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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:

Our last issue was devoted entirely to one big topic. This issue, by contrast, covers a variety of items and issues, mostly in "Update" form.

#1. STOP THE PRESSES ... PORCs LIVE TO SEE ANOTHER DAY. As you know, Dear Reader, I'm rarely "early" in sending out this quarterly publication. I'm usually targeting the end of the month following the quarter as the date to have the issue completed. Well, this September was going to be different. And as a result of Herculean efforts on the part of myself and my staff, we had this quarter's issue "printer ready," and I was ready to meet with the printer on Monday, September 27 for what we call the "hand-off." I had left the office late Friday afternoon, the 24th, in one of my better frames of mind.

On Saturday, I routinely checked my e-mails. The headings on two of them abruptly caught my attention ... ***"Stop the Presses!"*** and ***"Ding-Dong, the Witch Is Dead!"*** Both were sent by PORC industry experts informing me that on Friday afternoon, September 24, the IRS had issued Notice 2004-65. In this Notice, the IRS has done a "flip-flop" and effectively removed dealer PORCs from listed transaction status in Notice 2002-70.

Great news, but a greater problem for Yours Truly, the *DTW* editor. Here's what I decided to do... First, leave all of the PORC-related material in Update #9 and on pages 15-29 about reporting and disclosure alone and publish it as originally planned. Second, include the full text of IRS Notice 2004-65, with a few comments on pages 30-31. Third, plan to include the article on the new financial reporting rules for Buy-Here, Pay-Here dealers that was scheduled to appear on pages 30-31 in a subsequent issue of the *Dealer Tax Watch*.

Here's why I decided to handle this development this way. First, the effective date of Notice 2004-65 is such that a few years (2002-2003) are excluded, although from a practical standpoint, it seems unlikely that the IRS will want to venture back in time on this. Second, the tough new tax shelter disclosure laws enacted by California still need to be contended with, even though dealer PORCs now "may" not be their primary focus as a result of this change. Third, although the article in the *Automotive News* seems more like a tempest in a teapot, it is, nevertheless, a recent development–although now of lesser importance.

Keep all of this in mind in reading Update #10 and the materials on pages 15-20 relating to tax return disclosures for PORCs. If you're bottom-line-ori-

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ented, you might want to skip these 6 pages. On the other hand, some CPAs may find this information helpful. If you're one of the latter, you can go hog-wild over all the details.

#2. YEAR-END TAX PLANNING OPPORTUNITIES LETTER. Before you know it, we'll start running out of time to do any meaningful year-end planning. In making my own rounds with dealer clients to discuss various planning opportunities, there are many things to say and talk about. In these meetings, I always have a discussion agenda, outline or a letter to help keep the discussion focused. And, since I can't talk to every dealer personally, a timely letter summarizing these points can easily be sent to each dealer to encourage calls for further discussion.

This year's letter appears on pages 8-11. We welcome any suggestions or comments on it.

#3. UPDATE ON ACCOUNTABLE PLANS FOR SERVICE TECHNICIANS. It's been a while since we checked in on technician tool reimbursement accountable plans, and now is a good time for an update on the IRS' activity in this area. For the details, see page 7.

#4. WHEN THE TAXMAN SENDS THE DEALERSHIP A LETTER, WILL YOU BE READY? Given the present low rate of actual dealership audits by the IRS, one might rephrase the question by asking, "If the IRS ever gets around to knocking on your door, will you be ready?" But, let's put that aside for the moment. The IRS has continually indicated its concern over dealerships that do not have proper documentation and compliance with the electronic recordkeeping requirements set forth in Revenue Procedure 98-25.

At the 2003 AICPA Auto Dealership Conference, Terri Harris said that IRS computer audit specialists are continuing to report that auto dealerships comprise one of the few industries that still is not complying with Rev. Proc. 98-25. We have written quite a bit about this in past issues of the *DTW*.

On page 10 of the December 2003 *DTW*, we reported that Ms. Harris indicated that the IRS was working with some of the vendors who provide software to dealerships in trying to get them (i.e., the vendors) to understand what the IRS really needs from them. Right now, we have not heard of any progress in this regard. Ms. Harris also said that she hoped CPAs would be instrumental in bring these requirements to the attention of their dealers. Has anyone volunteered to help?

Have you ever heard of *Tax Audit for Life*? Well, it could save your dealer's *"life"* if the IRS actually does come around. For more information on this product and service, see page 3.

#5. OLDSMOBILE DEALERS ... UPDATE ON POSSIBLE TAX RELIEF. In the December 2003, *Dealer Tax Watch*, Update Item #1 and the related article on possible tax relief (see page 6 of that issue), we referred to pending legislation (both House and Senate bills) that might benefit Oldsmobile dealers and others in transition. On August 9, 2004, the *Automotive News* reported that these dealers now "have their best chance in three years to get a tax break on the money General Motors is paying to eliminate their franchises."

It was reported that 2,802 U.S. Oldsmobile dealers might be "in line for a federal tax break averaging an estimated $67,000 per dealer." The status and final form of any relief will be worked out in a conference committee meeting at some future date, with speculation that it might be before the end of 2004. As we go to press, no specifics are available on when such a provision might be passed or what the final provisions might be.

In our latest check with NADA's legislative office, we were advised (on September 24, 2004) that "[the Oldsmobile legislation] passed Senate in corporate tax bill–House corporate tax bill does not include it. It will be Conference issue–Senate has appointed conferees and House expected to appoint as early as next week. The Bill, however, may not be totally resolved until lame duck [session] after election."

One question still up in the air is whether any tax relief might be limited only to GM/Oldsmobile dealers, or whether that relief also would be available to other dealers who had buy-outs from other manufacturers under similar circumstances.

#6. DEALER CHALLENGES. On a somewhat pessimistic note, the *Automotive News* recently reported (June 21, 2004, page 10) that "most dealers expect lower profits in '04." According to an NADA survey, 3 out of 5 new car dealers say that they expect their profits to decline this year.

A list of automotive industry trends and some speculation about what the future may hold appears on page 5. This was compiled from a recent presentation to CPAs at a mid-summer meeting. It's included here because you might want to use it, or some parts of it, for a discussion agenda the next time you get together with your dealer clients. Just ask them how they think they are being affected by these trends ... or what they've done or are planning to do about them.

#7. BHPH DEALERS - NEW FINANCIAL REPORTING RULES FOR AUTOMOTIVE FINANCE COMPANIES. These new rules were issued by the AICPA in *Statement of Position 03-3*.

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IF THE TAXMAN EVER KNOCKS AT YOUR DOOR ... WILL YOU BE READY?

TAX AUDIT FOR LIFE ...Could Save Your Life

One View
... IRS ...
Rev. Proc. 98-25

We believe that readers of the *Dealer Tax Watch* can benefit from knowing about products and services in the dealership marketplace almost as much as they can benefit from good technical information. In this regard, the larger your dealership client becomes, the more we believe that you should look into the new service now available from One View, Inc., called ***Tax Audit for Life.***

This product was developed for a major group of auto dealers with input from the IRS. Should the IRS ever knock on your door, you should be ready for any IRS audit inquiries involving electronic recordkeeping requirements under Revenue Procedure 98-25 if you were using the ***Tax Audit for Life*** back-up procedures and services provided for a low monthly cost by One View, Inc.

Here's what Dave DeHaven, President of One View, Inc., has told us about how *Tax Audit for Life* was born and what it does.

"As with most of One View's products, necessity is the mother of invention for *Tax Audit for Life.* A large dealer consolidator came to One View with a need and asked if One View had or could develop a solution. The need arose in maintaining archived records for a very large consolidated group of more than 100 dealerships. Due to normal document archiving procedure, each dealership was responsible for submitting their documents for archiving. Regardless of the destination of this data, relying on intervention or activation by non-technical staff is a recipe for problems. At a minimum, 100 dealerships per month times twelve months equals 1,200 incidents per year for possible mistakes. To sidestep this error-prone procedure, One View developed *Tax Audit for Life.*"

Tax Audit for Life takes raw data from the DMS (Dealership Management System) automatically, either triggered at a predetermined time, or triggered manually after the month-end close. At this activation time, raw data is complied, encrypted and sent to One View from the following sources:

- General Ledger Detail and Control Files,
- Chart of Accounts and Control Files,
- Account Beginning Balances and Control Files,
- Account Ending Balances and Control Files, and
- Master Vendor Information and Control Files.

In other words, all control and detail files are sent.

When the data arrives at One View, the detail is validated using the control files and check figures to verify *absolutely* that all data was received and received correctly. Once verified, the data is submitted to a database containing the data from all related dealerships - those with common ownership.

When this data is needed for review, auditing or for IRS audit purposes, the dealer principal, or his/her representative simply logs into the secure One View *Tax Audit* web page. Easy to understand pull-down menus and check boxes allow the selection of the particular dealership, year, month or months, and data type (i.e., GL Detail, Chart of Accounts, etc.). The resulting file is then downloaded to the requester's PC to a user-specified location. The file is in a universally acceptable and usable format - ASCII text. This delimited text file can be easily opened in Microsoft© Excel, Word, Access and most other windows and non-Windows applications suitable for processing data. ***The extract file type, content and layout were designed using specific input from the Internal Revenue Service.***

All the data is collected; all the data is stored; all the data is backed up continually ... all of the time. The data will be available for extract 24 hours a day, 365 days a year. In addition to the backup procedures employed by One View, ***for further data security***, a back-up copy of the raw and processed data is sent to the dealer/customer.

For more information on *Tax Audit for Life*, call David DeHaven at (317) 915-9039 (e-mail: ddehaven@one-view.com) or Jeffrey Todd (e-mail jtodd@one-view.com). One View is headquartered at 8531 Bash Street, Indianapolis, IN, 46250.

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Technically, these rules are not required to be implemented for 2004. However, CPAs should consider reflecting these reporting changes in 2004 financial statements in order to prepare the financial community for the impact that they will have in 2005, if no advance warning is given.

As we understand it, the effect of these new reporting changes is that a significant portion of the adjustment previously booked by companies related to the discount on a "package" or "lot" of notes cannot be recognized in income in the year when the notes are purchased.

Some (many?) companies previously have taken the discount on the initial purchase of the loan package into income almost immediately. Under the new rules, only if the underlying loans perform better (than anticipated by the initial discount) over the life of the loans can any amount be taken into income. And, the amount that can be taken into income under the new rules will be related only to the difference between (1) the actual performance of the loan package of notes as it is evaluated over the life of the loan and (2) the initial discount involved at the time when the loans were purchased.

For example, assume that a discount of 35% had been deemed to be appropriate in connection with the initial acquisition of some loans. Assume further that over the life of the loans, the loans perform more poorly than anticipated, and it is determined that a discount rate of 45% should have been applicable. Under the new reporting rules, only the 10% differential between the initial 35% discount rate and the actual 45% performance rate will be taken into income/earnings.

Conversely, assume that a discount rate of 35% had been deemed to be appropriate in connection with the initial acquisition of some loans, but a better-than-anticipated performance rate occurs and as time goes by the more appropriate discount rate is determined to be only 15%. In this case, only an amount corresponding to the 20% differential between the discount rates will be taken into income/earnings.

These new rules will provide a much greater challenge to CPAs for buy-here, pay-here dealers and their sub-prime loan activities because of the difficulty in evaluating, measuring, quantifying the performance of these loans.

These financial reporting rules are not mandatory for Federal income tax reporting purposes. Therefore, if they are reflected for accounting/financial purposes, but not for income tax purposes, they will cause book-tax (Schedule M-1 or Schedule M-3) reporting differences.

Ken Shilson (713-290-8171) is an expert in this area who frequently contributes his knowledge to articles in the *Dealer Tax Watch*. He believes that, despite some practical difficulties, the implementation of these new rules is a necessary step in the long-run to reduce the significant variations that previously were being employed to record discount and/or amortization charges in the financial statements.

#8. BHPH DEALERS - FORM 1099-C REPORTING REQUIREMENTS. A second development that BHPH CPAs should be aware of has been hanging around for a long time waiting to happen. In June of 2002, the IRS issued Proposed Regulations on Form 1099 reporting of the discharge of debt under Section 6050P. The Proposed Regulations affect organizations in the trade or business of lending money. It's taken the IRS quite a while to come to grips with some safe harbor rules to include or exclude certain types of businesses from the Form 1099-C, *Cancellation of Debt*, reporting requirements.

In discussing this recently with Ken Shilson, he mentioned that although the Regulations are "Proposed," according to the IRS, that simply means that they are subject to further amendment. Nevertheless, the Form 1099-C filing requirement is effective for calendar year 2004. All CPAs for auto dealerships–and especially CPAs for BHPH dealers–should look very carefully at the 2004 instructions for Forms 1099-A and 1099-C, which are now available.

Note that Form 1099-A is required in connection with the *Acquisition or Abandonment of Secured Property*. The instructions for Forms 1099-A and 1099-C are combined to provide for the coordination and/or elimination of duplicate filings of both forms. The instructions state that if, in the same calendar year, you cancel a debt in connection with a foreclosure or abandonment of secured property, it is not necessary to file both Form 1099-A and Form 1099-C for the same debtor. You only have to file Form 1099-C and make entries in Boxes 5 (*Debt Description*) and 7 (*Fair Market Value of Property*).

Shouting in the Wind. In a letter to the IRS earlier this year commenting on the Section 6050P Proposed Regulations, one CPA pointed out how confusing things become ...especially where BHPH operations are conducted through multiple corporate entities.

It would appear that some of the defaults being reported to the IRS may result from bankruptcy proceedings in which the debtor may be insolvent either before and/or after the discharge of his/her auto

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Automotive Industry Trends & Future Prospects	

Automotive Industry Trends ...
 	
