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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

Volume 11, Number 4 | Publisher: Willard J. De Filipps, C.P.A. | December 2004

DEALER TAX WATCH *OUT*

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

#1. AMERICAN JOBS CREATION ACT OF 2004 ... SOME TIDBITS FOR DEALERS. Just before the November elections, Congress approved and sent to President Bush its third major piece of tax legislation for 2004. The President signed the American Jobs Creation Act of 2004 (AJCA) on October 22, 2004.

The AJCA contains several hundred changes which are intended to give taxpayers $137 billion in tax relief ... and, of course, to create $137 billion in additional tax revenues to compensate for that relief.

Out of all of these changes, we've selected three for particular attention. Two of them are revenue raisers. That means, "watch out," they could affect you negatively. Here we're talking about the absence of any specific relief for Oldsmobile dealers and about new limitations on the ability to deduct certain corporate aircraft costs and expenses.

On the other hand, we've selected one "tax break" that, at first glance, may seem like it doesn't fit in with auto dealerships at all. But after you've read pages 3-4, maybe you'll think otherwise.

#2. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. The AICPA 10th Annual National Auto Dealership Conference was held October 21-22, 2004 at Caesars Palace in Las Vegas. We've selected 4 presentations from this Conference to mention in our report.

We think you'll find Larry Miller's thoughts and ideas on his "practical approach to dealership acquisitions" to be extremely valuable. Our coverage begins on page 5.

#3. PORC UPDATE CONFERENCE REPORT. After a hiatus of a few years, while the IRS was trying to figure out what really was going on in the world with PORCs and what it was going to do about it, this excellent 2-day conference reappeared with a superb faculty on November 4-5, 2004.

The Conference, sponsored by CreditRe, had the all-encompassing title: *Economic, Tax and Regulatory Issues of Risk Transfer on Automobile F & I Products.* Of course, "F & I" refers to "Finance & Insurance." If you've a taste for PORC, our review of this Conference begins on page 9.

WATCHING OUT FOR

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

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#4. BUY-HERE, PAY-HERE MATTERS. Our good friend and buy-here, pay-here expert, Ken Shilson, has kindly provided the information appearing on pages14-15 to update you on the new financial accounting reporting rules for buy-here, pay-here dealers and a list of 10 ways dealers can improve their collections. Ken's list is based on his thorough analysis of the performance of over $500 million of sub-prime buy-here, pay-here loans for dealers throughout the U.S.

#5. SCH. M-3 ... CLOSER TO FINAL VERSION. The IRS has almost finalized the new Schedule M-3 that has to be completed with Form 1120 this year. Our June *Dealer Tax Watch* was entirely devoted to the new Schedule M-3. At that time, the most recent version was dated July 7, 2004. The IRS has issued a revised, but not final, draft as of October 25, 2004. This is not the final of all final versions. That yet remains to be released.

The October 2004 draft retains the 3 page format. It has simply shifted some of the lines for income and expense/deduction reconciling items between pages 2 and 3. This version seems to be an improvement over the July version since it reflects some practitioner suggestions and comments. See pages 16-18 for a look at the revised Schedule M-3.

#6. COST SEGREGATION STUDIES ... *IRS Audit Techniques Guide*. Earlier this year, the IRS released a *Cost Segregation Audit Techniques Guide*. Many articles have appeared in the *Dealer Tax Watch* on the benefits of, and IRS concerns related to, cost segregation studies. The IRS *Guide* is dated April 30, 2004, but it was not available to the public until just recently.

The *Guide* does not provide specifics on auto dealer applications. The two industry applications it provides specifics on are casinos and restaurants. Nevertheless, there is a certain amount of useful information in the *Guide*, particularly in some of the listings of useful lives for various types of depreciable fixed assets and their categorization under either Sections 1245 or 1250.

The *Guide* also spells out in some detail what the IRS considers to be the essential ingredients for any cost segregation study to pass muster. We've provided an overview of the IRS' *Cost Segregation Audit Techniques Guide* on pages19-22.

#7. DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST. After giving some thought to what might be most useful to you in this year-end issue, I concluded that it's about time to put together a tax return review checklist that would be tailored to your auto dealership clients and activities. Over the years, we've included specific checklists and/or *Practice Guides* in writing about specific issues and subjects, but never done anything this comprehensive.

As developments occurred, there was some overlap, but we seem to be seeing or hearing about many of the same issues time and time again. You've probably seen enough tax return checklists by now: Short form, long form, PPC, AICPA, etc., etc. Many of these checklists are very good and very detailed ... I don't think you need another one of these.

However, our *Practice Guide* checklist is more tailored to dealership planning and opportunities and should be beneficial to you. You can use this checklist to review returns that you've already prepared for 2004 or use it in connection with returns on extension that you will be preparing over the next several weeks or months. This is exactly the kind of tool that I use in my own practice (I simply haven't formalized it in this fashion until now).

There are several other ways you could use this *Practice Guide*. For example, you might use it as a teaching guide for your new staff members. Or, you might assign one person to several of the areas covered, and have them prepare or review the checklist for all of your dealer clients. This will concentrate continuity and greater application experience on certain issues in various individuals.

Any comments, suggestions and/or corrections will be greatly appreciated.

AMERICAN JOBS CREATION ACT OF 2004 ... SOME TIDBITS FOR DEALERS

The American Jobs Creation Act of 2004 (AJCA) became Public Law 108-357 when it was signed by President Bush on October 22, 2004. Although there are many, many provisions in this act, only 3 have been selected for discussion here.

OLDSMOBILE DEALERS' TAX RELIEF PROVISIONS NOT ENACTED

Most notably missing from this legislation was any relief for Oldsmobile dealers that we have discussed in previous issues of the *Dealer Tax Watch.* Apparently, some members of Congress felt that any special treatment for payments to Oldsmobile dealers for terminating their franchises (by General Motors) was not warranted.

Our observation ... Just because Congress did not enact any special tax legislation for the treatment of these payments, that does not mean that dealers may not be entitled to favorable tax treatment under existing Sections of the Code. Prime candidates include Section 1031 (Tax-free exchanges) and Section 1033 (Involuntary conversions).

In this regard, we remind readers that some dealers have obtained favorable tax treatment by filing amended returns claiming the tax deferral benefits afforded by these provisions. (See the December 2003, *Dealer Tax Watch*, Update #1, page 1.)

As we've observed before... "what have you got to lose?"

CORPORATE AIRCRAFT EXPENSE DEDUCTION NOW LIMITED

Many dealerships and/or management companies own aircraft which are used in connection with various dealership activities. In a previous tax case, *Sutherland Lumber-Southwest, Inc. v. Comm.* (114 T.C. 197), the corporate taxpayer was allowed a deduction for its cost of maintaining its corporate aircraft, where this cost was considerably in excess of the amount that the employee was required to report as income in his personal income tax return. The amout the employee had to report as the value of this fringe benefit was based on using the *Standard Industry Fare Level* (SIFL) rates found in the Regulations.

Simple example: If the allocable cost to the corporate owner of the aircraft of the personal flight(s) used by the employee was $5,400, the amount that the employee was required to report on his Form 1040 might be only $1,300 based on the SIFL rates.

Somehow, the IRS was unhappy with this disparity and it felt there should be some adjustment for the $4,100 difference. So, it persuaded Congress to change the law.

As a result, the AJCA now provides that the company's deduction in its income tax return that is attributable to the employee's personal use of an employer-provided aircraft is limited to the amount that is included in the employee's income under Section 61 and Reg. Sec. 1.61-21.

This provision applies to officers, directors and 10% or more owners of private and publicly-held companies. This provision is effective for expenses incurred after October 22, 2004 (the date of enactment).

So, be careful with your 2004 tax returns as this provision applies to expenses related to personal use during the last ten weeks of calendar 2004.

For a discussion of another case, *E.W. Richardson,* involving the deductibility of corporate-owned aircraft, see *Planes & Jets ... Is that Airplane really Deductible?* in the June 1996, *Dealer Tax Watch.* This article includes (on page 7) a "Corporate Aircraft Planning & Documentation Checklist."

A FREEBIE FOR DEALERS HIDDEN IN THE 3% - 6% - 9% DOMESTIC MANUFACTURING DEDUCTION?

The basic motivation for the American Jobs Creation Act was the need to repeal the Internal Revenue Code's favorable tax rules for foreign sales corporations and the extra-territorial income exclusion (ETI) provisions. These had been ruled to constitute illegal export subsidies by the World Trade Organization and international political pressure apparently dictated their removal from the Internal Revenue Code.

Accordingly, the AJCA has replaced these provisions with Section 199 which allows a deduction for certain domestic production activities. However, Section 199 is not limited to taxpayers who are doing business beyond the U.S. borders. When fully phased-in, this deduction will be 9%.

What is particularly intriguing for automobile dealerships is this...could this deduction result in some benefit for many of the activities undertaken by dealerships in their service, vehicle get-ready and body shop departments? Why not?

This deduction applies to all taxpayers deriving income from qualified domestic production activities,

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regardless of whether or not they are engaged in international operations or export operations. Furthermore, it is available to all types of taxpayers ... corporations, partnerships, other pass-through entities and individuals.

