-key” process
 - d. Also, lock in the cost for ongoing program analysis for subsequent year-end inventories, as that should be considered as part of the overall compliance costs
- E. **Both changes at once ... or split them over two years?**
 - 1. It is usually be desirable to make both changes in accounting method (i.e., for both trade discounts and for ad fees and expenses) at the same time / in the same year
 - 2. However, there are circumstances when it may be advantageous for the dealer to make the changes in different years
- F. For more specific information, refer to last year’s AICPA Auto Dealership Conference proceedings. Also, discussions have appeared in recent *Dealer Tax Watch*, *LIFO Lookout* and in other publications

Willard J. De Filippis, CPA
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TAX STRATEGIES & IRS ACTIVITIES

UPDATE FOR AUTO DEALERS

RECENT DEVELOPMENTS, CASES
& SPECIAL PLANNING AREAS

OCTOBER 2003

A Seminar for the Clients / Staff of ...

Your Firm Name Here



Tax Strategies & IRS Activities

Update for Auto Dealers

Recent Developments, Cases & Special Planning Areas

PRESENTED BY

Your Firm Info Here

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October 2003

MAJOR SUBJECTS INCLUDE

- Job & Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) Tax Rate Reductions & Other Changes, Expanding Sept. 11, 2001 Tax Relief Changes
 - Expanded Net Operating Loss Carryback Rules
 - Increased Special Depreciation - 30% ... 50%
 - Increased Section 179 Expense Limitations
 - Reduced Individual Tax Rates on Dividend Income & Long-Term Capital Gains
- Cost Segregation Studies for Dealership Facilities
- Technician Accountable Plan Reimbursements under Section 62(c)
- Common Dealership Related Party Issues & Other Audit Issues
- Dealership Entity Planning, Structuring and Restructuring ... Including PORCs & Notice 2002-70 Listed Transactions & Reporting Requirements
- Tax Issues for Dealers in Transition, Including IRS Ruling on GM Transitional Allowance Payments to Olds Dealers
- Changes in Accounting Methods: Updated Rules, Guidelines & Special Dealership Applications
- LIFO Reserve Recapture Issues, S Corps & Q-Subs ... Opportunities & Pitfalls
- Used Vehicles: Valuation, LIFO & the Alt. LIFO Method ... Rev. Proc. 2001-23
- Parts & Accessories Inventories ... Valuation at Replacement Cost is Acceptable
- Demonstrator Vehicles
- Other New Developments & Pronouncements from the IRS

OBJECTIVE: To provide detailed discussions of current tax and IRS audit issues and planning strategies for CPAs providing services to automobile dealers.

SEMINAR FORMAT: Lecture and group discussion with "Questions and Answers" throughout the session.

COURSE LEVEL: Basic to Intermediate.

FIELD OF STUDY: Specialized Knowledge & Applications

ADVANCE PREPARATION: No advance preparation is required.

PREREQUISITE: At least one year's experience with automobile dealerships.

SEMINAR LEADER: Your Firm's Info Here

RECOMMENDED CPE CREDIT: Each seminar is intended to qualify for 8 hours of CPE, but each State has its own CPE rules. You must have your own NASBA Number.