Right Now
	• Consolidation continues in the industry
	• Average revenues per store is increasing
	• Small volume stores are declining
	• Minority dealer body is still not representative of national demographics
	• Impact of large operator (not just public dealers) is becoming more significant
	• Small or single franchise operator strategy is a significant long-term risk
	  ♦ Franchise favor tends to change more rapidly
	• Improved earnings quality
	  ♦ Less dependent on new vehicle sales
	  ♦ Increased used vehicles and parts and service penetration - both of which are countercyclical to new vehicle sales
	  ♦ Financing and insurance is a large, high margin component of new and used vehicle profits
	• Reliability and quality of dealers' earnings and consolidation has attracted more private and public buyers
	• Greater understanding of automotive industry
	• Organic growth of new points not satisfying many dealer owners' needs for growth
	• Public dealership multiples are recovering
	• Blue sky is getting more expensive
	• Greater emphasis on internal controls
	• Higher quality of financial reporting
	• Cost to acquire an operation is increasing
	• Store operating trends
	  ♦ Longer factory warranties - more service
	  ♦ Certified Pre-Owned display, sales areas
	  ♦ Certified Pre-Owned vehicles resulting in extended warranties - more service
	• Air conditioned service areas
	• Manufacturers demands for facility compliance
	  ♦ Blue Oval, Image changes, Alpha, Channeling strategies
	• Cafes, creature comforts in waiting rooms
	• New product launches and realignments
	• Large volume exclusives receive higher allocations
	• Cost to build or remodel a dealership is increasing

What Does The Future Look Like?	• Larger dealerships, more franchise diversification • OEM's desire fewer and larger dealerships ... Significant upgrades also may be required • More manufacturer pressure • Areas will have less dealerships for many miles, some manufacturers will allow "service centers" • Mega-Groups will enter more markets, increasing operating costs and decreasing market shares for dealers • More competition • More capital required
Source	• Capital Automotive REIT presentation by Joe Connolly, June 2004.

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installment contract obligation. Section 108 provides that in certain circumstances, a debtor will have no gross income as a result of the discharge or cancellation of indebtedness. It is understandable that, in some situations, amounts reported on Forms 1099-C may cause problems with the IRS' "matching" program and/or in the determination of the proper amount to be included or excluded from income in the recipient's income tax return–if they are filing one or are even required to file an income tax return.

The writer also discussed three levels or categories of potential confusion and/or harm resulting from applying the Section 6050P Regulations to BHPH dealers and their customers. ***Customer harm*** ... confusion and frustration over the receipt of Forms 1099 that they don't understand, etc. ***Dealer harm***... cost of compliance, potential dollar penalties for failure to file, loss of goodwill and adverse customer perception, i.e. perceiving the dealer as a "bad guy," IRS informant, etc. ***IRS harm*** ... cost of administration, storing and matching 1099 information, excessive and/or confusing correspondence with taxpayers, etc.

"Catch 22"? In connection with the Form 1099-C filing regulations, Ken Shilson has another suggestion. Finance companies and dealers should discuss these new filing requirements with their attorneys in connection with whether, if Form 1099-C is issued, that may prevent the reporting taxpayer (BHPH dealer or finance company) from garnishing the debtor's wages or otherwise trying to bring any further action to recover on the debt at a later date. Apparently some attorneys have expressed the concern that filing Forms 1099-C could preclude the dealer from these or other further actions. A "Catch 22" of sorts.

#9. REAL ESTATE INVESTMENT TRUSTS (REITs) & HOW DEALERSHIPS CAN USE THEM IN THEIR TAX PLANNING. Homeowners strapped for cash have home equity loans and reverse mortgage arrangements as cash flow options to consider. Equivalent financing vehicles are not readily available to dealers who would like to tap into the equity that they have built up in their property. In advising dealers in these circumstances, one alternative to traditional bank or Factory financing could be a transaction with a REIT.

At a conference of auto dealership CPAs earlier this year, Joe Connolly, Vice President of Acquisitions of CARS (Capital Automotive REIT), discussed how CPAs could help their dealerships in evaluating the possibilities of using REITs in connection with their expansion and other planning activities. His presentation has been included in the material on REITs on pages 12-14. If you would like a copy of Joe's PowerPoint presentation materials or the *Capital Automotive REIT Annual Report* for 2003, please contact him directly at jconnlly@capitalautomotive.com.

#10. PORCs ... LOTS TO REPORT. *Changes by the Pension Funding Equity Act of 2004 that could affect your dealers' PORCs.* On pages 21-25 you'll find an update of the important changes affecting non-life insurance companies that were included in the ***Pension Funding Act of 2004,*** signed by the President on April 10. These changes apply to tax years ending after December 31, 2003, and for calendar year taxpayers, they are effective immediately.

Disclosure & Reporting. In terms of the Form 8886 disclosure and reporting requirements, if you're still (a little) confused about what to do about them, don't worry ... after reading the materials on pages 15-20, you still may be (but, go back and read update #1 on Page 1 before getting too excited).

The information in the articles and materials (pages 15-25) is borrowed, with consent, from a presentation that Mr. Gregory Petrowski made to a group of dealership CPAs in June. Mr. Petrowski is the Secretary-Treasurer of GPW& Associates, Inc., in Phoenix, Arizona. He has kindly consented to my reformatting his information as the basis for these update articles and various supplementary materials. Mr. Petrowski is an excellent resource for you in the area of dealer (and other) PORCs, and if you have technical questions regarding the application of this information to specific situations–or any other general questions on PORCs–you can reach him at (602) 200-6900 or gpetrowski@gpwa.com.

California Horrors. If you have clients located in California–or even non-residents who are filing income tax returns with the State of California–you've got even more to *think* about (correction: make that *be scared* about) as a result of the Golden State's enactment of tough new tax shelter disclosure legislation. The comments of several authors on these California requirements, reported on pages 28-29, should be enough to convey just how tough and problematic the California legislation is. If you're a California CPA, no doubt, you've already spent a good deal of time wrestling with this; however, many *DTW* readers in other states may have clients filing California (non-resident) returns and also need to be conversant with these requirements.

And don't just relate this legislation to PORC disclosures. It also relates to many investment tax shelters individuals are involved with on their personal tax returns.

Automotive News Article on PORCs Causes a Stir. There is one "article" that is not included in the

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ACCOUNTABLE PLANS FOR SERVICE TECHNICIANS' TOOLS

The last time we talked about technician tool reimbursement accountable plans was back in the September 2003 issue of the *Dealer Tax Watch*. In Update #4, we reported that in IR-2003-92, the IRS decided not to include in its Industry Issue Resolution Program a submission we had been involved with requesting clarification of various tax issues concerning Section 62(c) accountable plans for service technicians.

We reported (in the December, 2003 *DTW*, pages 10-11) that during the Question & Answer session at the 2003 AICPA Auto Dealership Conference, someone asked Terri Harris, the IRS Motor Vehicle Technical Advisor, ***"Is there anything new on service tech tools?"***

In reply, Ms. Harris answered, "... They were submitted under that Industry Issue Resolution Program ... At this point, there is no work on one, it has not been accepted into that (Program). ...It is a Coordinated Issue in the Motor Vehicle Program which means that our Agents must raise it (the issue) and cannot deviate from the Service's position without permission of the Motor Vehicle Technical Advisor Program...."

Ms. Harris added: "...There was a perception out there that we said that service technician tool reimbursement plans could not be done correctly ... ***and that is not right; they can be done correctly.*** So, there is minimal activity on them, and they are still out there ... ***and we are looking to get you additional guidance.***" Note that Ms. Harris referred to reimbursement plans, not to "rental" plans.

Pro-Check National, Inc., a third-party accountable plan provider, has tried to take Ms. Harris up on her request for information to help the IRS better understand accountable plans for service technicians.

In February of 2004, one dealer who had adopted an accountable plan administered by Pro-Check National, requested a Private Letter Ruling from the Internal Revenue Service. This request for Ruling disclosed basically anything and everything that the IRS could need to carefully consider a specific plan under Section 62(c). Information submitted included a detailed description of the plan, statements of law, arguments differentiating this specific plan from those more generally described in the IRS Coordinated Issue Paper of June 2000, and specific requests for rulings.

Several months later, the IRS sent the taxpayer a letter advising it that the Service would not be able to issue a ruling in this matter. The Service cited its "discretionary authority to issue Letter Rulings when appropriate in the interest of sound tax administration," and it also cited Section 5 of Revenue Procedure 2004-3. This Section provides several areas under ***extensive study*** in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a Revenue Ruling, Revenue Procedure, Regulations or otherwise. The IRS's letter said ... "One of these areas of extensive study included reimbursement arrangements. ... After careful consideration, we have determined that your request comes within this area of extensive study."

At the same time that all of this was going on, requests were again made to the IRS by other parties to consider service technician reimbursement / accountable plan issues in connection with the IRS Industry Issue Resolution Program for 2004. These requests were made several times during the year, and in all cases, the IRS declined.

On July 26, 2004, the IRS announced the release of its 2004-05 Priority Guidance Plan. This so-called Plan contains 276 projects that the IRS intends to complete over the 12-month period from July 2004 through June 2005. In a response to a Congressman's inquiry made to the IRS on behalf of the dealer whose request for the Private Letter Ruling had been denied, the Service indicated that it was "pleased to tell ... the Congressman ... that the specific issue ... is one of 276 projects listed on the Priority Guidance Plan."

In fact, under *Section B, Executive Compensation, Health Care and Other Benefits, and Employment Taxes*, Item #4 of the 2004-05 Priority Guidance Plan (PGP) includes the entry, "Revenue Ruling on Tool Rental."

It appears that we will now have to just wait and see what the IRS comes out with on this. We have repeatedly tried to convince the IRS that it should distinguish between ***rental*** programs or arrangements and ***Section 62(c) accountable plan*** programs or arrangements. So far, to no avail.

Needless to say, this is one area we are watching closely.

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Re: Year-End Dealership Tax Planning Opportunities

Dear Client:

Several topics come to mind in thinking about year-end tax planning that we should be considering. This letter briefly talks about four opportunities to consider before year-end.

- Taking advantage of the favorable income tax rates on dividend income,
- Taking a second look at accountable plans for reimbursing technicians for using their tools,
- Considering some changes in accounting methods to reduce your taxable income, and
- Accelerating depreciation deductions based on cost segregation studies.

REDUCED TAX RATES FOR QUALIFIED DIVIDEND INCOME

Preferential Rates on Investment Income. By way of background, the *Jobs and Growth Tax Relief Reconciliation Act of 2003* enacted lower tax rates on income from investments, including so-called ***"qualified dividends"*** and capital gains realized from sales after May 5, 2003. In the past, you were taxed on all dividend income at your highest marginal tax rate, and long-term capital gains were generally taxed at a flat 20%.

The way the preferential tax rates for qualifying dividends work is that ...

(1) ***A flat 5% tax rate*** is applied to that portion of the qualified dividend income you received that would otherwise be taxed in your return in either the 10% or in the 15% tax rate brackets.

(2) ***A flat 15% tax rate*** is applied to the remaining portion of any qualified dividend income that would otherwise be taxed in your return in the higher-than-15% tax rate brackets (i.e., that would have fallen into the 25%, 28%, 33% or 35% tax brackets).

(3) Basically the same two-step approach above applies to the taxation of capital gains resulting from sales after May 5, 2003, and the beneficial tax treatment for both qualified dividends and these capital gains is also available in computing your tax liability under the Alternative Minimum Tax.

(4) "New" columns had to be added to the Forms 1099 that you received this year in order to record this special dividend and capital gain information because some of your dividend income may not be considered "qualified" due to the character of the underlying security or because certain holding period requirements were not met.

Proactive Planning for the Lower Rates. So, what does all of this mean? As the impact of the provisions of *JGTRRA* on investors and business owners became evident, many of us saw opportunities for some full-scale tax planning in order to take advantage of the seemingly, "too-good-to-be-true" low rates on investment income.

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Some dealers have built up accumulated *earnings and profits* (somewhat similar - but for tax purposes, not technically the same as - *retained earnings*) in their regular C corporations or in years before they switched from being taxed as C Corps. to S Corps. The lower *JGTRRA* tax rates on eligible dividend income are considered by many to be an invitation (possibly short-term?) to withdraw some of this accumulated income at minimum tax cost. After all, who knows how long these lower tax rates are going to last?

For some dealers (and other owners of closely-held corporations), the opportunity was too good to resist, and they decided last year to take out rather sizeable dividends at very low effective tax rates. Typically, the effective income tax rate on the shareholder will fall somewhere between ***more than 15% and less than 20%.***

This could be especially attractive to more elderly individuals whose corporations had accumulated assets (not necessarily cash) and who now wanted to take some of that accumulation out of the corporation. In family business continuity planning situations, relieving the corporation of unneeded, accumulated assets often makes it easier for the next generation of successors to pay for the stock they are acquiring in the dealership/business.

Another related planning opportunity involves a corporation that owns property that is not really needed in the operations of the business. In this case, when the corporation distributes this property as a (non-liquidating) dividend, it will have to pay tax at the corporate level because that distribution is treated as a sale of the property. However, if the amount of corporate tax on the distribution will not be significant, then the payment of a small amount of tax at the corporate level will be worth it to "simplify" things and reduce exposure to the IRS questioning the ownership and use of these assets by the corporation. So, in this case, the shareholder benefits from the low rates on qualified dividend income since the property distribution is pulling out accumulated earnings and profits and, after the distribution, the corporation's balance sheet will look a lot "cleaner."

In connection with planning to pull out large dividend distributions, it is necessary to project the taxes resulting from both (1) the regular income rates and (2) the Alternative Minimum Tax rates. In one case last year, when we discussed the opportunity of withdrawing a large dividend at a low tax cost, the client was told that, although the new flat rate of tax on the dividend would be 15%, the ***effective rate of tax*** probably would be a little higher because of the interplay with the Alternative Minimum Tax.