The deduction is a percentage of the lesser of (1) the qualified production activities income (QPAI) of the taxpayer for the tax year, or (2) taxable income (determined without regard to this provision) for the tax year.

The amount of "qualified production activities income" is determined as follows. QPAI equals "domestic production gross receipts," reduced by the sum of (1) the cost of goods sold allocable to such receipts, (2) other deductions, expenses or losses that are *directly* allocable to such receipts, and (3) a proper allocable share of all other deductions, expenses and losses that are *indirectly* allocable to such receipts.

This deduction is not available for 2004. Beginning in 2005, the deduction will be phased-in over a period of years. In the years 2005-2006, the deduction percentage phase-in is 3%. In the years 2007-2009, the deduction percentage phase-in is 6%. In years after 2009, the deduction percentage will be a flat 9%.

When fully phased-in, this deduction is intended to be the equivalent of a 3% income tax rate reduction for qualifying domestic activities for taxpayers in the maximum income tax bracket (33-35%). It is allowable for both the regular and the Alternative Minimum Tax computations.

The deduction is limited by wages and cannot exceed 50% of the wages reported on Forms W-2, regardless of whether the employees are engaged in qualifying production activities. However, this limitation should not have any impact on dealership application situations.

There are other limitations, mostly relating to the inability of a taxpayer with a net operating loss to claim the benefit of the deduction. Taxpayers with net operating loss carryforwards won't be able to get the benefit of this deduction if the NOL carryover available results in no current-year net taxable income.

Financial statement reporting (i.e., the accounting treatment) for this deduction has been clarified. According to recently issued proposed FASB guidance (FAS 109-a), the domestic manufacturing deduction should be accounted for as a *special deduction*, under FASB Statement 109, rather than as a *rate reduction*.

The FASB staff reached the conclusion that special deduction treatment, rather than rate reduction treatment, is more appropriate "because the domestic manufacturing deduction is based on the future performance of specific activities." Therefore, this makes it more similar to the special deduction examples in paragraph 231 of Statement 109.

It will be interesting to see what definition or definitions the IRS will use for determining what constitutes "domestic manufacturing activities." The definitions and rules under Section 263A that define manufacturing, producing and processing activities are extremely broad.

So, perhaps there might be a "freebie" deduction in this legislation for dealers who can do the requisite recordkeeping and cost accounting to come up with the amount of "qualified production activities income" to which the 3%-6%-9% deduction factors will be applied.

More on this in the future.

AICPA 10th ANNUAL NATIONAL AUTO DEALERSHIP CONFERENCE

CONF REPORT

The AICPA 10th Annual National Auto Dealership Conference was held October 21-22, 2004 at Caesars Palace in Las Vegas. We've selected four sessions to report on. Tapes of all sessions can be purchased; however, in many instances, the quality of some tapes may be inferior and distracting.

#1. IRS UPDATE

Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, spoke again at the Conference. If you're a reader of this publication, you won't find anything "new" in her comments. However, here's essentially what she covered in her presentation.

PORCs. Ms. Harris spent the first half hour discussing the "good news" that IRS Notice 2004-65 removed PORCs from the IRS list of "Listed Transactions." She warned the audience not to assume that all PORCs are "good" as a result of 2004-65, nor to necessarily assume that all PORCs are bad.

She said that the IRS would still be looking for *"Wright"* issues, referring, of course, to the infamous William Wright of fraudulent, sham transaction PORC fame. The three typical *"Wright"* issues the IRS is on the lookout for are (1) pricing issues (i.e., especially changes in commission rates charged before and after a PORC is established); (2) adequate entity capitalization and (3) loans to shareholders and officers that are not at "arm's-length."

Ms. Harris also reviewed the changes made by the Pension Funding Equity Act of 2004. These should now effectively remove tax exemption under Section 501(c)(15) as a PORC-abuse. This legislative change is especially relevant where the PORC is "stuffed" with appreciated assets which are sold, thus generating significant investment income from the investment of the sales proceeds.

Ms. Harris indicated that additional guidance should be coming out on PORCs "by the end of the year." Note: This might have been a veiled reference to the Technical Advice Memoranda that were mentioned at the PORC conference in Dallas in November (see page 13 in this issue of the *DTW*).

Electronic recordkeeping requirements & Rev. Procs. 98-25 & 97-22. In discussing this topic, Ms. Harris lamented that the auto dealer industry is about the only major industry that still is noncompliant with these clear recordkeeping requirements. Unfortunately, it appears that the IRS is a toothless tiger in these situations. It makes you wonder, doesn't it?

These requirements apply to taxpayers with assets in excess of $10 million. Just look at the year-end balance sheet to see if you're covered. Records retained must be "capable of being processed," which means one must be able to retrieve, manipulate, print and produce output. Also, records retained must contain sufficient transaction-level detail. In the event of an IRS audit, taxpayers must provide resources to assist the IRS to process records, and this includes providing the hardware, software, terminal access, computer time and the personnel.

Rev. Proc. 97-22 allows document imaging if documents are retrievable by a computer software indexing system. Documents should not be capable of being altered once they have been imaged. If the IRS cannot access/retrieve image documents, then the taxpayer is not in compliance with Rev. Proc. 97-22. For this purpose, "electronic storage system" is broadly defined as a system to prepare, record, transfer, index, store, preserve, retrieve and reproduce books and records by either (a) electronically imaging hard copy documents to an electronic storage media, or (b) transferring computerized books and records to an electronic storage media that allows them to be viewed or reproduced without using the original program.

Accountable plan reimbursement programs for service technicians. Ms. Harris didn't say much about this subject except that it has been moved onto the IRS' Priority Guidance List for 2004 - 2005. So, hopefully, some guidance should be forthcoming in the near future. This is one subject that is near and dear to our hearts and we've had a lot of interaction with the IRS on this.

IRS Audit Technique Guide for Dealerships. Ms. Harris indicated that almost all levels of review have signed off on the newest revision of this document. She expects that it should be available to agents (and to us under the Freedom of Information Act) fairly soon. We'll keep watching out for it.

#2. HOW TO MAKE THE TAX SYSTEM WORK TO YOUR ADVANTAGE

This session was a joint presentation by Joseph Magyar and Robert Zwiers, both of Crowe Chizek. Essentially, this was a repeat of Mr. Zwiers' presentation at the NADA Convention earlier this year in Las Vegas. His presentation was covered in detail in "Tax Strategies for Dealers (NADA Workshop Report)," *Dealer Tax Watch*, March 2004, pages 4-9.

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As you might expect, there was a bit of overlap in parts of the Magyar/Zwiers presentation and Ms. Harris' comments. For emphasis, we'll repeat the list of "IRS Audit Issues" from their presentation, as follows: (1) Tax shelters–PORCs, (2) Forms 8300s–$25,000 penalty per violations, (3) Demos, (4) LIFO, (5) Computerized record retention, (6) Extended service contracts, (7) Tool plans and (8) UNICAP–Section 263A.

Our comment: Same old stuff.

#3. WILL THE DEALERSHIP SURVIVE AS A FAMILY ENTERPRISE?

This presentation by David A. Brackenbury was, in my opinion, one of the two best presentations of the Conference. I strongly urge you to get the tape and listen to it carefully. Mr. Brackenbury discussed several of the critical areas that a dealer must address in connection with succession planning, with special emphasis on the so-called "soft" issues involving dynamics between the family members and the manufacturer and the dealer/dealership.

Mr. Brackenbury stressed the importance of creating financial security for the dealer's spouse. He added that, in this regard, it is often necessary to review the insurance policies that were purchased in the past to see whether they are "adequately performing" or performing as expected.

In many instances, insurance policies bought in the past have not performed according to underlying "assumptions." In these cases, shortfalls, either in dollar amount of coverage or in the term of coverage, may be significant. Mr. Brackenbury suggests that "reproposals" be obtained in connection with older insurance policies in order to see exactly what the current coverage levels and limits are.

Another area he discussed was the importance of creating an environment in which the successors will really have a chance to succeed. Here, it is important that each family member has been given the opportunity to share or discuss his or her thoughts, concerns and even objections to the "overall plan" of which he or she is intended to be a part.

Does everyone (i.e., do all family members) really know what the plan is? Has an agreement on guidelines been established concerning such matters as "ownership" and "employment?" It is most important that these understandings and guidelines be established "while Dad is still alive." Without attention to matters like this, the foundation of the succession planning is a shaky illusion at best.

Mr. Brackenbury also addressed how dealers might come to grips with "fairness" issues in terms of children (or other family members) who may not be active in the business ... some by choice ... some because of (lack of) interest or competence ... or others simply excluded because it was assumed that they might not want to be involved in the business. Also, he addressed the need for clarification where different levels of responsibility–and salary–affect different family members.

Obviously, successful succession planning involves addressing the various technical estate tax planning issues and strategies ... but only after the soft issues have been adequately addressed.

Ironically, I recently observed two dealer conferences where succession planning was one topic of discussion. In one of these sessions, it was very evident that little, if any, attention had been given to these soft issues. I felt extremely sorry for the young "dealer in grooming." It was obvious to him, but not to his dad, that the more he helped to grow the business, the more he'll have to pay and the larger the problems he'll have to face in the future because these soft issues are not being realistically addressed right now.