TAX STRATEGIES & IRS ACTIVITIES

UPDATE FOR AUTO DEALERS

Recent Developments, Cases & Special Planning Areas

SEMINAR DISCUSSION OUTLINE

Page 1 of 10

- I. Job & Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) Tax Rate Reductions & Other Changes, Expanding September 11, 2001 Tax Relief Changes**
- A. Expanded net operating loss carryback rules
 - B. Increased special depreciation - 30% ... 50%
 - C. Increased Section 179 expense limitations
 - D. Reduced individual tax rates on certain dividend income & long-term capital gains
- II. Cost Segregation Studies - Triple Benefits**
- A. More depreciation, faster write-offs & 100% of negative Sec. 481(a) adjustment can be taken in the year of change (i.e., thus, creating possibility for NOL carrybacks and tax refunds)
 - B. Automatic change, advance approval from the IRS is not required (Rev. Proc. 2002-9)
 - C. Increased special depreciation - 30% ... 50% under 9/11 tax relief and 2003 JGTRRA changes
- III. Technician Tool Reimbursement and/or Rental Plans**
- A. Accountable plan reimbursement requirements under Section 62(c)
 - 1. Business connection
 - 2. Substantiation (including proper resolution of tax issues in determining hourly reimbursement rate)
 - 3. Returning amounts in excess of expenses
 - B. IRS Coordinated Issue Paper June 2000 ... Negative or unfavorable toward technician reimbursement plans in general, especially as a result of *Shotgun Delivery, Inc.* and "recharacterization" issues
 - C. Requests for inclusion of rate determination tax issues in connection with technician Sec. 62(c) plans
 - 1. IRS Priority Guidance List
 - 2. IRS Industry Issue Resolution Program
 - 3. Private Letter Ruling Request(s)

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TAX STRATEGIES & IRS ACTIVITIES UPDATE

FOR AUTO DEALERS

Page 2 of 10

III. *Technician Tool Rental and Reimbursement Plans (Continued)*

- D. Mid-summer IRS guidance on payments to employees for equipment ... Rev. Rul. 2002-35 and Rev. Proc. 2002-41 deemed substantiation rule for use in implementing an accountable plan for reimbursements
- E. Two 2001 FSAs also negative on these plans; both plans held to be abusive under Reg. Sec. 1.62-2(k): FSA 200132003/ Courier Delivery Service and FSA 200127004 / Rig Welders

IV. *Dealership Entity Planning, Structuring and Restructuring ... Including PORCs*

- A. Dealership entity planning, structuring and restructuring
 - 1. Dealership entity planning
 - (a) Multiple entities - "One Man's Game Plan"
 - (b) Different tax entities & tax structures
 - (1) C Corp. ... S Corp. ... QSub Groups
 - (2) LLCs & LLPs ... Other ... more exotic?
 - 2. **PORCs: Producer Owned Reinsurance Companies**
 - (a) IRS still is looking into these, especially for situations where the dealer retains control over the funds or borrows (excessively)
 - (b) **IRS Notice 2002-70** ... Issued November 14, 2002
 - (1) Listed shelters, special "red flag" attachments to returns, promoter lists
 - (2) In describing potentially abusive tax shelters and listed transactions, the Notice used broad language stating that the IRS was concerned with reinsurance transactions similar to those used by some PORCs, thus drawing dealer PORCs into its ambit or reach.
 - (3) IRS expressed concern that some PORCs may not be entitled to receive the special tax benefits they are claiming under Sections 831(b) for small property and casualty insurance companies, Section 806 for small life insurance companies which enjoy a maximum tax rate of 13.6% and/or Section 501(c)(15) tax exempt organizations.
 - Note: Does not apply to PORC activities included in non-controlled foreign corporation arrangements because they do not file U.S. income tax returns
 - (4) If a transaction is a listed transaction, certain reporting requirements must be met on tax returns filed
 - (5) **Safe harbor:** If a PORC filed a tax return on or before February 28, 2000, the disclosure requirements **do not** apply ... Emphasizes that PORC must have filed income tax returns on or before February 28, 2000
 - Note: Taxpayer technically falls under Notice 2002-70, it just does not have to file any notices with tax returns ... Temp. Reg. Sec. 1.6011-4T(h), Feb. 28, 2002, amended June 2002
 - (6) **Caution:** If there is a material change in the way the PORC does business ... such as the addition of new lines and/or a change in carriers ... that change may void the safe harbor protection
 - (c) IRS PORC Task Force and Industry Professionals Meeting ... August 19, 2003
 - (d) Consensus of advisors seems to be that properly structured & implemented PORCs should be O.K.
 - (e) Structurally ... Brother-Sister Corporate group arrangements are all right but Parent-Subsidiary group structure is not ... due to leading case and recent IRS pronouncements
 - (f) *William Wright* (TC Memo 1993-328)
 - (g) *William F. McCurley* (TC Memo 1997-371)
 - 3. Used car dealers & buy-here, pay-here operations
 - (a) Related finance company planning
 - (b) Sales of BHPH notes to unrelated loan servicing companies ... LTRs 199909002 - 003