At that time, before year-end, there were too many variables and unknowns that had to be estimated, and that prevented a more precise estimate of the effective tax rate on the contemplated dividend. After year-end, when we prepared the client's income tax return for 2003, the effective rate of tax on that dividend was calculated to be 17.7%. This was slightly higher than the flat rate of 15%. However, the client still believed that it was very much to his advantage to take out a large dividend at the low net tax cost of 17.7%.

Note that if the corporation does not have adequate cash immediately available to pay out a dividend in order to take advantage of the lower income tax rates, there is no prohibition against borrowing the money in order to pay out the dividend.

If this strategy for benefiting from lower effective tax rates is attractive to you, we should start considering the alternatives as soon as possible.

ACCOUNTABLE PLANS FOR REIMBURSING SERVICE TECHNICIANS FOR USING THEIR TOOLS

Did you know that, according to a NADA recent survey, three out of five new car dealers expect their profits to decline in 2004? And, did you know that dealers are having trouble finding and retaining good service technicians because of an industry-wide shortage of 35,000 technicians which is expected to last through 2010?

(Continued)

If you take a new look at how you are paying your technicians and then set up a tax-favored plan under the Section 62(c) rules for accountable plans, you can address both of these concerns in a tax-beneficial way for yourself and for your technicians.

Under these arrangements, each paycheck to service technicians is split into two separate payments. One payment continues to be for their services rendered and constitutes wages reportable on year-end Forms W-2. The second payment constitutes a reimbursement for tools owned by the technician which he/she provides as a condition of his/her employment.

If you want a vivid example of these benefits, just ask Terri Gonzalez, the dealer at Hubbard Chevrolet in Hubbard, Oregon (terri@hubbardchevrolet.com or 800-247-4336). She recently adopted a Section 62(c) accountable plan for her dealership's technicians, and she will tell you that they are receiving larger paychecks each week. In addition, the program has been excellent for employee retention and morale. And, the dealership also saves payroll taxes, as well.

A "rate-based" accountable plan like the one used by Hubbard Chevrolet or other "dollar-for-dollar" reimbursement plans involve less tax uncertainty than other types of plans being marketed to dealers. Examples of other types of plans include "rental" plans - which definitely have adverse consequences for technicians - and "depreciation-based" accountable plans - which generally provide greater reimbursement rates based on more aggressive interpretations of some of the underlying tax issues. We would be pleased to discuss further any of the income tax and/or employment tax issues related to adopting an accountable plan under Section 62(c).

Please note ... You've got to be careful with these tax issues; but with "rate-based" accountable plans, these issues are manageable, especially when monitored by a third-party administrator who handles all of the paperwork for the dealership. For specific information on how easy it is to install a rate-based accountable plan, you can contact Tom Lower at Pro-Check National, Inc. (616-890-3087).

ACCELERATED DEDUCTION BENEFITS BY CHANGING TO MORE FAVORABLE TAX ACCOUNTING METHODS

This topic groups together a number of opportunities available to dealers by changing their current accounting methods for certain items to more favorable methods that the IRS has said it will permit. These are changes that every dealership should consider making because they basically create interest-free loans from the government. ***In addition, they are often accompanied by significantly large first-year deductions that are allowed by Section 481(a) as a result of the transition to the new method of accounting.***

Treatment of Nonrefundable Advertising Charges. Dealers should consider deducting advertising charges for local (not national) advertising when the vehicle is purchased ... not when the vehicle is sold, which may be in a later year. Dealers making this change in method do not have to change the way they handle the treatment of these accounting charges internally during the year. Their controllers or CPAs can make a single adjustment at the end of the year to reflect the net amount for all year-end invoices involved. This single year-end adjustment allows the accounting department to continue its "normal" processing of these vehicle invoices throughout the year.

In most cases, you can't simply look at the invoices to see what the advertising charges are. Some manufacturers - like Chrysler - include a charge for advertising in the base price of the vehicle, rather than listing that charge separately, or the total amount charged, on the face of the invoice. So, you have to know where to look for this information or how to find it elsewhere. Additionally, not all advertising charges are what they appear to be. Portions of these advertising charges qualify as trade discounts and should be treated differently.

Treatment of Floorplan / Interest Assistance Payments ... So-Called "Trade Discounts" ... Received from the Manufacturer. Another change in accounting method that dealers should consider is one involving the

(Continued)

treatment of interest assistance payments that dealers receive from the Factory to compensate them for (or to offset) some of the floorplan interest that they pay on their inventory.

Most manufacturers give this money to the dealership, regardless of how much the dealership pays in floorplan interest or how high the prevailing interest rate might be. Most dealerships report these amounts received from the Factory as income in the year that they receive the payments. As an alternative, some dealerships will reduce the amount of their interest expense at the time when they receive these interest assistance payments.

The IRS allows dealerships to treat these interest assistance payments as "trade discounts" because the dealership does not have to do anything in order to earn or receive the payments. The Regulations clearly state that ***trade discount amounts should not be included in capitalized inventory cost.*** Instead, dealerships should reduce the cost of the vehicle by the amount of the trade discount on a vehicle-by-vehicle basis. In other words, this adjustment cannot be estimated or approximated. It must be determined by analyzing the invoice for each vehicle in ending inventory. However, the net result of this analysis can be recorded by the dealership as a single net adjusting entry at year-end.

By changing the method of accounting for tax purposes, the treatment of the trade discount as a reduction of the cost of the ending inventory enables the dealer to defer reporting the related interest assistance payments until the year in which the vehicle is sold. Timing is everything.

We have assisted all of our major dealer client groups in making these changes, and the tax benefits have been significant. It's important to note that "many dealers are receiving IRS consent letters for advertising changes within 90 to 120 days," says Todd Boren of Green Outsourcing. "The luxury of waiting until the last minute is probably not the best option." You can obtain an estimate of the potential Section 481(a) adjustment/deduction for 2004 by going to www.greenoutsourcing.com. It takes only a few moments to enter the basic data, and you will immediately have an accurate projection ... at no cost. Alternatively, you call Todd Boren at Green Outsourcing at (214) 350-8197, ext. 301.

Cost Segregation Studies. If you have recently constructed or expanded your facilities, it may be possible for you to significantly accelerate your depreciation deductions by having a cost segregation study performed by a qualified professional engineer. The taxpayer benefit payback from these studies is astounding, and - despite first reactions - it is literally just too good to be true. We'd be pleased to discuss these benefits further and make arrangements for one of these studies for you.

In general, taxpayers cannot unilaterally change to a more favorable tax treatment and claim the benefits in the current year's income tax return they file. Nor can they get those benefits by claiming deductions on amended returns for past years. However, the IRS recently has looked at so many similar requests by taxpayers that it has now determined that many such requests no longer require the Service to evaluate and approve them in advance. Accordingly, the IRS has published a list of accounting method changes which are "automatic" and this includes changes for trade discounts (but not for advertising fees). These automatic changes stand in contrast with other accounting method changes for which the IRS must first grant permission. The IRS recently revised Form 3115 which is to be used in connection with making these changes, and it is now easier to make these changes than it has been in the past.

CONCLUSION

Implementing any of these suggestions could reward you with immediate and substantial tax savings at year-end. Call us now for more details on any of these.

Sincerely,

Willard J. De Filipps, CPA

REITs	**PLANNING ALTERNATIVES INVOLVING REITs FOR DEALERSHIP REAL ESTATE**
Introduction	• A question that dealers frequently ask is, "Why would I ever sell my real estate?" • Before Capital Automotive REIT came along in 1998, a dealer had few alternatives … ♦ The dealer owned the real estate. ♦ The dealer leased the property from an independent third party (who typically knew little or nothing about the automotive retail industry). ♦ The dealer leased the property from the Factory.
	Expansion Related Considerations
Greater Return on Investment	• Dealer real estate should appreciate at the rate of inflation, approximately 3% per year. • Most dealers agree that they can attain a significantly higher return on their dealership operations compared to their real estate. Therefore, even though the dealer who sells his/her real estate to Capital Automotive REIT may not own the real estate, in 20-30 years, he/she will have made a better return on his/her equity by putting it to use in the operations than he/she would have made by holding onto the real estate and paying tax on the gain on the property's appreciation when it is sold.
More Efficient Expansion	• By tapping into his/her real estate equity, a dealer may be able to expand without having to bring in equity partners in the dealership operation (the highest yielding part of the business). • This not only means that a dealer can expand more quickly, but this leveraging of the property equity should result in better returns over the long term.
Control Without Ownership	• ***"You don't have to own it, to control it."*** • Despite not owning the property, a dealer can control his/her real estate through a long-term lease with Capital Automotive as the lessor. • ***Typical lease terms*** ♦ Fifteen-year initial term, ♦ Multiple ten-year renewal options, which allow dealers to have long-term control over their sites. • As a relationship-oriented landlord, Capital Automotive is in a position to provide its tenants with funding for expansion, new construction and factory image upgrades as needed.
	Estate Planning Considerations With Sale & Leaseback
Liquidity, Diversification & Flexibility	• ***Unlocks Inefficient Equity Tied-up in Real Estate.*** ♦ Return on equity on real estate … 8% - 12%. ♦ Return on equity on dealership operations … 25% - 45%. ♦ By selling his/her real estate, a dealer can provide a significant amount of liquidity to his/her estate. In addition to having the flexibility of diversifying one's investments, it may be easier for the dealer's heirs to divide the estate if it does not contain illiquid real estate. • ***No Personal Guarantees.*** Since Capital Automotive does business with multi-franchised dealers located in established markets with top tier franchises and stable cash flows, Capital Automotive usually does not require personal guarantees. • ***No More Loan Renewals.*** Capital Automotive's standard lease is 15 years with two 10-year renewal options. This avoids the risks associated with ballooning mortgages and future interest rate changes. • ***Facilitates the Sale of the Dealership.*** ♦ Maximize after-tax proceeds through tax deferral. ♦ Increase proceeds by bifurcating sale ▪ By separating blue sky multiple from real estate value. ▪ Market valuation of real estate may have greater multiple. ♦ Increases the pool of potential buyers by including buyers who may be interested in purchasing the dealership operations, but who do not want to purchase the real estate.

PLANNING ALTERNATIVES INVOLVING REITs FOR DEALERSHIP REAL ESTATE

The REIT Transaction Process	• A simple concept - Sale and leaseback. ♦ "You don't have to own it to control it." ♦ Control is maintained by careful structuring of long-term lease provisions to provide flexibility for the dealer and to allow the dealer to have site control. • Initial meeting with CPA and/or dealer to gather dealership financial and real estate information and to discuss alternatives. ♦ Due diligence: ▪ Financial ▪ Appraisal ▪ Environmental … Note: One of the advantages to the dealer is that future ***environmental hazard risks*** may be minimized or avoided. ▪ Survey structural. ▪ Tax consequence, estate & succession planning ♦ Purchase and lease agreement negotiations. ♦ Purchaser/REIT may pay for the equity either by paying the selling dealer cash and/or by issuing Stock Operating Partnership Units (OP Units). • CARS prepares a Letter of Intent (LOI). • Client reads, evaluates, makes final decisions and signs proposal. • Entire transaction may take less than 90 days to complete. Closing in approximately 60 days from LOI signing.
Dealer's Choice … ? ***Capital Gain Deferral Option***	• If a dealer chooses, he/she can defer taxes on the gains from selling his/her property to Capital Automotive. ♦ The sales proceeds can be taken in cash or units in Capital Automotive, LP, or some combination of the two. ♦ After receiving cash in an amount equal to the tax basis in the property, the gain portion of the sales proceeds can be paid for by issuing units of ownership in Capital Automotive, LP ♦ These units, called Operating Partnership Units ("Units"), can be converted into common stock in Capital Automotive REIT, a publicly traded company (NASDAQ: CARS), after a 12 to 18-month period. ♦ Units in Capital Automotive, LP, have a similar public market and receive a quarterly dividend. • While the Units never have to be converted into common stock, if a dealer chooses to convert the Units, the capital gain tax will be triggered at the time the Units are converted to common stock. • To date, a majority of the dealers who have entered into transactions with Capital Automotive have chosen not to convert their Units. Rather, they have chosen to hold the Units in their estate in order to receive Capital Automotive's regular dividend payments and to benefit from appreciation in the stock price. • In effect, by taking Units, a dealer exchanges the ownership in his/her real estate holdings for an interest in Capital Automotive's entire portfolio of 330 (and growing) properties housing 473 franchises. • This provides the dealer and/or his/her estate with liquidity, diversification, and cash flow (from Capital Automotive's dividend which presently has a yield of approximately 5.5%). • Upon the dealer's death, under current law, his/her heirs will receive a step-up in basis to the market price of the common stock at date of death or estate valuation. This avoids or eliminates the taxes on the built-in, long-term gain.