#4. LARRY MILLER'S PRACTICAL APPROACH TO DEALERSHIP ACQUISITIONS

Mr. Miller is an extremely successful businessman in the Salt Lake City area and elsewhere. With roughly 4 dozen dealership acquisitions over a long period of time, Mr. Miller is continually approached with or by potential candidates for acquisition.

Mr. Miller shared his simple–almost Warren Buffett-like–three test approach for evaluating quickly (in a few minutes, almost a back-of-an-envelope-type thing) whether a deal looks like it has real potential.

First, Mr. Miller wants a deal that will have a $300 per vehicle rent factor guideline. Per vehicle means only new and used retail sales; and it excludes anticipated wholesale and fleet sales.

Second, he wants the amount paid for blue sky to be an amount approximately equal to the last three years' earnings combined.

Third, he wants to know if the first 60 months' pretax earnings will be sufficient to pay for all of the ***other*** assets he is acquiring in the deal. These ***other*** assets include (1) the parts and other non-vehicle inventories; (2) all equipment, furniture, fixtures, etc.; and (3) the goodwill he is paying for. Real estate and new and used vehicle inventories are excluded for purposes of this test. Mr. Miller is asking simply: Can I buy these all of these ***other*** assets with my first 5 years' pre-tax earnings?

After Mr. Miller applies his "three tests" to the potential deal, if it measures up to these tests, he then turns it over to his team of CPAs for further in-depth →

due diligence work. If his staff's detail analysis reaches contrary conclusions, then they will look further to see why the results of their analysis are different from Mr. Miller's rules of thumb and to see if they can reconcile the different conclusions.

Each of these tests is discussed further below.

Will the real estate be bought or leased? If it's a purchase situation, Mr. Miller converts to a rental factor equivalent using a 12% return on investment. Mr. Miller says he uses 12% because he can "do it in his head," and that's 1% per month. Therefore, if the real estate is going to cost $4 million, that converts to $40,000 per month, at 1% per month. He then looks at how many new and used vehicles he expects to sell and what is the gross needed to make the rent factor.

Mr. Miller currently uses a rent factor guideline of $300 per vehicle new or used (but, not considering wholesale and/or fleet sales). He previously used $250 per vehicle, but just recently, and somewhat reluctantly, he increased this guideline amount to $300. He indicated that new construction costs approximate $110 per foot for most franchises, but that for certain luxury vehicle facilities, the costs can go as high as $160 per foot.

Blue sky. Generally, the real estate and the blue sky components of Mr. Miller's deals will constitute roughly 85% of the total purchase price. With blue sky, the basic question is: Is the value of the operation going to hold up and justify the amount paid for the intangible value of the business?

Mr. Miller said that he tries to assuage his fears and provide some downside or cushion by using the following "kindergarten simple" formula. The amount paid for blue sky should not exceed an amount equal to the last three years' earnings combined.

He emphasized that this is ***not*** the same as "3 times the last year's earnings." He candidly mentioned the need to be alert for "engineered" financial statements, commenting that statements can easily be made to show many different things, especially if the seller starts anticipating 12 to 18 months in advance that the selling price is likely to be based on the results reported on that financial statement.

Mr. Miller indicated that in evaluating the prospective deal, his staff pours over 3 years' financial statements, plus the current-year-to-date statements. In addition, they also ask for the last 3 years' income tax returns. "Tax returns can be messed with, but at a much greater degree of risk." Mr. Miller's staff will analyze financials statements for trends and reconcile the financial statement operating results to the taxable income per the tax returns filed.

The "last 3 years' earnings" formula works for most mainstream dealerships. However, exceptions are made for some of the highline franchises, including BMW, Mercedes, Lexus, Honda and Toyota (a Larry Miller favorite).

Another consideration to take into account is whether the manufacturer is exerting any significant pressure for the construction of new facilities or major upgrades. Sometimes, that pressure may be what is really causing the selling dealer to want to sell. Also, it is important to consider the adequacy of the service department facilities and whether the unit in operation is adequate for anticipated growth or volume levels.

Mr. Miller indicated that in some situations, he would make an exception for an amount to be paid for blue sky that would be considerably higher than his "kindergarten simple" formula amount. However, at the higher price range, the price should include the manufacturer's net working capital requirement. Mr. Miller said that, in these higher ranges, the purchaser should be sure to say or ask ... "I assume this asking price includes the manufacturer's net working capital requirement, doesn't it?"

Mr. Miller pointed out that the philosophy of the publicly-held automobile dealership groups, in general, seems to be somewhat different from his own. The "publics" are looking for 18 to 22% return on investment, which at the 20% (mid-range), suggests 5 times earnings on pre-tax dollars. Mr. Miller's philosophy becomes more subjective to the extent that he factors in the question ... "Is there really an opportunity here so that we can do better? ... In other words, what can we expect to do with the operations in comparison to what the seller has been doing to date with the operations?"

To what extent, if any, are certain "extraordinary" items adjusted for in arriving at pre-tax earnings amounts? "How do you adjust for the owner's salary and bonus? Do you add any of it back?" Mr. Miller said that he generally asks the selling dealer whether he is also paying a qualified General Manager, and if so, how much that General Manager is being paid.

If the selling dealer is paying a General Manager a salary and bonus at the market rate, Mr. Miller will add back the dealer's salary (and some of the dealer's bonus) to "normalize" earnings because the dealer's salary and bonus is really a duplication that will not be recur after the acquisition is completed. If the dealer isn't paying a General Manager, then Mr. Miller may only add back some of the dealer's compensation and that add-back would be the part that is not reasonable.

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Other extraordinary items that may be added back to arrive at more normal earnings might include costs and expenses deducted for planes, boats and other items of that type or for personal items that are being paid for the dealer by his corporation.

What do you where the selling dealer owns the real estate and rents it to the dealership? In this situation, there may be an adjustment, depending on whether the rent reflected in the financial statements is at a reasonable market rate rental. Here, the issue is not whether the rent factor under the previous owner (i.e., the selling dealer) was reasonable. Rather, the key or issue is what rent factor Mr. Miller thinks he will need to be able to support at the performance level he is expecting from the dealership. That is the critical factor.

In some cases, the previous amount paid for rent might be either above (excessive) or below a fair market rental rate. Mr. Miller indicated that, if his new rent factor will be higher (say, $40,000 per month) than the selling dealer's rental factor (say, $20,000 per month), then Mr. Miller will subtract the difference (i.e., $240,000) in order to adjust the historical earnings he is looking at. He commented that although this is really only a shift, if the amount of rent the selling dealer has been paying is under market, then the shift is necessary because without that adjustment, the operational side of the dealership is being overstated.

Mr. Miler's third test. Mr. Miller describes his third test as a "radical third element." He basically asks whether he can purchase all of the other assets (excluding real estate and new and used vehicle inventories) out of the first 5 years' pre-tax earnings.

Here's his third test stated another way... Taking all the non-real estate and the non-vehicle assets, but including goodwill, ask the following question, "If 100% leveraged, could those assets be purchased with 60 months' pre-tax income dollars?"

If not, then usually he will think that the deal is not even close. However, if this "test" can be satisfied with 6 to 6½ years' earnings, "and if everything else lines up pretty favorably," then Mr. Miller may consider the deal on the strength of its other merits. Mr. Miller's philosophy is that if you knowingly pay more than 5 years' pre-tax dollars for all the other assets, including goodwill, you're not going to be building up much significant equity in the deal ... so, he concludes, you might just as well go ahead and work for the seller.

Mr. Miller said that there may be times when you, as the buyer, reasonably believe that you will not be able to do as good a job in maintaining the performance/volume levels in the new operation as the previous dealer has been doing. In this case, if the seller is asking you to pay an amount for blue sky based on what he was able to do, then this test really becomes significant to Mr. Miller, as the purchaser.

Stock vs. asset deal. Mr. Miller said that the first thing he'll ask, although it is not an absolue factor, is whether the deal is going to be a stock or an asset deal. He indicated that, in some instances, exceptions will be made to allow the deal to be a stock deal if the dealership has a large LIFO reserve recapture issue. But, he warned, you've got to know who you're dealing with, because, in a stock deal, you're acquiring all the assets and all the liabilities, whether disclosed or undisclosed. He mentioned EPA liabilities as an example that can be hidden for years, even decades, and well off everyone's radar screens. But, if you've bought stock, you're going to get stuck with them whenever they surface.

LIFO is "not worth the bother." Another question was whether Mr. Miller uses LIFO in his newly acquired dealerships. His answer ... "No."

Mr. Miller views LIFO as a more-or-less onerous, contingent liability that has to be dealt with sooner or later. He added that all one really makes off of LIFO is the after-tax dollars on the equivalent interest earnings. To his way of thinking, this benefit does not make the use of LIFO worth the hassle, so he quit using LIFO about 5 years ago. He did say that LIFO certainly was good for you if you are in a start-up or growth situation. However, its onerous, contingent liability aspect was something that he prefers not to deal with, nor to leave it as an eventual problem or burden to be dealt with by someone else, or by his heirs.