(Continued)



TAX STRATEGIES & IRS ACTIVITIES UPDATE

FOR AUTO DEALERS

Page 3 of 10

V. *Tax Issues for Dealers in Transition: Including GM's Phase-Out of Oldsmobile Dealers*

A. Basic issues

1. Current taxability of certain payments vs. offset against basis in other assets: Look for the IRS to try to set up capitalized assets whose creation generates immediate tax consequences which are offset by deductions in later years
2. Taxability of gains as ordinary income vs. long-term capital gain
 - (a) IRS Private Letter Ruling involving application of Section 1241 ... see B. below
3. Constructive receipt issues where checks are written directly to the dealer's designee, rather than directly to the dealer who, in turn, would channel them elsewhere
4. Special documentation and measurement problems may arise in connection with more nebulous **understandings** that may arise in favor of dealers cooperating with transition programs, in return for which they may expect better allocations or other considerations from the Factory in the future
5. Other forms of consideration (and concessions) given to dealers by the Factory may generate future tax planning opportunities and/or controversies
 - (a) Deferred financing on facilities, image enhancements, relocation costs, signage
 - (b) Favorable terms on real estate loans
 - (c) Future reductions or abatements of rents, interest, other charges
 - (d) Security deposits with lease options
6. Deferral of gain opportunities for exchanges of like-kind property under Section 1031
7. Allocation of payments and proceeds among consulting agreements, blue sky, goodwill, covenants not-to-compete and other intangibles
8. Recapture of LIFO (Last-In, First-Out) inventory reserves
9. Forgiveness of indebtedness, Section 108 and basis adjustments
10. Income triggered by Section 357(c) where liabilities exceed the basis of assets transferred
11. Non-shareholder contributions to capital under Section 118

B. IRS Private Letter Ruling involving application of Section 1241 to Olds dealer termination payments

1. In late 2001 - early 2002, the IRS issued a Private Letter Ruling to an Oldsmobile dealership selected by NADA as a test case ... Citation is **LTR 200218034**
2. The facts involved in this dealership ruling are very simple and almost unrealistically simple.
3. IRS rulings, based on the information submitted
 - (a) **The transition payments received by the dealer are considered amounts received in exchange for the cancellation of its Distributor Agreement pursuant to Section 1241.** The Service is very careful to use the term *distributor agreement*, and not "franchise," in any of its discussions.
 - (b) **The gain calculated upon the exchange will be considered as long-term capital gain to the taxpayer within the meaning of Sections 1221 or 1231.** The Service accepted the fact that the Distributor Agreement was an asset used in the taxpayer's trade or business that does not fall within any of the listed exceptions to capital gain treatment in Sections 1221 or 1231. Therefore, it said that it did not need to decide whether the Distributor Agreement was a capital asset or a Section 1231 asset because, in either case, gain from the sale of such an asset would be capital gain for the taxpayer.
 - (c) **The taxpayer is eligible to report the gain from the exchange on the installment method pursuant to Section 453,** because at least one transition payment will be received by the taxpayer after the year of disposition.

(Continued)



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V. *Tax Issues for Dealers in Transition: Including GM's Phase-Out of Oldsmobile Dealers (Continued)*

B. IRS Private Letter Ruling involving application of Section 1241 to Olds dealer termination payments (Continued)

4. Many different fact patterns & "special circumstances" may give rise to termination payments by GM that may not be covered by the NADA/Olds ruling
5. Many other areas are not specifically covered by this IRS Olds ruling
6. Observations
 - (a) On the surface, it looks like the IRS has given Oldsmobile dealers the benefit of the doubt in interpreting the characterization of GM transition payments. However, the Ruling seems to be of little help where GM Transition Assistance Payments may consist of several components.
 - (b) Where GM is trying to unwind a deal where the dealer recently acquired the Olds franchise, there is great likelihood that transition payments more clearly relate to helping the dealer acquire an asset (i.e., the new franchise to be acquired as a substitute for the old Olds franchise) within the same corporate solution.
 - (c) In distinguishing between the simplified facts in the Ruling and more likely fact patterns of greater complexity, on a case-by-case basis, it may appear that (long-term) capital gain characterization of some payments may be incorrect or at least debatable.
 - (d) ***In these situations, practitioners should consider advising their dealers to secure their own Letter Rulings from the Service based on their own specific facts.***