PLANNING ALTERNATIVES INVOLVING REITs FOR DEALERSHIP REAL ESTATE

What Is A REIT?	• A Real Estate Investment Trust, or REIT, is required to distribute a least 90% of its taxable income to its shareholders and to comply with certain other requirements. • Basically, the shareholders pay tax on the income that the REIT distributes to them, with the REIT being essentially a conduit for that income. ♦ If a REIT declares a dividend in October, November or December payable to shareholders of record on a specified date in such a month, the dividends are treated as having been paid by the REIT and received by the recipients on December 31 of such year ***as long as the REIT actually pays the dividends during January of the following year.*** • The taxability of the REIT's distributions of income to its shareholders is determined by the REIT's *"earnings and profits"* which generally differs from the amount of income that the REIT reports for financial reporting purposes. Adjustments reconciling net income available to REIT shareholders with the REIT's taxable income may include... ♦ Straight-line revenue timing differences ♦ Depreciation timing differences on real estate ♦ Other adjustments, possibly including stock option compensation expense for tax purposes in excess of GAAP expense amount • Generally, a REIT is not subject to Federal income tax on taxable income that it distributes to its shareholders. • For more details, see Code Section 856 and Regulations thereunder.
"Retiring On The Rents"	
"Retiring on the Rents" ... An Alternative	• Some dealers, however, insist on "retiring on the rents." This is not necessarily a bad alternative. However, if a dealer is going to choose this approach, there are a few considerations to keep in mind when writing up the lease for the dealership property. • The factors outlined below should be taken into consideration in order to avoid having the property value significantly reduced as a result of having it encumbered by the lease.
Checklist for Leases	• ***Always have a Net, Net, Net lease.*** Leases should always be triple net, thus making the tenant responsible for the payment of property taxes, insurance and maintenance. • ***Charge market rents.*** ♦ On average, annual rents should be 9.0% to 11.0% of the property's value. ♦ If a third party becomes interested in purchasing the property at a later date, the value or marketability of the property may be diminished if the lease income stream and terms of the lease do not reflect current market rents. • ***The longer the lease term, the better.*** If one has a ten-year lease with three five-year renewal options, in year five of the lease, a potential buyer may be concerned about renewal risk. Therefore, the longer the lease term, the more value and liquidity will be realized should its owner want to sell. Capital Automotive generally has a 15-year initial lease term. • ***In a rising interest rate environment, the value of real estate subject to a lease will decline*** as the potential buyers have to increase their minimum return on investment hurdles. • ***Rent escalators are critical to maintaining the value of the property.*** Escalators should occur in order to keep pace with the CPI (Consumer Price Index). If a lease does not contain escalators, the lease may not be as valuable as the property over time.
For More Information	• For more information on Capital Automotive REIT or to discuss the finer points in this summary, contact Joe Connolly, Vice President of Acquisitions of CARS (Capital Automotive REIT) at jconnlly@capitalautomotive.com. • If you would like a copy of Joe's presentation hand-out materials, including the *Capital Automotive REIT Annual Report* for 2003, you can request these directly from him.

PORCs ... UPDATE & SIGNIFICANT PORC CHANGES MADE BY THE PENSION FUNDING EQUITY ACT OF 2004

The PORC update in the 4th Quarter 2003 issue of the *Dealer Tax Watch* observed that there still was not much new out of the IRS on the subject. Our observations and materials in that issue included a report of comments made by Terri Harris, the IRS Motor Vehicle Technical Advisor, at the AICPA Auto Dealership Conference and one set of proforma Form 8886 disclosures for dealer PORCs.

In discussing the dilemma some CPAs faced in deciding what or what not to disclose and/or report, we mentioned a "grandfather" position or interpretation which concluded that if the Producer-Owned Reinsurance Company filed a tax return before February 28, 2000, the disclosure filing requirements ***do not*** apply. ... Technically, the taxpayer falls under Notice 2002-70; it just is not required to file anything with the IRS. This interpretation or position was set forth by Mr. Greg Petrowski at the AICPA Auto Dealership Conference. This PORC update includes more detail on the basis for *his* "grandfather" position relating to required PORC filings.

Background on IRS Notice 2002-70. In November 2002, the IRS issued Notice 2002-70. This Notice was broadly written and referred to reinsurance transactions similar to those found in dealer PORCs. These transactions are now "listed transactions" (potentially "abusive tax shelters"), which trigger certain reporting requirements for the various parties involved. The Notice also stated the IRS position that some PORCs might not be entitled to receive the tax benefits they were claiming.

To Whom Does the Notice Apply? Basically, the Notice applies to both U.S. domiciled and foreign Producer-Owned Reinsurance Companies that have elected to be taxed as U.S. insurance companies under IRC Section 953(d). The two more popular domiciles for these PORCs are (1) Nevis and (2) Turks and Caicos. The Notice applies to PORCs that are taxed under Section 501(c)(15) (tax exempt), Section 831(b) (small property and casualty insurance companies), or Section 806 (small life insurance companies).

Reporting Requirements. Under Notice 2002-70, there are three general areas involving reporting requirements: (1) disclosure, (2) registration as a "tax shelter," and (3) maintenance of investor lists.

Disclosure Requirements. The disclosure requirements are summarized on pages 16 and 17 and in the accompanying *Disclosure Requirements* chart. Also, the basis for the position that some PORCs may not be required to make any disclosures (i.e., the *"grandfather" position*) is explained in some detail. To date, the IRS still has not made any formal comment on whether or not it agrees with this position.

Registration as a "Tax Shelter." Registration requirements fall under Reg. Sec. 301.6111-2, which provides for the registration of a confidential "tax shelter" with the IRS only if the transaction meets all three of the following criteria: (1) Significant tax avoidance purpose, (2) Transaction offered under condition of confidentiality, and (3) Payment of fees in excess of $100,000 to the promoter(s).

Typical dealer PORC situations ordinarily do not meet the requirements for registration.

Maintenance of Investor Lists. Under Notice 2002-70 and Reg. Sec. 301.6112-1, each organizer or promoter must maintain lists of all investors in the transaction if the transaction meets certain criteria.

Typically, these lists are required to be maintained only by tax shelter "promoters." However, material advisors (those parties who can receive $50,000 or more from the transaction, $10,000 or

see **SIGNIFICANT PORC CHANGES**, page 20

This PORC update information and the discussion of the Pension Funding Equity Act of 2004 changes in this article are taken from a presentation made to a group of dealership CPAs earlier this year by Mr. Gregory L. Petrowski. Mr. Petrowski is the Secretary-Treasurer of GPW & Associates, Inc. in Phoenix, Arizona. He has permitted us to reformat some of his information which is the basis for this update article and various supplementary materials. Mr. Petrowski is an excellent resource for you in the area of dealer (and other) PORCs, and if you have technical questions regarding the application of this information to specific situations - or any other general questions on PORCs - you can reach Greg at (602) 200-6900 or gpetrowski@gpwa.com.

IRS Notice 2002-70 *Disclosure Requirements ... Including "Grandfather" Exemption Position*	
Who Must File a Disclosure Statement?	• Disclosure statements for reportable transaction (Reg. Sec. 1.6011-4(a)) must be attached to the tax returns of potentially affected parties. • Potentially affected parties include ♦ Producer Owned Reinsurance Company, ♦ Shareholders of the PORC, ♦ Affiliated dealership, and ♦ Shareholders of the affiliated dealership. • The filing requirements specified in Notice 2002-70 refer to "parties to the reinsurance transaction." ♦ While the dealership technically may not be a "party" to the reinsurance transaction, the IRS believes that they possess the ability to reallocate income from one tax paying entity to another. Therefore, under the IRS interpretation or belief, the dealership may be included in the term "parties to the reinsurance transaction" that are required to file disclosure statements. • A copy of disclosure statements must also be filed with the IRS Office of Tax Shelter Analysis. (Reg. Sec. 1.6011-4(d))
Information to Include	• Disclosure statements filed should include: ♦ Identification of the party making the disclosure ♦ Identification and description of transaction ♦ Registration status under IRC Section 6111 ♦ Principal tax benefits of transaction ♦ Amount of estimated reduction in Federal income tax liability by year (1999 forward). ♦ Names and addresses of material parties to the transaction (Promoters, insurance carriers, other material advisors)
"Grandfather" Exemption Position	• If the PORC filed a tax return on or before February 28, 2000, the disclosure filing requirements ***do not*** apply. (See Temp. Reg. Sec. 1.6011-4T(h), issued Feb. 28, 2002 and amended June, 2002.) • The final version of T. Reg. Sec. 1.6011-4 provides that the disclosure requirement apply to transactions entered into on or after the date the Regulation becomes effective (2/28/2003). • Regulations in effect prior to that date govern transactions entered into prior to the effective date of the Final Treasury Regulations. • Prior Temporary Regulations adopted February 28, 2000 state that ♦ "...a listed transaction is not treated as a reportable transaction for purposes of Section 6011 if it has affected the taxpayer's Federal income tax liability as reported on any tax returns filed on or before February 28, 2000." (Treasury Decision 8877). ♦ "The fact that a transaction becomes a listed transaction does not imply that the transaction was not otherwise a reportable transaction prior thereto." (Temp. Reg. Sec. 1.6011-4T(b)(2)) • The definition of the term ***"transaction"*** is very broad, and it includes any series of related steps carried out as part of a pre-arranged plan or any series of substantially similar transactions entered into. • Therefore, a reasonable interpretation of a Producer Owned Reinsurance program "transaction" would be *the execution of the reinsurance agreement*, and not the issuance of each underlying insurance contract by the insurance carrier that is reinsured under the (reinsurance) agreement. • For further discussion or updates on this position, contact Gregory Petrowski at (602) 200-6900.

IRS Notice 2002-70

Disclosure Requirements ... Including "Grandfather" Exemption Position

Use of Form 8886	• ***Disclosure by filing IRS Form 8886,*** **Reportable Transaction Disclosure Statement,** ***is required for the 2003 tax year and in subsequent years.*** (Reg. Sec. 1.6011-4(d)) ♦ See proforma ***8886s*** on pages 18-19 of this issue of the *Dealer Tax Watch.* ♦ Also see proforma ***8886s*** included in Dec. 2003 *Dealer Tax Watch* (pgs 21-22). ♦ Also see summary of Form 8886 *Instructions* in Dec. 2003 *Dealer Tax Watch* (pg 20).
Protective Disclosures	• Failure to disclose a reportable transaction to the IRS ... ♦ Will affect that taxpayer's ability to claim protection under the "reasonable cause" exception to penalties if, upon audit, the IRS asserts penalties in connection with a questionable transaction. ♦ Also may result in criminal penalties of up to $100,000 and/or imprisonment if the failure to disclose is deemed to be a willful act by the taxpayer. ♦ ***Accordingly, when in doubt, taxpayers should provide/make "Protective Disclosure" under Reg. Sec. 1.6011-4(f)(2).***

IRS Notice 2002-70 Disclosure Requirements

Entity	Type	Disclosure Form	Protective Disclosure
Producer Owned Reinsurance Company	All	Yes	N/A
Producer Owned Reinsurance Company Shareholder	All	No	No
Affiliated Dealership	All	No	Yes
Shareholder of C Corp Affiliated Dealership	Majority Minority	No No	Yes No
Shareholder of S Corp or Partnership Affiliated Dealership	All	No	Yes

Form **8886** (March 2003)
Department of the Treasury Internal Revenue Service

Reportable Transaction Disclosure Statement

▶ Attach to your tax return.
▶ See separate instructions.

OMB No. 1545-1800
Attachment Sequence No. 137

Name(s) shown on return: Company
Identifying number: EIN

Number, street, and room or suite no.: 2700 North Third Street, Suite 2000

City or town, state, and ZIP code: Phoenix, Arizona 85004

1a Name of reportable transaction: Certain Reinsurance Arrangements that may be substantially similar to those described in IRS Notice 2002-70

1b Tax shelter registration number (11-digits) (if any): Unregistered

2 Identify the type of reportable transaction. Check the box(es) that apply. (see instructions)

- a ☒ Listed transaction
- b ☐ Confidential transaction
- c ☐ Transaction with contractual protection
- d ☐ Loss transaction
- e ☐ Transaction with significant book-tax difference
- f ☐ Transaction with brief asset holding period

3 If the transaction is a "listed transaction" or substantially similar to a listed transaction, identify the listed transaction (see instructions) ▶ Certain reinsurance arrangements described in IRS Notice 2002-70

4 Enter the number of transactions reported on this form . . . . . ▶ 1

5 If you invested in the transaction through another entity, such as a partnership, an S corporation, or a foreign corporation, identify the name and employer identification number (EIN) (if any) of that entity . . . . . ▶ N/A

6 Enter in columns (a) and (b) below, the name and address of each person to whom you paid a fee with regard to the transaction if that person promoted, solicited, or recommended your participation in the transaction, or provided tax advice related to the transaction.

(a) Name	(b) Address
GPW and Associates, Inc.	2700 N. 3rd Street, Suite 2000, Phoenix, AZ 85004 Material Advisor that provides actuarial, accounting and tax preparation services.
XYZ Insurance Company	Address Provides fronting and administrative services.

Cat. No. 34654G Form **8886** (3-2003)

7 **Facts.** Describe the facts of the transaction that relate to the expected tax benefits, including your participation in the transaction.

Reinsurance of certain insurance products sold through affiliated automobile dealership(s).

8 **Expected tax benefits.** Describe the expected tax benefits, including deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, etc. See instructions for more details.

The potential tax benefit is the amount of the difference between what the Taxpayer would have paid had the tax been based upon the taxable income under IRC §831(a) or §801 (whichever is applicable) or the actual taxable income utilizing the provisions of IRC §831(b), §806, or §501(c)(15) (whichever is applicable).

9 **Estimated tax benefits.** Provide a separate estimate of the amount of each of the expected tax benefits described above for each affected tax year (including prior and future years).

	2003	2002	2001	2000	1999
Actual Tax					
Tax Under IRC §831(a)					
Reduction					

PROTECTIVE DISCLOSURE

Form **8886** (March 2003) Department of the Treasury Internal Revenue Service

Reportable Transaction Disclosure Statement

▶ Attach to your tax return.
▶ See separate instructions.

OMB No. 1545-1800

Attachment Sequence No. 137

Name(s) shown on return: Dealership(s)/Dealership Principal(s)

Identifying number: EIN/SSN

Number, street, and room or suite no.: Street Address

City or town, state, and ZIP code: City, State, Zip Code

1a Name of reportable transaction: Certain Reinsurance Arrangements that may be substantially similar to those described in IRS Notice 2002-70.