The Factory's right of first refusal. Another question was "How do you overcome or defeat the Factory's right of first refusal in an acquisition situation?" Mr. Miller said, "That's very difficult to do." In circumstances where the Factory is exercising a golden parachute for a retiring executive or where there exists significant pressure for "diversity candidates," there may be no way to defeat the Factory's right of first refusal.

In other situations, Mr. Miller said that it is very important to have two things: (1) a reputation as a good operator in the community and (2) significant financial strength that is demonstrable. The latter is especially important where facilities upgrades are going to be part of the overall situation.

CONCLUSION

Mr. Miller's candid observations are very interesting and instructive. I urge you to get this tape and give it your full attention.

PORC UPDATE CONFERENCE REPORT

A few years back, this PORC conference was being presented on a regular, annual basis in Dallas. (See the September 1997 *Dealer Tax Watch,* pages 27-29.) Then, all of a sudden, PORCs became a really hot topic just before the IRS issued Notice 2002-70. So hot, in fact, that the sponsors of these annual PORC updating conferences decided that it was best to hold off for a while until things cleared up.

Accordingly, due to the issuance of Notice 2004-65 and a few other developments, the Conference promoters decided it was safe to go back into the water, and they organized an excellent 2-day conference in Dallas on November 4-5, 2004.

Prior PORC conferences usually included the full name "Producer Owned Reinsurance Companies," and sometimes even the words "vehicle service contracts." This year's conference title was: *Economic, Tax and Regulatory Issues of Risk Transfer on Automobile F & I Products.* Of course, "F & I" refers to "Finance & Insurance."

The knowledge base and range of the faculty was extraordinary. It was clearly evidenced in presentations by Mark Anderson (the guru of all things insurance and PORC-related), Terri Merriam (formerly with the IRS and the litigating attorney in *William Wright v. Comm.,* now in private practice), Greg Petrowski (whose previous analyses of PORC-related matters appeared in the September *Dealer Tax Watch*), Andrew Weill (a Certified Tax Law Specialist in the San Francisco law firm of Benjamin, Weill & Mazer) who has been completely immersed in dealing with the IRS in connection with its Notices in representing the activities of Steve Mailho, and Gary Fagg (a consulting actuary and expert in all areas of credit-insurance operations, with particular emphasis on the measurement of loss experience and producer-affiliated reinsurers).

Other participants/presenters were equally engaging, and the Conference atmosphere was comfortable and informal. Several presentations were panel discussions, and these resulted in a very interesting and spontaneous flow of thoughts and information.

As one becomes more familiar with the PORC industry and the players/promoters within it, one becomes more aware of the different factions and interests within it. These different interests are not necessarily always aligned with each other.

However, when the IRS dropped the Notice 2002-70 "listed transactions" bombshell on the PORC industry, all factions temporarily set aside their differences and joined forces to mount a united front in ***resisting*** the IRS on this issue. Clearly, an adverse development of this magnitude affected the entire PORC industry, and in this case, "what affects one, affects all." The differences existing between/among the various factions were not as great as the differences between the IRS and the aggregate factions making up the PORC industry.

Before proceeding with a discussion of some of the sessions, let's get to what, in my opinion, are few of the Conference highlights.

First, a big debate–and that's putting it mildly–erupted during a discussion of whether the name "PORCs" was really inadequate (suggesting a parent-child or parent-subsidiary relationship) and should be replaced by an arguably more accurate term such as "ARCs." "ARCs" is the label of choice preferred by Messers Mailho and Weill and stands for "Affiliated Reinsurance Companies."

All of Mr. Mailho's activities are now being described in terms of ARCs rather than PORCs. Mr. Weill presented a number of arguments in support of the use of the term "ARCs," but I must report that his arguments did not seem to receive majority support. If you want more specifics on both sides of the issue, you should talk directly to Andrew Weill for the "pro-ARC" view and to Jim Smith for the "con-ARC" view.

Second, although no IRS employees attended the Conference, several presentations addressed typical IRS audit issues. (On a related note, see page 5 for the summary of Terri Harris' remarks on PORC issues at the AICPA National Auto Dealership Conference.) We know that the IRS will be on the "lookout" for commission rate adjustments and "thinly capitalized" PORCs.

Here's a key point, if you ever have the IRS raise an audit issue over a "commission rate adjustment" in connection with your PORC, you should be sure to contact Gary Fagg, who gave a thorough presentation on why insurance commissions should be adjusted (frequently) as conditions warrant and what factors warrant changes in commission rates (see pages 11-12). This obviously ties-in with the IRS' often-expressed concerns over what it calls "oversubmits."

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On a similar potential IRS audit note, if you ever have the IRS raise a question in connection with the alleged "thin capitalization" of your PORC, you may want to contact Andrew Weill, who gave a presentation on why and how significantly small levels of capitalization may be justified/rationalized in connection with PORCs/ARCs.

It appears that the IRS tends to view things in a static, unchanging way. The Conference presentations, as a whole, underscored the fact that very thoughtful arguments can be presented to counter positions traditionally taken by the IRS about its concern over changes in commission rates (pre-PORC and post-PORC) and thin capitalization. Both Mr. Fagg and Mr. Weill would be excellent resources to contact for support to counter the IRS if these audit issues were raised in connection with PORCs.

The last overall comment is simply that the Conference Manual is outstanding. In addition, each participant was given a CD-Rom reference which is a four-volume comprehensive compilation of all industry-specific materials relating to PORCs and PORC issues. This includes all the relevant Code and Regulation Sections, cases, IRS pronouncements (Chief Council Advice, FSAs, Letter Rulings and TAMs, Notices, Revenue Rulings and Revenue Procedures, etc.) and articles and papers. All of this is cross-referenced and linked and includes materials covered in prior years' PORC conferences.

What follows are selected comments and observations on some of the Conference sessions.

"What Is Insurance for State Regulatory Purposes and Federal Income Tax Purposes" ... Mark E. Anderson. This session dealt with the basic questions suggested in the title, since neither the Internal Revenue Code nor the Regulations defines the terms *insurance* and *insurance contract*. The accepted definition of "insurance" for Federal income tax purposes goes back to the 1941 Supreme Court case of *Helvering v. Le Gierse* which stated that "historically and commonly, insurance involves risk-shifting and risk-distributing." Mr. Anderson looked in detail at these two aspects of insurance ... (1) risk transfer and (2) risk distribution.

Mr. Anderson emphasized the importance of looking at the event being insured against, and not necessarily looking at the entity that is securing the insurance to protect against the event.

In other words, he contrasted the situation of (1) 500 corporations with each insuring against 1 event and (2) 1 corporation with 500 locations, all of which were insuring against the occurrence of the same event. His presentation included discussions of Revenue Ruling 92-93, Revenue Ruling 2002-90 and *Clougherty Packing Co. v. Comm.*

"Risk Participation Structures by Automobile Dealers" ... Mark E. Anderson. In his second presentation, Mr. Anderson provided an overview of front commissions, retroactive compensation structures, domestic reinsurance structures (both single-owner and multi-class), foreign-domiciled with Section 953(d) elections and non-controlled foreign corporations. The substance of Mr. Anderson's comments follow.

When determining what risk participation structure is "best" for a producer of risk, many factors have to be taken into account, and sometimes, the correct or "best" decision is simply the decision to not participate.

A key mistake frequently made is to believe that one risk participation structure fits the facts; often, many different variables have to be considered. These variables include (1) the immediacy of cashflow needs, (2) exposure to risks of other producers (i.e., commingling your risk with the risk of others so that your profits may be used to cover someone else's losses) and (3) the economic ramifications of the size/amount of the operating costs.

The third variable, operating costs, would include fees paid to third parties to manage the structure and ***all of the taxes*** that may be incurred, including Federal income tax, state premium taxes, state income taxes, taxes imposed by off-shore jurisdictions and Federal excise taxes. In this context, Mark indicated that decisions as to what structure best suits the facts should take into account all of the variables above, and not just the tax variable. In some instances, the cost of operating in one jurisdiction may be significantly higher or lower than the cost of operating in another jurisdiction.

Mr. Anderson's discussion was supplemented by extremely well-done schematics and flowcharts which diagrammed the various risk participation structures. These diagrams showed the relationships of all of the parties and entities in a variety of different possible arrangements. These also included the so-called "file cabinet companies" as well as the most common application where the reinsurer is a foreign corporation, and it makes an election under Section 953(d) to be taxed as a U.S. corporation. Mr. Anderson's charts also indicated whether dividends paid by the foreign reinsurer would be eligible for the favorable 15% dividend rate (as in the latter case) or not (as in the case of the "file cabinet company").

Mr. Anderson's diagrams of direct writer relationships included a number of variations such as the →

Illinois Protected Cell Company Law, the Rhode Island Protected Cell Companies Act and the Vermont-sponsored Captive Insurance Company. The basic issue underlying each of these variants is simply: ...when you go through all of the *cell capital*, then there should be some *core capital* left to absorb losses.