C. Consulting Opportunities ... Determination of Compensation for Loss of Franchise

1. *Changes in profitability* studies vs. traditional valuation of dealership issues
 - (a) Prepare a valuation by car line or franchise in connection with dualling or stand-alone status negotiations
 - (b) How many sales are expected to be generated out of a specific location or facility?
 - (c) Contribution to profitability by service, body shop and other operations
2. Review any recently completed valuations for the dealership ... How prominently is the value of the dealership factored into the dealer's post-retirement cash needs and other planning?
3. Selected articles
 - (a) "What's an Olds Franchise Worth?" M. Gordon. *Ward's Dealer Business*, Feb. 2001, pp. 40-42
 - (b) "Sharpen Those Pencils!" C. Woodward. *Ward's Dealer Business*, March 2001, p. 39

VI. *Common Dealership Related Party Issues*

- A. Recent IRS Audit Activity ... How much IRS auditing is really going on right now? ... What issues are being raised by IRS agents?
- B. How do you think the reduced 15% tax rate on dividend income under JGTRRA (which runs through 2008) alters or effects the more traditional IRS audit issues, including those below?
- C. Common dealership related party issues
 1. Constructive dividend issues & checklist
 2. Shareholder loans & other related party transactions
 3. Reasonable compensation (*AID, Inc.*, TC Memo 1994-298)
 4. Selected recent cases

(Continued)



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VII. Changes in Accounting Methods: Updated Rules, Guidelines & Special Dealership Applications

- A. Background and relevance
- B. General rules & discussion
 - 1. Positive Sec. 481(a) adjustments ... taken into income over 4 years
 - 2. Negative Sec. 481(a) adjustments ... taken into income (i.e., deducted) in one year (Rev. Proc. 2002-19)
- C. **Voluntary Changes - Automatic**
 - 1. Now covered by Rev. Proc. 2002-9 ... Superseding Rev. Procs. 99-49, 98-60, 97-37
 - 2. **Voluntary LIFO Election Terminations**
 - (a) Terminating *less than all* LIFO elections at the same time
 - (1) No longer requires advance permission from the IRS, nor payment of user fee
 - (2) Filing of Form 3115 is done *after* the end of the year of change as part of the income tax return for the year of change. A copy of Form 3115 must also be filed with the IRS National Office
 - (3) Rev. Proc. 2002-9 (Section 9.05) superseding Rev. Proc. 97-27 which previously treated this change as one requiring advance permission from the IRS
 - (4) Section 481(a) adjustment & spread periods ... positive adjustments ... negative adjustments
 - (5) Definition of "permitted method" ... problematic & troublesome?
 - (b) Terminating *all* LIFO elections at the same time
 - (1) Does not require advance permission from the IRS. Does not require payment of user fee
 - (2) Form 3115 is filed after the year end as part of the income tax return for the year of change. A copy of Form 3115 must also be filed with the IRS National Office
 - (3) Rev. Proc. 2002-9 superseding Rev. Proc. 97-27
 - 3. **Excluding Certain Costs from Inventory Carrying Value ... Currently Still a Very Hot Topic**
 - (a) *Trade discounts ... floorplan assistance payments*
 - (b) *Advertising fees & expenses*
 - (c) Various other rebates & programs (fuel, etc.)
 - (d) Excess Section 263A Costs ... critical questions ... special elections ... Form 3115 filings
 - 4. **Electing IRS-Approved Safe Harbor LIFO Calculation Methods**
 - (a) New vehicles ... Rev. Proc. 97-36: Alternative LIFO Method for New Vehicles
 - (b) Used vehicles ... Rev. Proc. 2001-23: Used Vehicle Alternative LIFO Method
 - 5. Determining the cost of used vehicles purchased or taken as a trade-in
 - 6. Certain IPIC (Inventory Price Index Computation) method changes
- D. **Permission-Required Changes**
 - 1. Now covered by Rev. Proc. 2002-19 ... Modifying RP 97-27
 - 2. General rules & discussion
 - 3. Special dealership applications
- E. **IRS Audit-Initiated ... (Involuntary) ... Method Changes**
 - 1. Now covered by Rev. Proc. 2002-18
 - 2. Superseding proposed Revenue Procedure included in Notice 98-31 which would have required Section 481(a) adjustment to be picked up 100% in earliest open year
 - 3. General rules & discussion
 - 4. Special dealership applications
- F. **Form 3115: Current Revision dated May, 1999**
 - 1. Form required to be filed in connection with accounting method changes
 - 2. General filing timing requirements ... automatic vs. changes requiring advance approval
 - 3. Other filing experiences with the National Office