1b Tax shelter registration number (11-digits) (if any): Unregistered

2 Identify the type of reportable transaction. Check the box(es) that apply. (see instructions)

- a [X] Listed transaction
- b [ ] Confidential transaction
- c [ ] Transaction with contractual protection
- d [ ] Loss transaction
- e [ ] Transaction with significant book-tax difference
- f [ ] Transaction with brief asset holding period

3 If the transaction is a "listed transaction" or substantially similar to a listed transaction, identify the listed transaction (see instructions) ▶ Certain reinsurance arrangements described in IRS Notice 2002-70.

4 Enter the number of transactions reported on this form . . . . . ▶ 1

5 If you invested in the transaction through another entity, such as a partnership, an S corporation, or a foreign corporation, identify the name and employer identification number (EIN) (if any) of that entity . . . . . ▶ N/A for Dealership and Reinsurance Company name and EIN for Dealer Principal(s) that own Reinsurance Company

6 Enter in **columns (a) and (b)** below, the name and address of each person to whom you paid a fee with regard to the transaction if that person promoted, solicited, or recommended your participation in the transaction, or provided tax advice related to the transaction.

(a) Name	(b) Address
GPW and Associates, Inc.	2700 N. 3rd Street, Suite 2000, Phoenix, AZ 85004 Material Advisor that provides actuarial, accounting and tax preparation services.
XYZ Insurance Company	Address Provides fronting and administrative services.

Cat. No. 34654G Form **8886** (3-2003)

Form 8886 (3-2003) Page 2

7 **Facts.** Describe the facts of the transaction that relate to the expected tax benefits, including your participation in the transaction.

Reinsurance of certain insurance products sold through affiliated automobile dealership(s).

8 **Expected tax benefits.** Describe the expected tax benefits, including deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, etc. See instructions for more details.

There are no tax benefits.

9 **Estimated tax benefits.** Provide a separate estimate of the amount of each of the expected tax benefits described above for each affected tax year (including prior and future years).

None.

Form **8886** (3-2003)

(Continued from page 15)

more if the transaction is a "listed transaction") are also required to maintain investor lists.

Most PORC transactions meet one of the three criteria for maintenance of the list. These lists must be maintained for 7 years and be made available to the IRS upon written request.

Subsequent Developments: What's Happened Since Notice 2002-70 Was Issued? On August 19, 2003, an IRS "PORC Task Force" and a few Industry professionals met to informally discuss the Industry's concern about Notice 2002-70. During the meeting, the IRS stated that the Notice was not just aimed at transactions involving automobile dealers and it acknowledged that most PORC programs were legitimate and the Notice was not the beginning of an IIR process.

Subsequent PORC developments through August 31, 2004 may be summarized as follows:

1. No additional guidance has been provided by the IRS.

2. The IRS has turned down requests by Industry professionals to have Notice 2002-70 included in the IRS Industry Issue Resolution Program.

3. The IRS has stated that "properly structured" PORC programs are legitimate business entities.

4. The IRS has identified potential abuses that may require reallocation of income among the affected parties. These abuses include the payment of reduced front-end commissions (credit insurance), the payment of non-market reinsurance premiums (vehicle service contracts), and certain ... usually non-performing and non-arm's-length ... shareholder loans.

5. Recent IRS audit activity suggests that a nationwide examination of PORCs is currently underway, with the IRS selecting companies for audit randomly from off-shore domiciled companies. Although the initial focus in these IRS audits appears to be in conjunction with IRS Notice 2002-70, in some cases, the IRS still continues to raise decade-old issues (transfer of risk, etc.).

PLANNING SUGGESTION

Our Year-end Dealership Tax Planning Opportunities Letter (see pages 8-9) mentions that the reduced income tax rates for qualified dividend income offer an excellent way to pull out accumulated earnings from a C corporation at a fairly low effective income tax rate. If a dealer has set up a PORC as a C corp. and now has second thoughts about either the viability of the PORC or the atmosphere of second-guessing that the IRS has created with regard to these entities and simply "wants out," one possibility to explore is the liquidation of the PORC and the payment of the tax based on either long-term capital gain or dividend treatment. Typically, the effective income tax rate will fall somewhere between 15% and 20%.

There are several variations on this theme, and the best approach will depend on the specific facts of the situation. The planning point is simply that while these low rates are still in effect, large accumulations/loans may be taken out in a very tax-advantageous way from certain C corporations.

CURRENT ARTICLES

Several excellent articles (see below) have appeared over the last few months and they are recommended for your further research efforts. →

Selected Current Articles ... PORCs, Disclosure, Reporting, Etc.

Hirsh, Bobbe and Alan Lederman. ***The Service Clarifies the Facts and Circumstances Approach to Captive Insurance Companies***. *Journal of Taxation*, March 2004, pgs. 168-180.

Lipton, Richard and Steven Dixon.

Implications of California's Tough New Anti-Tax Shelter Rules. *Practical Tax Strategies*, June 2004, pgs. 338-345.

"Tax Shelter" and "Tax Shelter Opinion" - IRS, in Another Try at Circular 230, Strikes Out Again. *Journal of Taxation*, March 2004, pgs. 134-143.

Raby, Burgess J.W. and William L. Raby. ***Practitioner "Due Diligence" and Listed Transactions*** (in the *Tax Analysts Tax Practice and Accounting News* Section). *Tax Notes*, May 3, 2004, pgs. 553-557.

Salmon, Scott and Sharlene Amitay. ***California Taxpayer Disclosure Requirements*** (in the *State & Local Taxes* Section). *The Tax Adviser*, September 2004, pgs. 576-580.

Silverstein, Amy and Prentiss Willson, Jr. ***California's Tax Shelter Law: A Guide to Disclosure and Penalties for Corporate Taxpayers***. *Journal of Taxation*, May 2004, pgs. 288-296.

PENSION FUNDING EQUITY ACT OF 2004

Background. As discussed in previous *Dealer Tax Watch* articles, dealer PORCs may be eligible for a variety of favorable tax treatments, depending on whether the composition of their income satisfies various tests and whether certain elections have been made under the Internal Revenue Code. Depending on these factors, alternative favorable tax treatments for dealer PORCs could include the following:

1. An election to be taxed solely on their investment income. This avoids U.S. tax on any underwriting profits. ... ***(Sec. 831(b) election)***

2. A complete exemption from U.S. tax as an exempt organization. ... ***(Sec. 501(c)(15))***

3. A phased-out deduction for certain non-life insurance company taxable income that usually results in a tax rate of 13.6% instead of 34%. ... ***(Sec. 806 election)***

4. An election to be treated for Federal income tax purposes as a U.S. domestic corporation if the PORC is a foreign corporation. ... ***(Sec. 953(d) election)***

New Law Effective for Calendar Year 2004 PORCs. On April 10, 2004, President Bush signed into law the Pension Funding Act of 2004 (PL 108-218). The Act included several important changes affecting non-life insurance companies.

- Definition of an insurance company for non-life insurance company tax rules (Section 831)
- Qualification tests for tax-exempt status under Section 501(c)(15)
- Qualification tests for the "small" non-life insurance company election under Section 831(b)

Several of the key provisions of the Act lack precise definitions, and they will have to be explained through additional guidance from the IRS. This new law applies to tax years ending after December 31, 2003.

The Congressional Budget Office Cost Estimate Report dated May 9, 2004 projects that the new law "will significantly affect Federal revenues by modifying the eligibility rules that exempt qualifying small property and casualty insurance companies from income tax. ... The Joint Committee on Taxation ... estimates that doing so will increase governmental receipts by $651 million over the 2004-2009 period and by about $1.4 billion over the 2004-2014 period."

In this new legislation, the ***"good news" for certain (dealer) PORCs*** is that the tests have been liberalized for electing tax-favorable treatment under Section 831(b) as a "small" non-life insurance company. On the other hand, the ***"bad news" for other (dealer) PORCs*** is that the statutory tests have been made considerably more restrictive before an entity can qualify as a tax-exempt organization (under Section 501(c)(15)).

Definition of an "Insurance Company" - Under Prior Law (Valid Through Dec. 31, 2003): The definition of an *"insurance company"* for purposes of the non-life insurance company tax rules in Section 831 explicitly defined the term *"insurance company"* to mean any company with ***more than half*** the business of which during the taxable year was the issuing or assuming of insurance or annuity contracts or the risks underwritten by insurance companies (Section 816(a)). The life insurance company statutory definition of an insurance company did not explicitly apply to non-life insurance companies.

Also under prior law, a Regulation that applied to non-life insurance companies (Reg. Sec. 1.801-3(a)(1)) provided a somewhat similar definition of an *"insurance company."* This Regulation provided that the term *"insurance company"* meant a company whose ***primary and predominant business activity*** during the taxable year was the issuing of insurance or annuity contracts or the reinsuring of risks undertaken by insurance companies.

Definition of an "Insurance Company" - Clarified Under New Law: Effective for tax years ending after Dec. 31, 2003, the new law conforms the non-life insurance company definition of an *"insurance company"* to the statutory rules for life insurance companies prescribed in Section 816(a).

The House of Representatives Conference Report provides that, "A company whose investment activities outweigh its insurance activities is not considered to be an insurance company under the Senate amendment. It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income."

In other words, under the new law, more than one-half (50%) of the activities of the company have to be insurance activities in order for the company to be treated as an insurance company for income tax purposes.

Qualification Test for Tax-exempt Insurance Companies. This area of change has perhaps the biggest impact on more aggressive PORCs that previously sought to be treated as tax-exempt orga-

see **SIGNIFICANT PORC CHANGES**, page 22

(Continued from page 21)

nizations. In this regard, the new law changes the qualification tests that a company has to pass in order to be a tax-exempt non-life insurance company under Code Section 501(c)(15).

Under prior law, valid through Dec. 31, 2003, a non-life insurance company could be exempt from Federal income tax if its ***controlled group*** net written premiums or direct written premiums (whichever is greater) did not exceed $350,000 for the tax year. All insurance companies (including both life and non-life insurance companies) with more than 50% common ownership were included in the controlled group premium tests.

Under the new law, effective for tax years ending after Dec. 31, 2003, a non-life insurance company is eligible to be a tax-exempt entity if it meets both of the following tests or criteria:

1. Controlled group gross receipts for the taxable year do not exceed $600,000, ***and***

2. The premiums received for the taxable year are greater than 50% of its gross receipts.

The new law has eliminated the ***premium*** test, and in its place, substituted a controlled group ***gross receipts*** test. Furthermore, if the entity satisfies the gross receipts test, it must also satisfy the 50% ratio-of-premiums-to-gross-receipts test. As a result of these changes, many companies will no longer be able to qualify for (i.e., retain) their tax-exempt treatment in a run-off situation.

To date, the Service has provided no additional guidance on how these new rules should be applied. This lack of guidance has created a number of questions and issues for the industry. See pages 24-25.

The third area changed by the PFEA Act of 2004 relates to the ***qualification tests for "small" non-life insurance company election under IRC Section 831(b).***

Under prior law, valid through Dec. 31, 2003, a non-life insurance company could elect to be taxed on net investment income only if its ***controlled group*** net written premiums or direct premiums (whichever is greater) were greater than $350,000, but did not exceed $1,200,000 for the tax year. In this regard, all insurance companies (both life and non-life companies) with more than 50% common ownership were included in the controlled group premium test calculations.

Under the new law (effective for tax years ending after Dec. 31, 2003), a non-life insurance company can elect to be taxed on investment income only if its ***controlled group*** net written premiums or direct premiums (whichever is greater) do not exceed $1,200,000. The *minimum threshold* test amount in prior law has been eliminated. Again, all insurance companies (both life and non-life companies) with more than 50% common ownership were included in the controlled group premium test calculations.

This liberalization, as mentioned earlier, is the "good news" for (dealer) PORCs in the new legislation.

KEY OBSERVATIONS & QUESTIONS

The accompanying *Taxation Flowchart* is a useful guide in summarizing changes under the new law.

Under the old law, there was no overlap in the qualification criteria. The qualification tests under (1) Section 501(c)(15) for tax-exempt status and (2) Section 831(b) for an election to be taxed on only investment income were based on successive tiers of annual premium volume.

Under the new law, the tax-exempt qualification test is now a two-pronged gross receipts test, while the test for eligibility to make the "small" non-life insurance company election is still based on annual net written premium volume.

Therefore, it is now possible to have a non-life insurance company that can qualify as both a tax-exempt entity under Section 501(c)(15) and as a "small" non-life insurance company under Section 831(b). This raises the question of whether a company finding itself in this situation ***must*** file as a tax-exempt organization.

Section 6033(a) mandates the filing as a tax-exempt organization for all companies that meet the tax-exempt criteria. In light of this requirement, will a company that qualifies as either tax-exempt or as a "small" non-life insurance company under the new law be able to choose which way it will file its income tax returns?

Other unanswered questions at the present time include ...