"Obligor Companies: Forms & Status. Mark E. Anderson. In this presentation, Mr. Anderson provided a brief history of the non-insurance status for VSCs from a state insurance regulatory perspective. He discussed the state law changes that, generally speaking, permit some party other than the dealership to be the obligor. This has resulted in an umbrella of diverse ownership possibilities ... dealer principal, dealership, administrator, insurers (including RRGs - Risk Retention Groups), manufacturers, retailers, agents and/or agencies.

Mr. Anderson demonstrated his broad range of knowledge and experience (i.e., his virtuosity) as he discussed the diverse ownership forms and 17 of the more recent Private Letter Rulings. Again, his PowerPoint schematics showed the different ways obligors could be owned, and he discussed other issues including state taxation (which may have minimal tax impact), performance guarantees and capital commitments and risk-mixing insurer concerns.

"Automobile Service Contract Obligor Companies Gap Overview"... Timothy J. Meenan. Mr. Meenan, of Blank, Meenan & Smith, PA, Tallahassee, Fla. is the General Counsel of the Service Contract Industry Council, Florida Service Agreement Association. He discussed his activities in working with various state regulatory authorities and agencies in working towards a model service contract. His presentation included maps showing 33 states with regulated motor vehicle contracts and the current dealer obligor states ... Nebraska, Kansas, Michigan, Pennsylvania, New Jersey, Massachusetts and Maine.

Mr. Meenan also discussed his experiences in working with the various regulatory agency interpretations involved with the somewhat controversial area of GAP (Guaranteed Asset Protection) insurance. GAP protection has been defined as "Two party contracts which provide that for consideration, the lender agrees to waive the buyer's loan balance that remains after the application of insurance proceeds following total loss of (the) automobile."

Different states seem to have different requirements and some raise the issue of debt waiver status versus pure insurance. Some require that if the GAP coverage is sold as "insurance," then the seller ***must*** use a personal and casualty insurance agent on ***each*** customer solicitation and ***must*** issue a personal lines policy to ***every*** customer. This GAP insurance area is further complicated by some interpretations as to whether there is a "debt suspension agreement" in place that would cancel a credit cardholder's debt for death, disability, loss of employment, call-up for military service, etc.

All of this suggests the importance of the Service Contract Industry Council to which Mr. Meenan is the General Counsel and whose daily activities involve working with a multiplicity state regulatory agencies which often have differing or conflicting requirements for the marketing of aftermarket products and services.

"Front Commission Levels in Credit Insurance" ... Gary Fagg. This session addressed commissions paid on the sale of single premium credit life and disability insurance. This is also known as *credit insurance* and may be defined as insurance products offered during the extension of customer credit where the entire premium for the insurance is paid in a single sum at the inception of the insurance.

The terms *front commissions* and *retros* should be defined before going further. A ***front commission*** is a percentage of the single premium that is paid to the producer at the inception of the insurance. The compensation is guaranteed. The direct writer does not have any recourse against the producer if the claims plus the front compensation produce a loss. In some states, there is a limit on this amount (a "commission cap") equal to xx% of the single premiums written less refunds ("net written premiums"). A producer cannot receive a front commission of more than xx% of the net written premiums.

Retroactive compensation (retro) is compensation paid to a producer *in addition to* the front commission. Periodically, the underwriting results are evaluated. The direct writer deducts front commissions, claims, premium taxes and its administrative fees from the earned premiums. The result is the underwriting profit, and some portion of this is then shared with the producer. The producer's share can be from 50% to 100% of the profit. The retro can never be less than zero; losses are carried forward and deducted from future profits. The direct writer holds the cash from the single premium and earns the investment income on the cash flow. Retros are included in the calculation of the commission cap in some states. If a producer receives the full front commission rate, it cannot receive any retro.

Mr. Fagg's presentation developed the following points... It is customary in the credit insurance

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industry to pay different levels of front commission depending on the extent to which the producer (i.e., the corporate entity presenting the credit insurance to the borrower/purchaser) participates in the insurance risk.

Generally speaking,

COMMISSION RATES

- Other things being equal, the highest commission rate will be paid if a producer receives only a front commission.
- A lower front commission rate is paid if the producer is eligible for retroactive compensation (i.e., "retro").
- The lowest front commission rate is paid if the producer accepts the full underwriting risk in a Producer-Owned Reinsurer (POR; i.e., the corporate structure where a producer owns a corporation licensed to conduct the business of underwriting insurance risks).

The primary justification or impetus for a reduced commission rate comes from the direct writer–the insurance company issuing the insurance policy. As a producer's compensation structure moves from front-commission only to retro to POR, the direct writer's profit margins are reduced, and it must change the front compensation to make a comparable reduction in its level of risk.

Direct writers are also subject to statutory accounting principles that impose stringent requirements on the underwriting of insurance risks. Some of these requirements, particularly "surplus strain," apply to reinsurance programs. These accounting principles affect the front commission level or levels as well as the structure of the insurance programs.

The commission rate paid to a particular producer, or the commission rate paid on a sub-category of a producer's business, is usually determined by many factors. Where only a front commission is paid, the factors include (1) expected losses by product, (2) expected insurer expense levels, (3) volume of business produced and (4) policy benefit variations.

If the business is reinsured, other determining factors would include the evaluation of the financial strength of the reinsurer, the structure of the reinsurance arrangements, and the treatment of the reinsurance program in the financial statements of the direct writer.

Although rather brief, this presentation was outstanding, and it resulted in one of my major take-away observations for anyone who might ever need assistance in explaining ... if challenged by the IRS on audit ... how commission rates are set and why they may vary widely. That major observation is to look to Mr. Fagg to assist in justifying or making a case for changing commissions based on changing business conditions.

"IRS Notice 2002-70 ... Past, Present and Past Again" ... James B. Smith. Jim Smith is the CEO of Southwest Re and his "presentation" was basically a "nonevent," rendered moot by the IRS' action in removing PORCs from its list of Listed Transactions.

Mr. Smith merrily related how happy he was to not have much to say. He asked the audience if anyone wanted to hear a discourse on the now defunct tax return disclosures and Forms 8886. Not much, make that, no interest was expressed. After three encores and ovations, Mr. Smith gracefully ceded the podium to the next speaker.

"Update on IRS Positions and Notices" ... Terri Merriam. Ms. Merriam started out with a detailed discussion of IRS Notice 2004-65 by which the IRS removed PORC transactions as "Listed" tax shelter transactions. She attributed this action by the IRS, in part, to the changes made by the Pension Funding Equity Act of 2004 that now significantly tighten the rules for eligibility for exemption from income tax under Section 501(c)(15). She also discussed the IRS' continuing focus on tax shelters as evidenced by the newly-enacted and considerably more severe *failure to disclose* penalties which are part of the American Jobs Creation Act of 2004.

The second part of her presentation dealt with current IRS examination audit issues. Here Ms. Merriam identified four issues: (1) understated commissions/oversubmits, (2) overstated premiums, (3) shareholder loans that are not at "arm's length" and (4) overstating reserves, which, in turn, defer the tax event.

Ms. Merriam's materials included a Form 4564, *Information Document Request (IDR),* which the IRS uses for PORC taxpayers. Interestingly, one of the items requested (#9) is a "diagram of ownership." Here is how the IRS expressed its request: "...Please provide a schematic diagram of all entities, foreign and domestic, in which [the taxpayer] held an ownership interest, legal or beneficial, at any time during the tax year(s) ending December 31, 2001. This diagram should include partnerships, joint ventures and trusts as well as corporate entities, including their foreign branches, and any other type of entity provided for by foreign laws, in which was held a direct or indirect, legal or beneficial, ownership interest."

The IDR request in connection with the diagram of ownership continues as follows: "(a) Indicate the percentage of ownership interest in each entity, (b) indicate the country in which the entity was created or →

organized, (c) indicate the country where the entity operates, (d) indicate whether the entity was formed for a particular purpose and what assets are held by the entity, (e) indicate any changes in ownership occurring during the tax year(s) ending December 31, 2001 ... Provide detailed information regarding any corporation or entities which [the taxpayer] owned during the calendar year ending December 31, 2001 but which it no longer owned for [the taxpayer's] calendar year ending December 31, 2002. Include the tax treatment of each change."

And, that's not all! The IDR also requested (1) all formation documents, (2) all tax returns, (3) all corporate books, (4) all bank statements and/or financial documents, (5) all prior Revenue Agent Reports, (6) all loan agreements, (7) all transfers of funds, (8) all consulting-type fees, (9) descriptions of all transactions, (10) a list of all clients, (11) all insurance policies, (12) all documents concerning capitalization, (13) all reports and (4) a listing of all assets, etc.

As this IDR shows, any PORC selected for audit by the IRS has been, or will be, subject to very close scrutiny.

"ARC Capitalization ... What's It for? ... Andrew J. Weill. Mr. Weill made the case for discontinuing the use of the pejorative "PORC" and replacing it with the term "ARC" (Associated Reinsurance Company). In his brief, thought-provoking, spirited presentation, Mr. Weill also discussed matters of capitalization, undercapitalization and what or which parties really need to be protected by adequate capitalization. He referred to undercapitalization as "non-issue" and discussed *Gulf Oil v. Comm.*, PLR 8111087 and Revenue Ruling 2002-90.