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VIII. LIFO Reserve Recapture Issues

- A. Special problems for Olds dealers being phased-out by GM and others in transition
 - 1. Different results depending on LIFO methods used: Alt. LIFO, IPIC, other methods
 - 2. Vertical slice approach ... See LTR below ... could be analogous
- B. Acceleration of repayment of LIFO reserves
 - 1. Vertical Slice ... LTR 199920001 doesn't involve auto dealer, but could be analogous
- C. Section 1363(d) Recapture of LIFO Reserve where C Corp. Changes to S Status
 - 1. LIFO election is not terminated ... Rev. Proc. 94-61 provides guidance
 - 2. Special collapsed layer is created
 - 3. Other special problems
 - 4. **Coggin Automotive Corporation**
 - (a) Tax Court (115 T.C. 349 [2000]) upheld IRS and required \$4.8 million recapture upon restructuring of consolidated automotive group ... see also Letter Ruling 9716003
 - (b) Appeals Court reversed IRS in Tax Court and did not require recapture (89 AFTR2d 2002-2826 [CA-11, 2002]) ... see *LIFO Lookout*, September 2002
 - 5. Special cautions for current restructurings
 - (a) "anti-abuse" of aggregation theory partnership regulation ... Reg. Sec. 1.701-2(e) ... effective for transactions after Dec. 29, 1994
 - (b) IRS may choose to contest similar transactions in jurisdictions outside of the 11th Circuit ... i.e., outside of Florida, Georgia and Alabama
 - (c) Best advice: Dealers should get a ruling from the IRS before undertaking restructuring
- D. LTR 200123035 ... No LIFO reserve recapture where S Corporation contributes auto dealerships' LIFO inventories to a newly-formed limited liability company
- E. **LIFOsuction** ... When LIFO recapture cannot be avoided, perhaps paying the tax on the recapture can be avoided ... if a buyer can be found for the stock of the dealership/business that has sold the inventory, triggering the recapture ... if that buyer has the ability to "use" the income against another line of business that is generating deductions
 - 1. In short, avoid full impact of the LIFO recapture (and have the owners end up with more cash after tax) by finding a buyer for the stock of the dealership after the sale of the inventory (or other appreciated assets) has occurred ... very specialized ... more details available on request

IX. LIFO, S Corporations & Q Sub Groups ... Opportunities & Pitfalls

- A. Tax returns, LIFO elections & election terminations
 - 1. Overall combination of assets, per statute
 - 2. No IRS formal guidance on how to combine all assets of Qsub group
 - (a) Initial LIFO elections ... Do all QSubs have to be on LIFO?
 - (b) Terminating LIFO elections for QSub members
- B. LIFO calculations, pooling & reserve recapture implications
 - 1. Should each Qsub's inventory constitute a separate pool?
 - 2. Is each Qsub a "separate trade or business?" If so, separate pooling implications. Resolution may depend on whether the Qsub is operated as a "separate trade or business"
 - 3. How Qsub inventories have been treated in the initial S corp. return filed to include the Qsubs could have "method of accounting" implications
 - 4. To date, the IRS has not issued any instructions or guidance on these LIFO/pooling inventory questions. Accordingly, there is no official IRS position requiring that these Qsub inventories should be treated separately
 - 5. If, in initial return, all LIFO inventories of all Qsubs were combined, that approach obviously provides greater protection against reductions in inventory resulting in LIFO reserve recapture