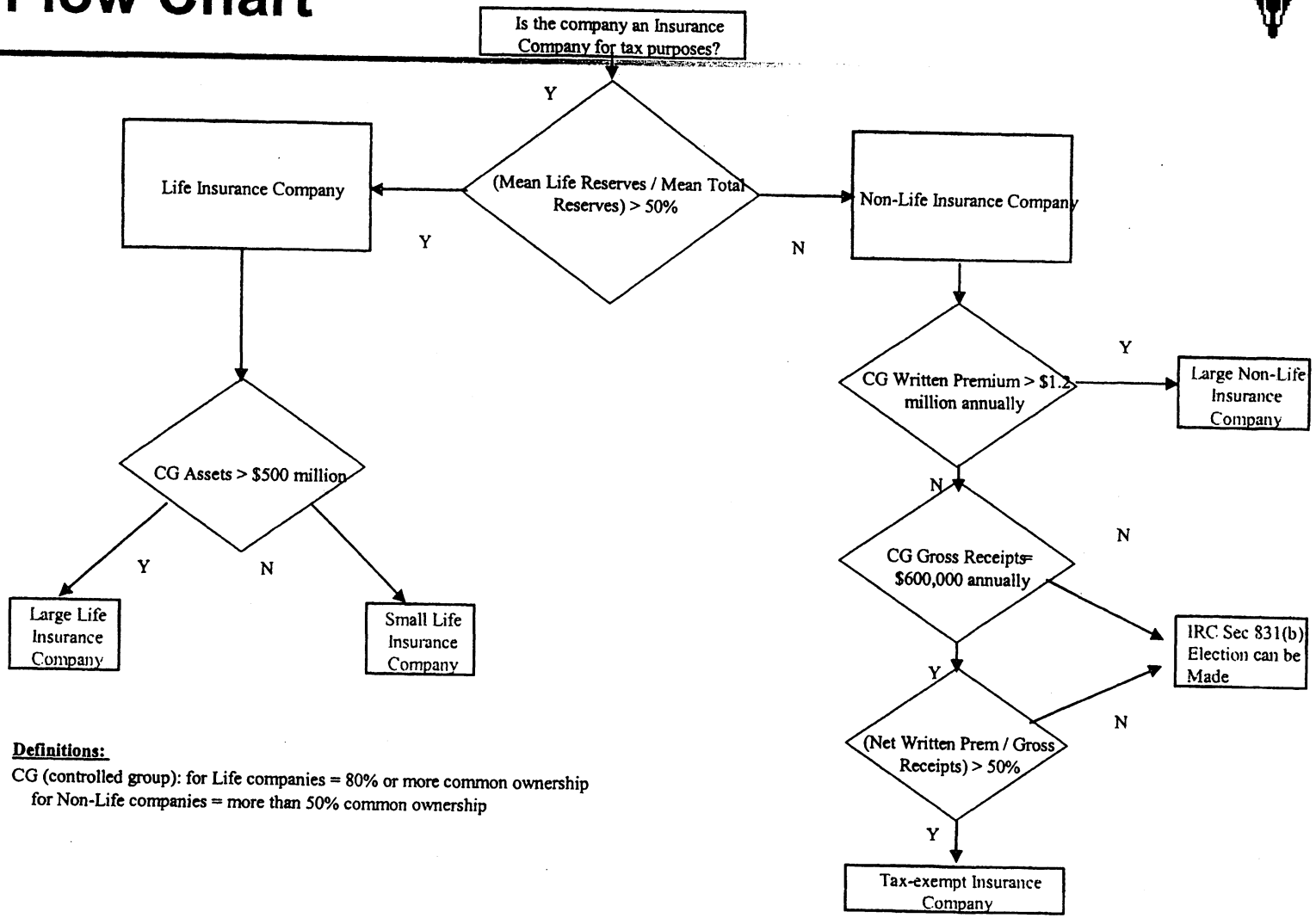
1. What if the corporation has not been in existence for an entire year? Should premiums and gross receipts be annualized?

2. What happens if net written premiums are negative? How would this affect the calculations in the gross receipts tests?

3. How will the IRS interpret the change in the definition of a non-life insurance company?

Sooner or later, the IRS will need to answer these and a number of other questions.

Pension Funding Equity Act of 2004
Taxation
Flow Chart



Definitions:

CG (controlled group): for Life companies = 80% or more common ownership
for Non-Life companies = more than 50% common ownership

Pension Funding Equity Act of 2004
Examples of New Determinations for Tax Return Filing Status

Facts & Assumptions	Question	Answer & Discussion
Example 1 Company A assumes VSC (Vehicle Service Contract) business only. There are no other insurance company members in its controlled group. For the 2004 tax year, the Company … • Assumed gross written premiums of $700,000, • Assumed net written premiums of $625,000; • Had underwriting income of $120,000, and • Had net investment income of $25,000.	***What type of Federal income tax return should Company A file for the year ended December 31, 2004?***	***Company A should file Form 1120-PC (Property and casualty).*** Form 1120-PC would be required because the Company had gross receipts in excess of $600,000. Since Company A's 2004 net written premium was less than $1,200,000, the Company is eligible to make the "small" non-life insurance company election under Section 831(b). If it did, the Company would base its taxable income on only the amount of its net investment income. Note: The "problem" with a Section 831(b) election is that it is binding. Therefore, if the Company in later years has underwriting losses or operating losses, those losses cannot be offset against its net investment income in computing its tax liability.
Example 2 Company B assumes VSC (Vehicle Service Contract) business only. There are no other insurance company members in its controlled group. For the 2004 tax year, the Company … • Assumed gross written premiums of $385,000, • Assumed net written premiums of $345,000; • Had underwriting income of $35,000, and • Had net investment income of $10,000.	***What type of Federal income tax return would Company B file for the year ended December 31, 2004?***	***Company B would file Form 990 Return of Organization Exempt from Income Tax.*** Since Company B's gross receipts were less than $600,000, ***and*** its net written premium was more than 50% of its total gross receipts, it would satisfy the tests under the new law to qualify as an exempt organization.
Example 3 Assume the same facts as in Example 2, except that for the year ended December 31, 2004, the Company … • Had gross written premiums of $0, • Had net written premiums of ($105,000) due to refunds, and • Had gross proceeds from investment income of $35,000.	***What type of Federal income tax return would Company B file for the year ended December 31, 2004?***	***Company B would file Form 1120-PC (Property and casualty).*** Although Company B's gross receipts in this case were less than $600,000, its net written premium was less than 50% of its total gross receipts. Therefore, Company B did not qualify under the second test as a tax-exempt entity under Section 501(c)(15). ***However, the Company is eligible to make the small non-life insurance company election under Section 831(b), if not already made this election in the previous tax year.*** See above discussion regarding binding nature of this election.

Pension Funding Equity Act of 2004
Unanswered Questions re: Changes in Qualification Test for PORCs that Want to Be Treated as Tax Exempt Insurance Companies Under Section 501(c)(15)

Question #1 What constitutes ***gross receipts*** as that term is used in the tax exempt insurance company tests?	• This question is not specifically answered in the new law. • The Internal Revenue Code and other related sources suggest that the term ***gross receipts*** should include net written premiums (gross written/assumed, less return premium), gross investment income (interest, dividends, rents, royalties, etc.…), and the ***gross proceeds*** from the sale of assets (not net gains or losses). (See Reg. Sec. 1.6033-2(g)(4).) • Other places where ***gross receipts*** definitions may be found: ♦ Section 6033 and related Reg. Sec. 1.6033 for definitions of gross receipts as applied to certain tax exempt organizations (not specifically non-life insurance companies). ♦ Revenue procedures and regulations, which mostly refer to Temporary Reg. Sec. 11.448-IT regarding small taxpayer exemptions and gross receipts test definitions (again, not specific to non-life insurance companies or tax-exempt entities). ♦ Instructions for the 2003 Form 990, *Return of Organization Exempt from Income Tax.*
Question #2 Who - or what entities - should be included in the computation for a ***controlled group*** for purposes of determining the amount of ***gross receipts*** used in the tax exempt insurance company tests?	• If one assumes that the controlled group rules under Section 1563(a) are to apply, then ***all*** members of a controlled group of corporations of which the company is a part should be taken into account. ♦ This would include the gross receipts of any foreign and other tax-exempt corporations. • A *"controlled group of corporations"* for this purpose consists of: ♦ Any group of ***corporations*** connected through stock ownership of greater than 50% stock with a common parent corporation ♦ Two or more corporations with common ownership, if five (5) or fewer persons who are individuals, estates or trusts own greater than 50% of the stock of each • The term *"controlled group of corporations"* for this purpose ***would include "S" Corporations.*** • However, the term *"controlled group of corporations"* for this purpose ***would NOT include entities that are not corporations, such as partnerships, trusts, estates and/or individuals.***

Form **1120-PC** — **U.S. Property and Casualty Insurance Company Income Tax Return** — OMB No. 1545-1027 — **2003**

Department of the Treasury, Internal Revenue Service — For calendar year 2003 or tax year beginning ..... and ending ..... — Instructions are separate. See page 10 for Paperwork Reduction Act Notice.

A Check applicable box if an election has been made under section(s): (1) ☐ 953(c)(3)(C) (2) ☐ 953(d)

Please print or type — Name — Number and street, and room or suite no. (If a P.O. box, see page 6 of instructions) — City or town — State — ZIP code

B Employer identification number — C Date incorporated — D Check if a consolidated return (Attach Form 851) ☐

E Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return

Tax Computation and Payments

1	Taxable income (Schedule A, line 37)	1 — 0
2	Taxable investment income for electing small companies (Schedule B, line 21)	2 — 0
3	Check if a member of a controlled group (see sections 1561 and 1563) ▶ ☐ Important: Members of a controlled group, see instructions on page 6. a If the box on line 3 is checked, enter the corporation's share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order): (1) $ (2) $ (3) $ b Enter the corporation's share of: (1) additional 5% tax (not to exceed $11,750) $ 0 (2) additional 3% tax (not to exceed $100,000) $ 0	
4	Income tax	4 — 0
5	Enter amount of tax that a reciprocal must include	5
6	Alternative minimum tax (attach Form 4626)	6 — 0
7	Total. Add lines 4 through 6	7 — 0
8 a	Foreign tax credit (attach Form 1118) — 8a — 0	
b	Other credits (see page 6 of instructions) — 8b	
c	General business credit. Check box(es) and indicate which forms are attached: ☐ 3800 ☐ Form(s) (specify) ▶ — 8c — 0	
d	Credit for prior year minimum tax (attach Form 8827) — 8d — 0	
e	Qualified zone academy bond credit (attach Form 8860) — 8e — 0	
f	Total credits. Add lines 8a through 8e	8f — 0
9	Subtract line 8f from line 7	9 — 0
10	Foreign corporations—Tax on income not connected with U.S. business	10
11	Personal holding company tax (attach Schedule PH (Form 1120))	11 — 0
12	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Other (attach schedule)	12 — 0
13	Total tax. Add lines 9 through 12	13 — 0
14	Payments: a 2002 overpayment credited to 2003 — 14a	
b	Prior year(s) special estimated tax payments to be applied — 14b	
c	2003 estimated tax payments (see instructions) — 14c	
d	2003 special estimated tax payments (Do not include on line 14f) — 14d	
e	Less 2003 refund applied for on Form 4466 — 14e — 0	
f	Enter the total of lines 14a through 14c less line 14e — 14f — 0	
g	Tax deposited with Form 7004 — 14g — 0	
h	Credit by reciprocal for tax paid by attorney-in-fact under section 835(d) — 14h	
i	Other credits and payments — 14i	14i — 0
15	Estimated tax penalty (see page 9 of instructions). Check if Form 2220 is attached ▶ ☐	15 — 0
16	Tax due. If line 14j is smaller than the total of lines 13 and 15, enter amount owed	16 — 0
17	Overpayment. If line 14j is larger than the total of lines 13 and 15, enter amount overpaid	17 — 0
18	Enter amount of line 17 you want: Credited to 2004 estimated tax ▶ $ 0 Refunded ▶	18 — 0

Sign Here — Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. — Signature of officer — Date — Title — May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only — Preparer's signature — Date — Check if self-employed ☐ — Preparer's SSN or PTIN — Firm's name (or yours if self-employed), address, and ZIP code — EIN — Phone no.

(HTA) — Form 1120-PC (2003)

FORM 1120-PC ... 8 Pages ... Supporting Schedules Included on Pages 2 - 8

Page 1 ... above
Page 2 ... Sch. A ... Taxable Income - Section 832
Page 3 ... Sch. B ... Part I ...Taxable Investment Income of Electing Small Companies - Section 834
Part II ...Invested Assets Book Values
Page 4 ... Sch. C ... Dividends and Special Deductions
Sch. D ... Capital Gain Net Income ... Not a separate 1120-PC Schedule - use regular 1120 Sch. D.
Page 5 ... Sch. E ... Premiums Earned - Section 832
Sch. F ... Losses Incurred - Section 832
Page 6 ... Sch. G ... Other Capital Losses
Sch. H ... Special Deduction and Ending Adjusting Surplus for Section 833 Organizations
Page 7 ... Sch. I ... Other Information & Questions
Page 8 ... Sch. L ... Balance Sheet per Books
Sch. M-1 ... Reconciliation of Income (Loss) per Books with Income per Return
Sch. M-2 ... Analysis of Unappropriated Retained Earnings per Books

Form **990** — **Return of Organization Exempt From Income Tax** — Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation) — OMB No. 1545-0047 — **2003** — Open to Public Inspection

Department of the Treasury, Internal Revenue Service — ▶ The organization may have to use a copy of this return to satisfy state reporting requirements.

A For the 2003 calendar year, or tax year beginning ..... and ending .....

B Check if applicable: ☐ Address change ☐ Name change ☐ Initial return ☐ Final return ☐ Amended return ☐ Application pending

Please use IRS label or print or type. See Specific Instructions. — C Name of organization — Number and street (or P.O. box if mail is not delivered to street address) — Room/suite — City or town — State or country — ZIP + 4

D Employer identification number — E Telephone number — F Accounting method: ☐ Cash ☐ Accrual ☐ Other (specify) ▶

G Website: ▶

H and I are not applicable to section 527 organizations. H(a) Is this a group return for affiliates? ☐ Yes ☐ No H(b) If "Yes," enter number of affiliates ▶ H(c) Are all affiliates included? ☐ Yes ☐ No (If "No," attach a list. See instructions.) H(d) Is this a separate return filed by an organization covered by a group ruling? ☐ Yes ☐ No

J Organization type (check only one) ▶ ☐ 501(c) ( ) ◀ (insert no.) ☐ 4947(a)(1) or ☐ 527

K Check here ▶ ☐ if the organization's gross receipts are normally not more than $25,000. The organization need not file a return with the IRS; but if the organization received a Form 990 Package in the mail, it should file a return without financial data. Some states require a complete return.