Mr. Weill also made reference to several taxpayer-favorable TAMs that were recently issued by the IRS National Office. These are expected to become available under the FOIA early next year. Apparently, these TAMs (there are 4 of them) have already been issued by the IRS to the taxpayers, and they result in what are basically no-change audit results.

In some of these exams, the IRS took the position that the capitalization was inadequate, although those issues will not be discussed in the TAMs. The IRS field agents initially argued that there was no risk distribution in the underlying contracts / arrangements. However, ultimately, the PORC arrangements were held not to be shams ala *William Wright*. Instead, the IRS National Office held them to be eligible for Section 501(c)(15) tax exemption.

Good news, for those PORCs, indeed!

As mentioned previously, Mr. Weill would be a good person to contact if the IRS were challenging your PORC in terms of the adequacy of its capitalization.

"Regulatory Environment Impacting Risk Participation Structures" ... Gregory L. Petrowski. In this presentation, Mr. Petrowski reviewed Internal Revenue Code Section 501(c)(15) and Section 831(b). He then reviewed to the provisions of the Pension Funding Equity Act of 2004 that relate to PORCs. His materials on the PFEA of 2004 are included in the September 2004 issue of the *Dealer Tax Watch*, pages 21-25.

"Service Contracts: State Regulatory Trends" ... Timothy J. Meenan. Mr. Meenan's second presentation was a review of recent legislative events and some previews of what may be coming in the next year or so. He identified California, Florida, New Hampshire, Alaska and Ohio as the key legislative states for the year 2004. He also identified Minnesota, New Jersey, Oklahoma and Florida as the key legislative states for 2005 .

Basically, you can call Mr. Meenan (850-681-6710) for an update on what has happened or what may be happening in your state. He has been working on a state-by-state basis with Regulatory agencies and state legislative bodies to try to obtain more uniform, user-friendly and industry-friendly regulatory requirements and interpretations.

"Other Federal Regulatory Environment Impacting Risk Participation Structures" ... Mark E. Anderson. In this discussion, Mark Anderson discussed Revenue Ruling 2001-31 in which the IRS abandoned its "economic family" argument or theory, and various other TAMs, PLRs and Announcements, including Notice 2004-61 and Revenue Procedure 2003-47, that not had been discussed elsewhere during the Conference.

Other conference presentations. Other presentations included discussions by Greg Petrowski on various refinements on Section 953(d) election and on domiciles other than Bermuda.

CONCLUSION

If you have clients who are interested in PORCs or who are already involved with PORC structures, I strongly recommend that you put this Conference on your schedule for next year.

NEW ACCOUNTING RULES FOR AUTOMOTIVE FINANCE COMPANIES

By: Kenneth B. Shilson, CPA

BHPH REPORTING SOP 03-3

The American Institute of Certified Public Accountants (AICPA) recently issued Statement of Position (SOP) 03-3 which provides important new guidance on the proper accounting for loans (including used automobile retail sales contracts) acquired by purchase and in other transfers.

This new SOP, issued earlier this year, must be applied prospectively by finance companies (both related and unrelated) in reporting financial results for years beginning ***after*** December 15, 2004. However, earlier adoption is strongly encouraged, so owners must deal with these new requirements now. The issuance of this new accounting guidance is part of a continuing effort by the AICPA to promote more consistency in reporting the results attributable to loan portfolios (and individual loans) which are acquired by purchase and via other types of transfers.

The new accounting guidance applies when loans are acquired by either a related finance company (from its affiliated dealership) or from unrelated dealer operators. However, the SOP does not apply if the loans are originated directly by the finance company itself (which is not a common practice in the Buy Here, Pay Here industry, anyway).

In general, the new SOP addresses how finance companies should account for the differences between contractual cash flows actually collected and those expected at the time of acquisition; when such differences are primarily attributable in whole, or in part, to the credit quality of the acquired loans.

It is very important to realize that for finance companies with a related dealership affiliate, these new rules only affect reported financial results when the finance company reports separately from its captive dealership. This occurs because the transactions addressed by the new SOP, (like purchase discount and related income) are eliminated when reporting the combined results of the finance company and the related dealership together.

These new accounting rules are for financial reporting purposes only and not for federal income tax. Therefore, finance companies need not change the way they have been reporting their discount for tax purposes.

The new SOP also establishes some new terminology such as "accretable yield" and "nonaccretable differences" and provides computational guidance on how to determine both.

Although the new pronouncement is very technical, the guidance generally precludes accretion (or recognition) of purchase discount income when actual collections equal those which were expected when the acquisition of the loan portfolio (or individual loans) was made. Additionally, a loss (provided via a valuation allowance) is required when actual collections are less than those expected at the time of acquisition. Only when actual cash flows exceed those which were expected at the time of acquisition, can the finance company recognize such differences into income subject to certain limitations. These new accounting rules will likely differ from the present accounting practices followed by many sub-prime auto finance companies, so owners should consult with their C.P.A. or financial advisor and evaluate how the new rules will effect their reported net income and financial results.

In addition to the different accounting treatment described above, the ability to apply these new rules seems largely dependent on having reasonable expectations about the timing and amount of cash flows which can be expected to be collected at the time the loans are acquired. Therefore, finance companies will need to perform more extensive financial analysis prior to acquiring the loans and more accurately predict portfolio losses which will be expected over the remaining life of the portfolio. The use of "static pool" loss analysis to project these losses now seems more necessary than ever, in these circumstances.

When finance company owners consult with their accountants to better understand the new SOP described above, they should also become familiar with a new audit guide for finance companies which the AICPA issued in January 2004. This new guide outlines the appropriate procedures auditors must now follow in performing attest engagements, like audits and reviews of finance company financial statements. Owners of finance companies should familiarize themselves with the accounting policies and practices described in the new audit guide, because they will be expected to apply them properly when reporting income, determining an appropriate allowance for credit losses, and in implementing credit underwriting procedures.

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Before owners conclude that the above sounds like something only an accountant should care about, they should remember that these new accounting rules will significantly impact the financial statements which they provide to their bankers, investors and other third parties who utilize them to evaluate their company's performance.

Therefore, it would seem that the Buy Here, Pay Here segment of the automotive industry which depends on these financial statements to obtain the capital needed to fund their operations, must quickly understand how both of these new technical pronouncements will impact their financial statements before this year ends. The AICPA believes that providing guidance like this will result in more consistency in financial reporting which also increases the comparability and understanding by those who use them. Users of the financial statements, like bankers and investors, must now become familiar with these new rules before they receive the financial statements which will be provided to them later this year. Therefore, it appears that both of these new pronouncements offer a little something for everyone!

10 WAYS BHPH DEALERS CAN IMPROVE COLLECTIONS

1. Controlling bad debt losses is a key to success in the BHPH business because approximately 30% of all principal originated ended up being written-off as uncollectible. This requires an understanding of why losses occur by analyzing them.
2. Losses can be reduced by increasing recoveries. Dealers who have established recovery departments are now reducing bad debt losses by approximately 25%.
3. Prudent, consistent underwriting is needed to reduce overall losses. Dealers must identify key "drivers" which affect collection performance like markup, down payment, payment amount, and loan term. They should accumulate information about how these "drivers" can be used to improve results.
4. Markup seems to be the most important individual "driver." Losses appear to double when vehicle markup exceeds $3,750 in many instances.
5. Dealers should analyze their credit losses even if they are also using credit-scoring systems. Such analysis helps dealers build a better scoring model.
6. Higher down payments do not assure collection performance. Over 25% of the losses we saw occurred on deals where customers made down payments of $1,000 or more. Large down payments should make a good deal better, not make the deal.
7. Vehicle mechanical performance is essential in collecting sub-prime notes. If the car stops running, the customer stops paying. More than 30% of the losses we studied came from vehicles which had over 100,000 miles when sold. Better cars get better customers.
8. Vehicle cost does affect collection performance. Cars costing between $3,000-$5,000 (including reconditioning) had the best overall default statistics.
9. The collectibility of add-on products like GAP (Guaranteed Asset Protection), A&H (Accident & Health), and Credit Life should be tracked to evaluate how such products affect collectibility. The use of extended service contracts definitely seems to improve collection performance, particularly when a 12 month/12,000 mile contract is used.
10. Dealer education is very important in improving collection performance. Knowing what works and what does not helps dealers avoid costly mistakes via trial and error. A good collection department represents 70% of a successful buy-here, pay-here operation.

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SCHEDULE M-3 (Form 1120) Department of the Treasury Internal Revenue Service	**Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More** ▶ Attach to Form 1120. ▶ See separate instructions.	OMB No. 1545-0123 **2004**

Name of corporation (common parent, if consolidated return) | Employer identification number

Part I **Financial Information and Net Income (Loss) Reconciliation**

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☐ **No.** Go to line 1b.

b Did the corporation prepare a certified audited income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☐ **No.** Go to line 1c.

c Did the corporation prepare an income statement for that period?
☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 10 and enter the corporation's net income (loss) per its books and records on line 11.