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- X. *Used Vehicles: Valuation, LIFO & the Used Vehicle Alternative LIFO Method ... Rev. Proc. 2001-23*
- A. Background
 - B. Relevance in light of current industry conditions (deflation over the past several years)
 - 1. Oversupply, vehicles coming off lease, price deflation
 - 2. For more recent used vehicle LIFO elections, 2001 calculations may have created negative reserves
 - 3. Termination of LIFO election as an alternative to continuing LIFO election in deflationary year(s)
 - 4. Continuing Used Vehicle LIFO election ... Have used vehicle prices touched bottom?
 - C. Planning ... for dealers who are still hanging on to their used vehicle LIFO elections
 - 1. Terminate LIFO election at end of year vs. continue on for one more year, wait & see approach
 - 2. Review LIFO layers and plan to reduce inventory levels in order to invade more recent layers which are contributing negative amounts to the LIFO reserve
 - (a) For multi-dealership groups, terminate some of the LIFO elections (i.e., those made more recently and keep in place the older LIFO elections where there is still a positive LIFO reserve
 - D. IRS safe harbor LIFO method for used vehicles... Rev. Proc. 2001-23
 - 1. Overview of used vehicle alternative LIFO method
 - 2. Determination of *current cost* (Rev. Proc. 2001-23, Sec. 4.02(4))
 - (a) *Purchased vehicles.* The current-year cost for each used vehicle purchased includes its purchase price plus reconditioning costs, delivery charges, and all other costs properly allocated to that particular vehicle under the taxpayer's method of accounting (which includes the taxpayer's method of accounting for Section 263A costs).
 - (b) *Trade-in vehicles.* The current-year cost for each used vehicle acquired via trade-in includes its "cost" plus reconditioning costs and all other costs properly allocated to that particular vehicle under the taxpayer's method of accounting (which includes the taxpayer's method of accounting for Section 263A costs).
 - (c) *The cost of a vehicle acquired via trade-in* must be determined by reference to the wholesale price listing, as permitted by Rev. Rul. 67-107, 1967-1 C.B. 115, in an official used vehicle guide for a similarly equipped, comparable base vehicle that reflects the trade-in vehicle's actual mileage and condition. The cost of a trade-in vehicle also must include prices reflected in the guide for installed options and accessories, if any.
 - (d) The official used vehicle guide from which prices are drawn to determine the cost of a trade-in vehicle must be the *guide that covers the day of acquisition of that specific vehicle.*
 - 3. Other Special rules, definitions, terms, conditions & requirements
 - (a) Use of base vehicle prices
 - (b) Use of official used vehicle guides
 - (c) Using different official used vehicle guides for different purposes
 - (d) Two LIFO pools ... #1. All Used Automobiles ... #2. All Used Light-duty Trucks
 - (e) Determination of the current-year cost of vehicles in ending inventory (see above)
 - (f) Determination of comparable base vehicle prices for index computations
 - (g) What to do when a prior-year comparable base vehicle listing does not exist
 - (h) Dollar-value, link-chain methodology
 - (i) Eight step calculation process, with any increment valued using current year cumulative index
 - (j) Every vehicle in each pool must be repriced in determining current year index of inflation/deflation
 - (k) Save all invoices. Copies of invoices for every vehicle in ending inventory should be saved indefinitely as permanent (corporate) tax records.
 - (l) All prior year used vehicle LIFO indexes must be rebased to 1.000 as of beginning of year of change to the Used Vehicle Alternative LIFO Method

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XI. *Parts & Accessories Inventories ... Valuation of Parts Inventories at Replacement Cost Is Acceptable*

A. Background and relevance

B. Discussion points

1. What specifically did you tell your clients when Rev. Proc. 2002-17 was issued?
2. What actions, if any, did you take on behalf of your clients as a result of Rev. Proc. 2002-17?
3. How would you summarize the overall controversy resulting from *Mountain State Ford* and the way the IRS "resolved" its victory?