I Group Exemption Number ▶

M Check ▶ ☐ if the organization is not required to attach Sch. B (Form 990, 990-EZ, or 990-PF).

L Gross receipts: Add lines 6b, 8b, 9b, and 10b to line 12 ▶ 0

Part I Revenues, Expenses, and Changes in Net Assets or Fund Balances (See page 18 of the instructions.)

Revenue	1 Contributions, gifts, grants, and similar amounts received:		
	a Direct public support — 1a		
	b Indirect public support — 1b		
	c Government contributions (grants) — 1c		
	d Total (add lines 1a through 1c) (cash $ noncash $)	1d	0
	2 Program service revenue including government fees and contracts (from Part VII, line 93)	2	0
	3 Membership dues and assessments	3	0
	4 Interest on savings and temporary cash investments	4	0
	5 Dividends and interest from securities	5	0
	6 a Gross rents — 6a		
	b Less: rental expenses — 6b		
	c Net rental income or (loss) (subtract line 6b from line 6a)	6c	0
	7 Other investment income (describe ▶)	7	0
	8 a Gross amount from sales of assets other than inventory — (A) Securities 0 — (B) Other		
	b Less: cost or other basis and sales expenses — 8b		
	c Gain or (loss) (attach schedule) — 8c		
	d Net gain or (loss) (combine line 8c, columns (A) and (B))	8d	0
	9 Special events and activities (attach schedule). If any amount is from gaming, check here ▶ ☐		
	a Gross revenue (not including $ 0 of contributions reported on line 1a) — 9a		
	b Less: direct expenses other than fundraising expenses — 9b		
	c Net income or (loss) from special events (subtract line 9b from line 9a)	9c	0
	10 a Gross sales of inventory, less returns and allowances — 10a		
	b Less: cost of goods sold — 10b		
	c Gross profit or (loss) from sales of inventory (attach schedule) (subtract line 10b from line 10a)	10c	0
	11 Other revenue (from Part VII, line 103)	11	0
	12 Total revenue (add lines 1d, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11)	12	0
Expenses	13 Program services (from line 44, column (B))	13	0
	14 Management and general (from line 44, column (C))	14	0
	15 Fundraising (from line 44, column (D))	15	0
	16 Payments to affiliates (attach schedule)	16	0
	17 Total expenses (add lines 13 and 44, column (A))	17	0
Net Assets	18 Excess or (deficit) for the year (subtract line 17 from line 12)	18	0
	19 Net assets or fund balances at beginning of year (from line 73, column (A))	19	0
	20 Other changes in net assets or fund balances (attach explanation)	20	0
	21 Net assets or fund balances at end of year (combine lines 18, 19, and 20)	21	0

For Paperwork Reduction Act Notice, see the separate instructions. — (HTA) — Form 990 (2003)

FORM 990 ... 6 Pages ... Supporting Schedules Included on Pages 2 - 6

Page 1 ... Part I ... Revenues, Expenses and Changes in Net Assets or Fund Balances ... Above
Page 2 ... Part II ... Statement of Functional Expenses
Part III ... Statement of Program Service Accomplishments
Page 3 ... Part IV ... Balance Sheets
Page 4 ... Part IV-A ... Reconciliation of Revenue per Audited Financial Statements with Revenue per Return
Part IV-B ... Reconciliation of Expenses per Audited Financial Statements with Expenses per Return
Part V ... List of Officers, Directors, Trustees and Key Employees
Page 5 ... Part VI ... Other Information and Questions
Page 6 ... Part VII ... Analysis of Income-Producing Activities
Part VIII ... Relationship of Activities to the Accomplishment of Exempt Purposes
Part IX ... Information Regarding Taxable Subsidiaries and Disregarded Entities
Part X ... Information Regarding Transfers Associated with Personal Benefit Contracts

AUTOMOTIVE NEWS PORC ARTICLE STIRS CONTROVERSY

In the "Finance & Insurance" section of the August 9, 2004 *Automotive News* (page 34), an interview with Larry Williams, of the Firm of Crowe Chizek, was published in a question and answer format. The headline was a grabber ... *Reinsurance Tax Breaks Are History, Expert Says.* (You can go on-line to get the entire text.)

Next to Mr. Williams's smiling face in the picture box was the quote, "I am not sure that a lot of dealers' accounting firms are aware of what's going on." Further on in the article, a qualifier appeared by the addition of the following ... "Or, they (i.e., accounting firms) may have a general sense, but do not keep up with the details unless they specialize in this area."

Several industry commentators have taken exception to Mr. Williams's comments as being far too broad in their simplifications about the IRS "turning up the heat on dealer-owned reinsurance companies" that "have been on the hot seat for two years." Below are rejoinders to the article by two industry experts, who rarely agree on anything, but in this case, seem to agree that they didn't like the story.

Comments on Article by Steve Mailho (Aug. 11, 2004)*

It's obvious if you abuse the tax code, you should and will be busted by the IRS

The Article

Unfortunate inflammatory language comes from *Automotive News* this week. Blaring statements such as "..[reinsurance] tax breaks are history", "turning up the heat", "hot seat", "eliminate tax exempt status on small reinsurance companies" are all designed to lead readers to believe the sky is falling; it is not.

The lead-in to the Q&A section was misleading - the IRS' American Bankers investigation focused ***not*** on car dealers but Finance, Rent-to-Own and Furniture & Appliance operators; one need only look to the public record for an accurate story. ... The IRS did lay out its case of some questionable practices but again, they were not automobile related.

To their credit, authors of the article did have an accurate statement "...[IRS} cracking down on questionable shelters". It is obvious - this is the IRS job. In prior *ENews* releases we discussed the genesis of Announcement 2002-70 being the Forbes Magazine Article and follow-on articles. The abuses chronicled were ***not*** automobile related.

Actual Practice

Most practitioners in the reinsurance company tax arena have filed required disclosure statements with the returns. In fact the IRS brief stated over 1,600 had been filed at their writing to petition the Court. These disclosures have not raised the level of audit activity for our customers.

What has happened during normal cyclical audits of a dealership, IRS agents ask whether reinsurance companies are in the economic scheme of things. When there are reinsurance companies, the IRS looks at these companies to satisfy themselves:

1. The premium charged is arm's-length,
2. There are no excessive accumulated earnings and profits, and
3. That normal corporate governance is being followed.

In abusive reinsurance arrangements, you'd expect see "over-remits," excessive investments beyond the normal needs of insurance enterprises or owners failing to memorialize regular meetings or co-mingling funds with their reinsurance companies. Those will be written-up and many won by the IRS - it's obvious.

The handful of audits we've seen have been resolved with "No Change" letters issued by the IRS. Significantly, these were reviewed by the IRS' own National experts. It is possible this could change but most automobile related ARCs (Affiliated Reinsurance Companies) simply do not abuse the law. These companies are organized to enjoy profits not otherwise available.

The Future

Yes, as reported in previous *ENews* releases, Congress raised the threshold for tax exempt status to $600,000 (from $350,000) while inserting language to eliminate abuses. We applaud Congressional action in this arena. As the *Automotive News* article implies, some have interpreted anti-abuse language to suggest that in determining the $600,000 premium level, you must add-in all receipts from controlled groups (dealership sales of cars, parts, service, etc.) to determine if it qualifies. The article is accurate if that was Congressional intent however the jury is still out.

Over recent years, our customers filed 2,717 tax-exempt returns. Virtually all of our tax-exempt approvals were contingent on the reinsurance company not being part of the dealership controlled group. Therefore, since the reinsurance company is not controlled with an automobile dealership, this point is moot.

We hope this helps balance the record. If you have any questions, drop me a note.

* Steve Mailho (800) 262-4546, e-mail: JSMailho@ReinsuranceNet.com

AUTOMOTIVE NEWS PORC ARTICLE STIRS CONTROVERSY

*Comments on Article by Jim Smith ** (Sept. 9, 2004)*

Clarification of "Reinsurance Tax Breaks Are History" Headline

...The potential tax attributes of properly structured, well-run reinsurance programs are ***not*** history. Moreover, with the passage of the Pension Act, reinsurance companies that utilize Section 831 (b)(2) become a more viable alternative.

The author in this instance was referring specifically to reinsurance companies requesting U.S. tax-exempt status under Section 501(c)(15). Our organization (SouthwestRe) does not advocate utilizing this section of the tax code.

He is correct in his statement that this type of company (i.e., Section 501 only) will find it more difficult to qualify under the revised revenue test contained in the Pension Act. The new revenue test for Section 501 companies requires the revenues (as opposed to "premiums" under the former legislation) of all "attributed" companies to be combined in the test to determine if it qualifies for tax-exempt status. And if the revenues of the producing organization (normally a dealership) are combined in the test, it will almost certainly exceed the new revenue threshold of $600,000 per year.

This new law ***does not*** apply to "U.S. Casualty Insurance Companies" filing their tax return under Section 831(b), except in a positive sense with the qualifying premium amounts expanded. In the case of SouthwestRe, since we have never advocated the tax-exempt option, this does not affect us in any significant manner. Moreover, the "revenue" test for Section 831 qualifying is still "insurance premiums" as opposed to "revenues" for Section 501(c)(15) electing companies.

Clarification of "Offshore" Domicile Implications

The author states that the "offshore" status would place the Reinsurance Company on the "radar screen." We disagree with this assessment because we believe it is not primarily the 953(d) filing (election for a foreign domiciled company to be taxed as a U.S. company) that puts the company on the "radar screen."

We believe it is the application for tax-exempt status (Form 1024) that the companies qualifying under Section 501(c)(15) must file. There has been a great deal of scrutiny over this application; moreover, the IRS suspended the issuance of determination letters for an extended period of time, forcing some companies to file "naked 990's" (i.e., filing the tax-exempt entity tax return without the IRS tax-exempt status acceptance letter). Conversely, Section 831(b) electing companies are not required to make this filing.

There are other implications relative to the domicile issue, which would probably result in a day-long debate. But at the end of the day, the "onshore" company versus the "offshore" company would end up filing the same type of tax returns based upon their relative premium. And if an audit were to occur, the structure of each type of program would dictate the acceptance of the program. We feel that with our *First Automotive Administrator Obligor* program, we have developed a program that has the safest structure for the dealer while allowing the dealer to participate to the greatest extent in the profits available.

Additional Considerations

The author's frame of reference is that this gentleman represents an accounting firm that has developed and helps promote an "obligor" domestic company vehicle service contract program. This program includes the creation of a "C" Corp in the U.S. which files its taxes as an insurance company but is not an insurance company for state purposes. The author does not mention that this type of company will theoretically operate under the same type of scrutiny and filing requirements as an "offshore" company that elects to be taxed as a U.S. Corporation. We feel that both of these facts should have been presented for the purpose of an objective evaluation.

Nor were some of the other practical issues mentioned concerning the "obligor" program that would make this type of program more problematical as to the ultimate acceptance by both the IRS and the state insurance and regulatory departments. Some of those issues are (1) premium rates (i.e., retail versus insurance), (2) state tax issues (i.e., How is the "C" corp. taxed?), (3) state insurance issues (i.e., a non- insurance company operating as an insurance company), to name just a few.

One final comment is that the author also states that, "I am not sure that a lot of dealers' accounting firms are aware of what's going on." I have to respectfully disagree because the firms that we deal with all receive timely updates on tax issues affecting reinsurance companies. In addition, the auto dealer CPA organizations constantly extend invitations to not only me, but other professionals, to make frequent presentations on this very same topic. I believe that most accounting firms that specialize in auto dealerships are aware of "what's going on," and what you know is more valid than what is implied in this article.

Summary ... The article painted with "too broad a brush" when discussing the tax attributes of reinsurance companies. It should have stated that it referred only to tax-exempt U.S. taxpayer reinsurance companies filing under Section 501(c)(15), not to Section 831(b) companies. Moreover, the "tax breaks" (really "tax attributes") that are mentioned in the headline are ***not*** history, there is just a change in who qualifies, and Section 831(b) companies continue to be eligible to qualify while the tax- exempt companies (Section 501(c)(15)) will find it more difficult to qualify.

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CALIFORNIA'S TOUGH NEW TAX SHELTER DISCLOSURE LEGISLATION

How "Bad" Are These Requirements? ... Here Are Some Opinions

Lipton & Dixon	• "All taxpayers who file returns in California will need to keep track of the IRS' announcements concerning listed transactions and those transactions that have been listed by the California Franchise Tax Board. • "...any ... high net worth individual who fails to include on any return or statement any information with respect to a reportable transaction must pay a penalty of $15,000, which is increased to $30,000 in the case of a listed transaction. ... ♦ "For purposes of this test, a high net worth individual is an individual whose net worth exceeds $2 million immediately before the transaction. • "This return preparer penalty is not limited to the individual tax return preparers who sign taxpayers' returns. ... ♦ "Pursuant to the Regulations under Section 6694, any individual who provides advice with respect to a position on a tax return is a 'non-signing preparer,' even if the individual never signs that return.... ♦ "As a result, all tax advisors whose clients are subject to taxation in California ... will need to banish the phrase 'return position' from their vocabulary and, henceforth, only advise clients to take positions that the tax advisor believes is more likely than not correct. • "The stringent requirements California imposes may differ from the requirements that the federal government will, in all likelihood, enact with new tax shelter legislation. ... ♦ "The California tax shelter rules may create uncertainty and conflicts about how those Federal rules might be understood if and when they are enacted. • "Without final federal legislation, the scope of California's anti-tax-shelter legislation cannot be fully understood. ... ♦ "By passing the legislation before any federal legislation was passed, California has left taxpayers and their advisors and preparers in a morass that may become only worse when federal legislation finally passes."
	Lipton, Richard and Steven Dixon. ***Implications of California's Tough New Anti-Tax Shelter Rules.*** *Practical Tax Strategies*, June 2004, pgs. 338-345.
Silverstein & Willson	• "...the striking difference between the California and federal regimes is a multitude of potentially severe penalties imposed by California law for taking positions deemed to be abusive and for failure to comply with disclosure requirements." ♦ Penalty and penalty interest rates are in the 20%-30%-40% range ♦ Under certain circumstances, the statute of limitations for deficiency assessments may be extended to 8 years. • "With time and experience, the collective sophistication of the state tax community in identifying and analyzing the issues surely will increase, and interpretive authorities will be available.... ♦ "In the meantime, taxpayers will have to assess their own risk tolerance in deciding how conservatively or aggressively to interpret California's rules in any given situation. To the extent that they can tolerate and/or manage the risk, we encourage taxpayers not to succumb to the most conservative interpretations; we are optimistic that the courts and even the FTB (The California Franchise Tax Board) ultimately will bring a level of practicality and fairness to their interpretations of the law."
	Silverstein, Amy and Prentiss Willson, Jr. ***California's Tax Shelter Law: A Guide to Disclosure and Penalties for Corporate Taxpayers.*** *Journal of Taxation*, May 2004, pgs. 288-296.