2a Enter the income statement period: Beginning ___/___/___ Ending ___/___/___

b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceeding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

3a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☐ **No.** If "No," go to line 4.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . . ☐☐☐☐☐

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . . . ☐☐☐☐☐☐☐☐☐

4	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4	
5a	Net income from nonincludible foreign entities (attach schedule)	5a	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) . .	5b	
6a	Net income from nonincludible U.S. entities (attach schedule)	6a	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount) . . .	6b	
7a	Net income of other includible corporations (attach schedule)	7a	
b	Net loss of other includible corporations (attach schedule)	7b	( )
8	Adjustment to eliminations of transactions between includible corporations and nonincludible entities (attach schedule)	8	
9	Adjustment to reconcile income statement period to tax year (attach schedule)	9	
10	Other adjustments to reconcile to amount on line 11 (attach schedule)	10	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Forms 1120 and 1120-A. Cat. No. 37961C **Schedule M-3 (Form 1120) 2004**

Name of corporation (common parent, if consolidated return)	Employer identification number
Name of subsidiary (if consolidated return)	Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return

	Income (Loss) Items	(a) Income (Loss) per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return (optional)
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation				
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships (attach schedule)				
10	Income (loss) from foreign partnerships (attach schedule)				
11	Income (loss) from other pass-through entities (attach schedule)				
12	Items relating to reportable transactions (attach details)				
13	Interest income				
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss)				
17	Inventory valuation adjustments				
18	Sale versus lease (for sellers and/or lessors)				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23a	Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and flow-through entities				
23b	Gross capital gains from Schedule D, excluding amounts from flow-through entities				
23c	Gross capital losses from Schedule D, excluding amounts from flow-through entities, abandonment losses, and worthless stock losses				
23d	Net gain/loss reported on Form 4797, line 17, excluding amounts from flow-through entities, abandonment losses, and worthless stock losses				
23e	Abandonment losses				
23f	Worthless stock losses (attach details)				
23g	Other gain/loss on disposition of assets other than inventory				
24	Disallowed capital loss in excess of capital gains				
25	Utilization of capital loss carryforward				
26	Other income (loss) items with differences (attach schedule)				
27	**Total income (loss) items.** Combine lines 1 through 26				
28	**Total expense/deduction items** (from Part III, line 36)				
29	Other income (loss) and expense/deduction items with no differences				
30	**Reconciliation totals.** Combine lines 27 through 29				

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Name of corporation (common parent, if consolidated return)	Employer identification number
Name of subsidiary (if consolidated return)	Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items

	Expense/Deduction Items	(a) Expense per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return (optional)
1	U.S. current income tax expense				
2	U.S. deferred income tax expense				
3	State and local current income tax expense				
4	State and local deferred income tax expense				
5	Foreign current income tax expense (other than foreign withholding taxes)				
6	Foreign deferred income tax expense				
7	Foreign withholding taxes				
8	Incentive stock options				
9	Nonqualified stock options				
10	Other equity-based compensation				
11	Meals and entertainment				
12	Fines and penalties				
13	Punitive damages				
14	Parachute payments				
15	Compensation with section 162(m) limitation				
16	Pension and profit-sharing				
17	Other post-retirement benefits				
18	Deferred compensation				
19	Charitable contribution of cash and tangible property				
20	Charitable contribution of intangible property				
21	Charitable contribution limitation				
22	Charitable contribution carryforward used				
23	Current year acquisition or reorganization investment banking fees				
24	Current year acquisition or reorganization legal and accounting fees				
25	Current year acquisition/reorganization other costs				
26	Amortization/impairment of goodwill				
27	Amortization of acquisition, reorganization, and start-up costs				
28	Other amortization or impairment write-offs				
29	Section 198 environmental remediation costs				
30	Depletion				
31	Depreciation				
32	Bad debt expense				
33	Corporate owned life insurance premiums				
34	Purchase versus lease (for purchasers and/or lessees)				
35	Other expense/deduction items with differences (attach schedule)				
36	**Total expense/deduction items.** Combine lines 1 through 35. Enter here and on Part II, line 28				

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Schedule M-3 (Form 1120) 2004

Cost Seg. At a Glance	COST SEGREGATION STUDIES IRS AUDIT TECHNIQUES GUIDE Page 1 of 4
Overview	• This *Audit Techniques Guide* (*ATG*) is divided into 3 sections ♦ Chapters 1-5 ... Contents are summarized below. ♦ Chapter 6 - Appendix ... Technical discussions and IDR formats ♦ Chapter 7 ... Industry-specific guidance for casinos and restaurants • The *ATG* shows an issuance date of April 30, 2004. It has been developed to assist IRS auditors in reviewing and examining cost segregation studies.
Introduction & Background ***Chapter 1***	• Depreciation issues involving cost segregation studies cross all LMSB industry lines and impact SB/SE taxpayers as well. • The use of cost segregation studies will likely continue to increase. The lack of consistency in cost segregation studies and the absence of bright-line tests for distinguishing property contribute to the difficulties of this issue. • There are no standards regarding the preparation of these studies. Studies vary widely in terms of the methodology, documentation, depth, format, and expertise of the study's preparer. This lack of consistency, coupled with the complexity of the law in this area, often results in an examination that is controversial and burdensome for all parties. • Examiners reviewing cost segregation studies may be able to evaluate a study without assistance. However, other studies may require specialists with expertise, industry experience and specialized training involving Engineers, Computer Audit Specialists and/or Technical Advisors. • Examiners should perform a risk analysis as early as possible to determine the depth of an exam and the possible need for assistance.
Legal Framework ***Chapter 2***	• This chapter reviews the relevant legislative and judicial history of the closely-related areas of depreciation, depreciation recapture, and personal property vs. real property classification and taxpayers' motivations to allocate costs to personal property. • Since neither Sections 167 nor 168 provides a definition of tangible property, it is necessary to look to the Regulations under Section 48 (the old investment credit rules) for definitions and examples of tangible property. • Technical discussions include ♦ Bulletin F ♦ Component depreciation ♦ Asset Depreciation Range (ADR) ♦ Accelerated Cost Recovery System (ACRS) ♦ Modified Accelerated Cost Recovery System (MACRS) ♦ Expensing provisions & bonus depreciation - IRC Secs 168, 179 and 1400L ♦ What is tangible personal property? ♦ Investment tax credit - IRC Section 48 ♦ Tangible personal property ♦ Buildings and structural components ♦ Section 1245 & Section 1250 property ... Recapture of deprecation deductions as ordinary income on the sale or disposition of the depreciable property. ♦ Functional use test ♦ Inherent permanency test and factors in *Whiteco Industries, Inc. v. Comm.* ♦ Repeal of the investment tax credit and repeal of component depreciation ♦ *Hospital Corporation of America (HCA) v. Comm.* ♦ Action on Decision (AOD CC-1999-008) ♦ Chief Counsel Guidance - Advice Memorandum dated May 28, 1999 ♦ Lack of bright-line tests for distinguishing Sec. 1245 & Sec. 1250 property *(Continued on Page 2 of 4)*

Cost Seg. At a Glance	**COST SEGREGATION STUDIES** **IRS AUDIT TECHNIQUES GUIDE**
Legal Framework **(Continued)** ***Chapter 2***	• Early administrative rulings relating to investment tax credit issues focused on a "*functional use*" test which evaluated the purpose for which the asset was used in order to determine whether it could be classified as Sec. 1245 property. • Following several conflicting court decisions, which addressed the inherent permanency of particular assets, the IRS shifted its focus of attention from the "*functional use*" test to an evaluation of factors indicating inherent permanency. • In *Hospital Corporation of America v. Comm.* (109 T.C. 21 (1997)) ... *HCA*, the Court determined that Section 168(f)(1), which prohibits component depreciation, applied only to Section 1250 property. • Thus, *HCA* provides legal support for the use of cost segregation studies by effectively reinstating a form of component depreciation for certain building support systems, such as the electrical and plumbing systems that directly serve tangible personal property. Cost segregation methodologies previously used to allocate the cost of a building between structural components and investment tax credit property can now be used for Section 1245 and for Section 1250 property. • "...the classification of assets is a factually intensive determination. Based on *HCA*, the recent AOD and the 1999 Chief Counsel Advice Memorandum, the use of cost segregation studies is expected to increase."
Six Common Methodologies For Cost Segregation Studies ***Chapter 3***	• ***Detailed engineering approach from actual cost records*** ... "detailed cost approach" uses costs from construction and contemporaneous accounting records. In general, it is the most methodical and accurate approach, relying on solid documentation and minimal estimation. It generally provides the most accurate cost allocations. • ***Detailed engineering cost estimate approach*** ... "detailed estimate approach" uses estimates of cost, rather than *actual* costs. This approach is often used when cost records are not available or for an acquisition when the purchase price must be allocated. If detailed cost estimates are prepared by qualified individuals, and the estimates are reconciled to actual costs, then reasonably accurate cost allocations are possible. • ***Survey or letter approach*** ... This is an alternative method for estimating costs in which contractors and subcontractors are contacted via a survey or letter to provide information on the cost of specific assets that they installed on a particular project. These costs are then used in one of the engineering approaches or in a "residual estimation" approach. • ***Residual estimation approach*** ... This is an abbreviated method in which only short-lived asset costs (such as 5-year or 7-year property) are determined. These short-lived asset costs are added together and the total cost is then subtracted from the total project cost. The remaining or "residual" cost is then assigned to the building and/or to other long-lived assets. This method generally does not reconcile total project costs. • ***Sampling or modeling approach*** ... This method uses a created model or template to analyze multiple facilities that are nearly identical in construction, appearance and use. Often used for fast food chains and retail outlets to minimize resources and costs compared to conducting studies on all properties. • ***"Rule of thumb" approach*** ... This method uses little or no documentation and is based upon a preparer's "experience" in a particular industry. These studies should be approached with caution since they usually lack sufficient documentation to support allocations of project costs. *(Continued on Page 3 of 4)*