C. *Mountain State Ford Truck Sales, Inc. v. Comm.* 112 T.C. No. 7 (March, 1999)

1. Use of the replacement cost method for parts-type inventories was disallowed by the Tax Court
2. The taxpayer in this case is a heavy-duty truck dealer who elected to apply LIFO to its parts inventory in 1980. The dealer used a dollar-value, link-chain LIFO method. It also elected to use "the most recent purchases method" in computing the "total current-year cost of items making up" its parts pool. In determining that current-year cost, the dealer used the Ford and Isuzu manufacturers' price lists that were in effect as of the date of its physical inventory - i.e., the replacement costs - for the inventoried parts that it had purchased.
3. The IRS position was that the use of replacement cost does not clearly reflect income because it is contrary to the requirements of Section 472. The IRS further determined that the dealer's income for 1991 should be adjusted to include the amount of the LIFO reserve that had been built up by inflation during the entire 12 year period from 1980 through 1991.
4. The IRS said that the term "cost" means *actual* cost. This required the determination of the current-year cost of items in the parts pool to be made on the basis of, or by reference to, *actual* costs.
5. The Tax Court Holdings
 - (a) The use of *replacement cost* in determining the current-year cost of the dealer's LIFO parts pool is *contrary to the LIFO regulations*.
 - (b) The use of replacement cost *does not clearly reflect income*.
 - (c) The dealer was entitled to *no relief because the dealer failed to maintain "detailed inventory records."* As a result, the IRS couldn't verify the dealer's inventory computations and/or their compliance with the regulations.
6. Taxpayer appealed the Tax Court's decision to the US Court of Appeals for the Tenth Circuit

D. Revenue Procedure 2002-17 ... issued March 11, 2002

1. Generally, effective for taxable years ending on or after December 31, 2001
2. Resulted, in part, from NADA efforts to try to compel IRS/Treasury to provide relief
3. Provides safe harbor accounting method for dealers' parts and accessories inventories
4. Allows dealers to approximate actual cost of parts inventory items by using replacement cost method based on end-of-the-year prices taken from manufacturers' price lists
5. Automatic consent to change to this method is granted in almost all cases
6. Rev. Proc. 2002-9 is modified to include this change as an automatic change in Appendix Sec. 10.02

E. Action / Form 3115 filings necessary to conform

1. Situations where no action is required, just keep doing what you have been doing in the past
2. "Do nothing" situations vs. other situations where filing Form 3115 is required

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XII. Demonstrator Vehicles

A. Discussion Questions re: CPAs advice to dealers

1. In early 2002, when the new demo guidelines were released, what advice did you give your dealer clients with respect to these new rules?
2. What were your dealers' reactions to this advice?
3. What changes did they (or did they not) implement?
4. At the present time, almost two years later,
 - (a) What are your dealer clients doing today in relation to providing demos to their salespeople?
 - (b) What are your dealer clients doing today in terms of complying with the "new" rules?

B. IRS guidance for valuing employee use of demonstrator vehicles ... Revenue Procedure 2001-56

1. R.P. effective for taxable years beginning on or after January 1, 2002
2. Good news & bad news: Certainty is provided, simplicity is permitted, but substantiation is required
3. The Revenue Procedure offers dealerships optional methods to select from for valuing the amounts to be included in income where demos are used by certain employees. These optional, simplified methods are structured so that if the use of a vehicle by an employee does not qualify for treatment under one method, that use can instead be taken into account under a subsequent method with no additional recordkeeping. The *three* methods that dealerships can select from are
 - (a) The *Simplified Full Exclusion Method*,
 - (b) The *Simplified Partial Exclusion Method* and
 - (c) The *Simplified Full Inclusion Method*
4. If none of these methods satisfies or applies, then dealers revert to the *General Rule* ... and this requires valuation of the demonstrator vehicles at their "full fair market value." There are special terms, computations and conditions to satisfy ... but they all seem to be reasonable.
5. If the use of a demo by a full-time salesperson fails to qualify for full exclusion under the simplified full exclusion method, the use of that vehicle may still be accounted for under the partial exclusion method based on records otherwise available or already maintained.