Salmon & Amitay	• "The disclosure requirements facing California taxpayers in preparing their 2003 returns is daunting, and this is merely the first chapter in what is expected to be a long story for taxpayers. Many aspects of the California disclosure requirements may be revisited, including the possibility of an increase in some of the noncompliance penalties. • "In addition, other states are looking at California's system. During 2004, New York, Illinois, Connecticut, New Jersey and South Carolina all have engaged in legislative and/or administrative activity involving taxpayer disclosure. As of mid-summer, legislation has been passed in Illinois and was still pending in New York. • California's disclosure rules and associated penalties are complex and require significant attention and analysis. Ongoing activity there and in other states reinforces the need to carefully evaluate not only the current and future requirements that may be imposed for disclosing transactions, but also the transactions that will potentially trigger such requirements." Salmon, Scott and Sharlene Amitay. ***California Taxpayer Disclosure Requirements*** (in the *State & Local Taxes* Section). *The Tax Adviser*, September 2004, pgs. 576-580.
Raby & Raby	• "California tax practitioners, however, face quite a different calculus. The tax shelter registration requirements adopted by the California legislature in 2003 require that all taxpayers who are ***invested*** in a reportable transaction (as defined in Reg. Sec. 1.6011) must report the transaction with their California income tax returns by using the IRS Form 8886." • Note: In addition, the first time a transaction becomes reportable on a California tax return, the taxpayer is required to send a copy (of Form 8886) to the state's special Tax Shelter Office in Sacramento (Cal. Sec. 18407(a)(3)). • "All this [referring to penalties, interest rates and 8-year statute of limitations] ... seems to have gotten the attention of California practitioners. Concerned to help clients avoid possible penalties, and also to avoid possible repercussions they might face in the event such penalties were imposed, California practitioners have paid a great deal more attention to listed transactions than practitioners in ... other states." Raby, Burgess J.W. and William L. Raby. ***Practitioner "Due Diligence" and Listed Transactions*** (in the *Tax Analysts Tax Practice and Accounting News* Section). *Tax Notes*, May 3, 2004, pgs. 553-557.
"Blowing Off" Disclosures ***Raby & Raby*** ***... on Ethical Tax Practice Management Dilemmas***	• A failure to disclose using any of the IRS Forms 8275, 8275-R or 8886 "...makes highly probable the imposition of a Section 6662 penalty in the event of a deficiency, but ***neither taxpayers nor practitioners view a deficiency as having a high probability of occurring***. Tax practitioners in most local firms not filing tax returns in California currently have no sense of urgency about uncovering listed transactions and insisting that clients report them. They will get concerned about what 'due diligence' requires with reportable transactions when they perceive that the IRS is serious about directly or indirectly disciplining practitioners who fail to exercise 'due diligence.' • "The renewed emphasis emanating from the IRS about the responsibility of tax practitioners for the advice they give and the returns they prepare ... undoubtedly sounds so far like 'déjà vu all over again' to many. The IRS has failed to follow through on brave announcements in the past. ***The IRS's expectations that the professional associations will step in and police tax practice seems to us ... to be quite unrealistic.*** On the other hand, the idea that the newly renamed and restructured Office of Professional Responsibility should play a major role in enforcing the professional standards of the tax professions would seem to offer great possibilities if aggressively implemented. • ***"...What will really make it [the penalty approach] work, we predict, will be the plaintiff's bar, which will convert penalties and deficiencies imposed by the IRS on clients into substantial recoveries in tax malpractice suits.*** Those will get the attention of practitioners and of professional associations alike. The disciplinary mechanisms of the CPAs and of the bar work reasonably well if first there is disciplinary action by the IRS or if there are findings in civil litigation." Raby, Burgess J.W. and William L. Raby. ***Practitioner "Due Diligence" and Listed Transactions*** (in the *Tax Analysts Tax Practice and Accounting News* Section). *Tax Notes*, May 3, 2004, pgs. 553-557.

This Notice modifies Notice 2002-70, 2002-2 C.B. 765, and Notice 2003-76, 2003-49 I.R.B. 1181, ***by removing the identification of transactions that are the same as, or substantially similar to, transactions described in Notice 2002-70 as "listed transactions"*** for purposes of Section 1.6011-4(b)(2) of the Income Tax Regulations and Reg. Secs. 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations.

The Service will, however, continue to scrutinize transactions described in Notice 2002-70 that are being used to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. Federal income tax.

BACKGROUND

Notice 2002-70 describes a reinsurance arrangement involving a taxpayer ("Taxpayer") (typically a service provider, automobile dealer, lender, or retailer) that offers its customers the opportunity to purchase an insurance contract through Taxpayer in connection with the products or services being sold.

The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed. Taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company ("Company X").

Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers. Taxpayer forms a wholly owned corporation ("Company Y"), typically in a foreign country, to reinsure the policies sold by Taxpayer. Promoters sometimes refer to these companies as producer owned reinsurance companies or "PORCs."

If Company Y is a foreign corporation, it typically elects to be treated as a domestic insurance company under Section 953(d) of the Internal Revenue Code. Company Y takes the position that it is entitled to the benefits of ...

- Section 501(c)(15) ... providing that certain small non-life insurance companies are tax exempt,
- Section 806 ... providing a deduction for certain life insurance companies with life insurance company taxable income not in excess of $15,000,000, or
- Section 831(b) ... allowing qualifying non-life insurance companies whose net written premiums do not exceed $1,200,000 to elect to be taxed solely on investment income.

Taxpayer receives premiums from its customers and remits those premiums (typically net of its sales commission) to Company X. Company X pays any claims and state premium taxes due and retains an amount from the premiums received from Taxpayer. Under Company Y's reinsurance agreement with Company X, Company Y reinsures all insurance policies that Taxpayer sells to its customers. Company X transfers the remainder of the premiums to Company Y as reinsurance premiums.

Notice 2002-70 alerts taxpayers that, in appropriate cases, the Service intends to challenge the purported tax benefits from these transactions on a number of grounds. Notice 2002-70 also identifies transactions that are the same as, or substantially similar to, the transaction described in the Notice 2002-70 as "listed transactions" for purposes of Reg. Sec. 1.6011-4T(b)(2) of the temporary Income Tax Regulations (now Reg. Sec. 1.6011-4(b)(2) of the Income Tax Regulations) and Reg. Sec. 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations (now Reg. Sec. 301.6111-2(b)(2) of the Procedure and Administration Regulations).

Section 206 of the Pension Funding Equity Act, P.L. 108-218, amended Section 501(c)(15) effective for taxable years beginning after December 31, 2003. Notice 2004-64, 2004-41 I.R.B. _____ (October 12, 2004), describes the amendments and notifies taxpayers that the Service will continue to scrutinize the tax-exempt status of entities claiming to be described in Section 501(c)(15).

DISCUSSION

The Treasury Department and the Service have concluded that these transactions no longer should be identified as "listed transactions" for purposes of the disclosure, registration, and list maintenance requirements.

(Continued...)

Since issuing Notice 2002- 70, the Service has examined various types of these arrangements. ***These examinations have revealed fewer abusive transactions than anticipated.*** Further, the Treasury Department and the Service anticipate that the recent amendments to Section 501(c)(15) will curtail the use of this provision by a number of these arrangements.

Accordingly, transactions will no longer be identified as "listed transactions" for purposes of Reg. Secs. 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) solely because they are the same as, or substantially similar to, the transaction described in Notice 2002-70.

However, the Service will continue to scrutinize transactions described in Notice 2002-70 that are being used to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. Federal income tax.

Although a transaction is no longer a "listed transaction" solely because the transaction is described in Notice 2002-70, the transaction may still otherwise be subject to the disclosure requirement of Section 6011, the registration requirement of Section 6111, or the list maintenance requirement of Section 6112.

EFFECT ON OTHER DOCUMENTS

Notice 2002-70 and Notice 2003-76 are modified by removing the identification of transactions that are the same as, or substantially similar to, transactions described in Notice 2002-70 as "listed transactions" ***effective for taxable years for which the due date of the return (including extensions, whether or not actually requested) is after September 24, 2004.***

For further information regarding this notice contact Nancy Vozar Knapp at (202) 283-8622, John E. Glover (202) 622-3970, or Theodore Setzer at (202) 622-3870 (not toll-free calls).

*Comments on Notice 2004-65 by Steve Mailho **

ARCs (Allied Reinsurance Companies) are no longer considered *"Listed Transactions"* according to a new Internal Revenue Service announcement.

This is a triumph for the industry, a vindication of everything we have told the IRS for many years, and a tribute to the hard work, commitment, and toughness of the people who knew that they weren't doing anything wrong.

The combination of your letters to Congress, face-to-face meetings with the IRS and reinsurance company audits, the IRS concludes automobile dealer ARCs are not fertile ground to waste their resources.

This is not to suggest that anyone abusing the Tax Code using ARCs will not be caught. But the vast majority of dealer ARCs are fully complying with the Code and they will no longer be tainted by this broad brush.

In August 2003 several people were invited to Washington DC to address the IRS Task Force looking into ARCs. ... Each gave compelling arguments why the automobile field was fully complying with the Tax Code and intent of Congress.

Additionally several audits of ARCs were undertaken by the IRS resulting in No-Change letters.

We're certainly not finished with the IRS, but this is a very significant milestone.

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*Comments on Notice 2004-65 by Greg Petrowski ***

... Notice 2004-65 removes CFC (Producer owned reinsurance arrangements) from the "listed transaction" list. As you know, if a transaction was identified as a "listed transaction," the participating taxpayer was required to disclose on its tax return participation in the structure.

The IRS has cited that in its investigation of CFC arrangements it has discovered less abusive transactions than it thought would turn up (those of us in the industry have tried to tell them this same thing over the past 18 months).

Additionally, IRS has indicated that it believes the change to the tax law with regard to tax exempt insurance companies will curtail abusive transactions.

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(Continued from page 6)

PORC list of articles on page 20, and that omission is deliberate. The August 9 issue of the *Automotive News* included an article entitled "Reinsurance Tax Breaks Are History, Expert Says."

In this article, Larry Williams of Crowe Chizek stated that he was not sure that a lot of dealers' accounting firms are aware of what's going on. Or, they may have a general sense, but do not keep up with the details unless they specialize in this area.

Several industry commentators have taken exception to Mr. Williams's comments as being far too broad in their simplifications about the IRS "turning up the heat on dealer-owned reinsurance companies" that "have been on the hot seat for two years."

It would appear that Mr. Williams's comments, if more accurately reported, would have emphasized that the days of Section 501(c)(15) tax exempt PORCs are numbered (especially by the new legislation); however, several other practical alternatives are legitimately available to dealers having PORC activities.

In any event, it was interesting to learn from the article that 80% of the dealer clients serviced by Mr. Williams's firm have reinsurance companies of some sort and that more than 50% of them are off-shore. Some reactions to this article appear on pages 26-27.

Some Practitioners Still May Want to "Blow Off" the Whole Disclosure Thing. In trying to keep up with various PORC-related developments, we've seen several really good articles lately, and they are listed on page 20 for your further study.

It's obvious that there is a lot more for you to take into consideration now if you're going to advise clients and/or sign your name on their tax return as preparer. These considerations may be significant in many situations beyond the more narrow focus of disclosing dealer PORC activities to the IRS in Federal returns. As suggested earlier, think in terms of individual tax returns, Forms 1040, and tax shelter investments. In particular, these need to be considered in connection with the California reporting requirements.

Some of these considerations were discussed by authors Burgess J.W. Raby and William L. Raby in a recent article in the context of their presenting CPAs with ethical tax practice management dilemmas. We agree with their conclusions and have included them for your consideration on page 29.

#11. NICHE CONFERENCES & SEMINARS OF INTEREST. We're into the conference and seminar season, with some of them emphasizing issue awareness and year-end planning for CPAs who specialize in the dealer/dealership niche. You may want to consider some of these as your best networking opportunities.

My schedule for the next few months includes the AICPA Auto Dealership Conference in Las Vegas (October 21-22) and the dealer PORC conference offered by CreditRe Corporation in Irving, Texas (November 4-5). If you're interested in the PORC conference, its official name is *Economic and Regulatory Issues of Risk Transfer on After-Market Products Conference*, and you should call 847-788-8122 as soon as possible for further information.

In November, I will be presenting a few year-end tax planning for auto dealers seminars in connection with Pro-Check National, Inc. Information will be available on our web sites on these seminars as soon as details are finalized.

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De Filipps' DEALER TAX WATCH

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