C. Four Key Observations:

1. *First*, unless the full exclusion method applies, amounts are required to be included in employees income *no less often than monthly*.
2. *Second*, based on a review of odometer readings, the employer is required to make a determination of whether or not the use of the vehicle by the employee has been *limited*, and this determination must be made *no less often than monthly*.
3. *Third*, the amounts to be included in employees income (where applicable) are based upon the value of the demonstrator vehicles as determined from tables included in the Revenue Procedure for that purpose ... i.e., the includable amounts are *not* determined on a cents-per-mile driven basis.
4. *Fourth*, in all cases, corresponding Federal income tax withholding and other applicable employee payroll taxes and matching employer payroll taxes are required.

D. Dealerships have many options in applying the new rules.

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

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XII. Demonstrator Vehicles (Continued)

E. Practical Implementation Considerations

1. There are some employees with personality types completely resistant to all form of recordkeeping requests. And, if you change that request to a requirement, some become even more defiant and uncooperative. Maybe that's just human nature in some folks.
2. To accommodate these situations, if some employees are unwilling to maintain the records necessary to satisfy the full exclusion method, the employer can account for their use under the partial exclusion method (i.e., the second method) or under the full inclusion method (i.e., the third method) while still retaining the ability to use the full exclusion method (i.e., the first method) for the other employees who are willing to comply, cooperate and assist in the recordkeeping requirements.
3. The Revenue Procedure includes model plan wording for some of the simplified plans.

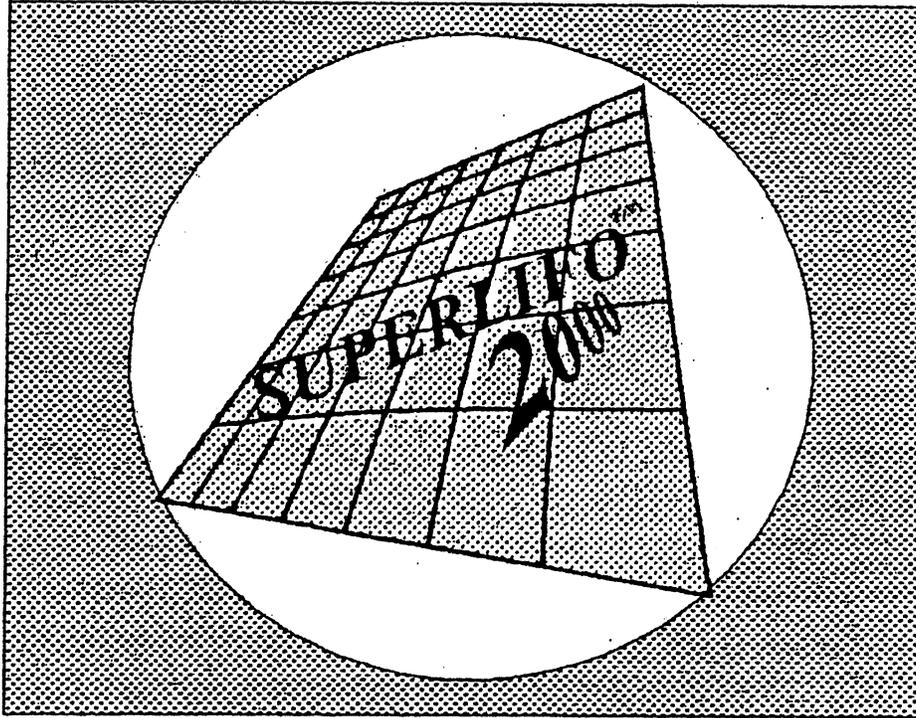
F. Previous IRS activity involving demonstrator vehicles

1. Incorrect use of lease valuation table ... *BMW of North America, Inc.* (Dec. 1998)
U.S. District Court - District of New Jersey
2. Sloppy recordkeeping & lack of Section 274 documentation ... Letter Ruling 9801002
3. Distributorship using wrong safe harbor rule ... Letter Ruling 9816007
4. See also Tax Court discussion of demo rules in *Herbert L. Whitehead v. Comm.* (TC Memo 2001-317)

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