COST SEGREGATION STUDIES
IRS AUDIT TECHNIQUES GUIDE

Six Common Methodologies For Cost Segregation Studies (Continued) ***Chapter 3***	• Neither the IRS nor any group or association of practitioners has established any requirements or standards for the preparation of cost segregation studies. • The courts have addressed component depreciation, but they have not specifically addressed the methodologies that may be used in preparing these studies. • Certain approaches ... such as studies based on actual costs or on proper estimation techniques ... produce more accurate and reliable allocations. • Despite the use of one or more of these more reliable methods, issues may still arise with respect to the proper classification of Section 1245 property. • The IRS does not "require" the use of any specific methodology.
What Is the IRS Looking for? **What Does It Take to Satisfy the IRS?** **It Takes a *"QUALITY"* Report** **Principal Elements & Report Contents** ***Chapter 4***	• A ***quality*** cost segregation study will be accurate and well-documented with regard to the following: ♦ Classification of assets into property classes ... land, land improvements, building, equipment, furniture, and fixtures, ♦ Explanation of the rationale, including legal citations, for classifying assets as either Section 1245 or Section 1250 property, and ♦ Substantiation of the cost basis of each asset and reconciliation of the total allocated costs to total actual costs. • ***13 Principal elements*** of a ***quality*** cost segregation study ♦ Preparation by an individual with expertise and experience ♦ Detailed description of the methodology ♦ Use of appropriate documentation, including ▪ Explanation of the treatment of land and land development costs ▪ Site visit to gain better perspective and understanding of the design and purpose of the project, as well as the use of specific assets. Land and site preparation costs are also documented by before-and-after photographs. ▪ Review of all pertinent construction documentation, blueprints, construction drawings and contract payments ▪ Review of the general contractor's Applications for Payment (AIA forms) ♦ Interviews conducted with appropriate parties ♦ Use of a common nomenclature ♦ Use of a standard numbering system ♦ Explanation of the legal analysis, including relevant citations to support Section 1245 property classifications. Also, if applicable, it includes a reconciliation of the classification treatment with possibly conflicting judicial decisions. ♦ Determination of unit costs and engineering "take-offs" ♦ Organization of assets into lists or groups ♦ Reconciliation of total allocated costs to total actual costs ♦ Explanation of the treatment of indirect costs ♦ Identification and listing of Section 1245 property ♦ Consideration of related aspects, such as elements of cost capitalization (Section 263A), changes in accounting method and sampling techniques • ***Report format / contents*** ... The following should be included in the Report: ♦ Summary letter/Executive summary ♦ Narrative report ♦ Schedules of assets, direct and indirect costs, and property units and costs ♦ Engineering procedures ♦ Statement of assumptions and limiting conditions ♦ Certificate ♦ Exhibits

COST SEGREGATION STUDIES
IRS AUDIT TECHNIQUES GUIDE

Cost Seg. At a Glance	
Suggested Audit Steps for Agents to Follow in the Review & Examination of a Cost Segregation Study *Chapter 5*	• Review a copy of the cost segregation study and report • Verify the cost basis and reconcile depreciation records • Conduct a risk analysis to evaluate audit potential • Interview the preparer • Inspect the property • Review and verify the classes of property • Perform a cost analysis ♦ Newly-constructed property ♦ Existing property • Review sampling techniques if sampling techniques were used • Consider IRC Section 263A ♦ All direct costs and certain indirect costs properly allocable to real property and to tangible personal property (produced by the taxpayer) must be capitalized ♦ In addition, Section 263A(f) requires the capitalization of certain ***interest expenses***, and changes to real and tangible personal property costs may impact the amount of capitalized interest. • Consider possible change in accounting method issues • Research the law, the Regulations and appropriate rulings • Summarize the findings and discuss the challenged assets with the taxpayer • Prepare the final report or the Notice of Proposed Adjustments
Appendix **Selected Technical Discussions** *Chapter 6*	• Uniform Capitalization • Change in Accounting Method ... including table of relevant Revenue Procedures • Depreciation Overview • Relevant Court Cases ... including tables by case citations, case names and CSI Master Format Division • Statistical Sampling ... text of *Field Directive on the Use of Estimates from Probability Samples* dated March 14, 2002 issued to provide field guidance on statistical sampling • Construction Process ... contains detailed discussion of 6 distinct construction stages - concept, contracts and bid documents, bidding, construction (field work), construction payments and completion (readying the building for occupancy). • Information Document Requests ... contains sample IDR language suggested to ♦ Identify the participants and their respective roles in the preparation of the cost segregation study / analysis ♦ Identify the specific properties involved ♦ Locate the source of property blueprints, drawings and other information ♦ Obtain a copy of the cost segregation study ♦ Secure a copy of the study computations and formulae ♦ Ask specific questions about segregated properties ♦ Request specific items and amounts in question
Industry-Specific Guidance *Chapter 7*	• ***Casinos*** ... *Field Directive on Class Assets & Deprecation for Casino Construction Costs*, March 7, 2003, memorandum for Industry Directors, LMSB ... Provides guidance in connection with land-based hotel/casino complexes. • ***Restaurants*** ... *Field Directive on the Planning & Examination of Cost Segregation Issues in the Restaurant Industry*, December 8, 2003, memorandum for Industry Directors, LMSB ... Contains a detailed matrix recommending the categorization and general depreciation system recovery period of various restaurant assets falling within both Sections 1245 and 1250.

Dealer Tax Watch Practice Guide	**DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST** Page 1 of 9	Yes	No	Comments
Dealership Summary	***Dealership Name:*** __________ Corporation: ___ C Corp. ___ S Corp. ___ Holding Company ___ Other __________ Other: ___ LLC ___ Partnership ___ LLP ___ Other __________ # of Franchises: _____ Names: __________ # of Locations: _____ City/State(s): __________ Year of Formation: __________ Name(s) of Dealer Principal(s): __________ How long has current Dealer Principal been running the dealership? _____ Years Shareholders (other than Dealer Principal) and percentage of ownership: __________ Total assets per balance sheet: Beginning of year $__________ End of year $__________ Year of last IRS audit: __________. Describe major IRS adjustments: __________			
Cash Transactions Reporting	1. Does the dealership have adequate procedures in place to • Comply with Form 8300 *Cash Reporting Requirements*? • Prevent the possibility of money laundering transactions from occurring within the dealership? 2. To what extent, if any, have you reviewed or sampled the Forms 8300 that have been filed? 3. When is the last time all individuals handling cash watched the NADA tape on cash reporting / Form 8300 filing requirements? • Currently, are there any individuals who should have viewed this tape but have not yet done so?			
Inventories, Proper Recording At Cost	1. ***Trade discounts*** ... The correct treatment for ***trade discounts*** is to reduce inventory cost by the amount of trade discounts. Reg. Sec. 1.471-3(b) and Rev. Rul. 84-41 require that amount of trade discounts not be included in capitalized inventory costs. This means it is mandatory that inventory cost should not include trade discounts, regardless of whether new vehicles are on LIFO or on specific identification. • If this is not being done, has appropriate disclosure of non-compliance with the Code and Regulations been made in the tax return? • Has Form 8275-R *Notice of Inconsistent Treatment* been included in the tax return? 2. ***Planning strategy*** ... For advertising costs and expenses associated with acquisition of inventory, has a comparable change in accounting method been considered to accelerate the deduction for certain advertising (local and regional, but not national) costs and expenses? • If not, why not?			

Dealer Tax Watch Practice Guide	DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST	Yes	No	Comments

New Vehicles

LIFO Matters

Inventories & Operations ...

VSCs

PORCs

1. Is the LIFO (Last-In, First-Out) inventory method used for valuing new vehicles?
   - If not, why not?
   - If yes, is the Alternative LIFO Method for New Vehicles (Rev. Proc. 97-36) being used?
     - ♦ If not, why not?
   - If yes, have any writedowns for demos or other new vehicles been reversed at year-end?
2. Is a copy of LIFO election form, Form 970, included in the permanent file?
3. Are copies of all Forms 3115 related to any LIFO changes included in the permanent file?
4. Has the projected change in the LIFO reserve been recorded in
   - The 12th and in the 13th (if any) financial statement sent to the manufacturer at year-end?
   - ***All other*** year-end financial statements issued to banks, other creditors and shareholders?
5. To assure the correct calculation of the LIFO reserve, have the amounts of the LIFO reserves at the beginning of the year and at the end of the year been reconciled to show how much each years' layer (expressed in base dollars) is contributing to the amount of the LIFO reserve?
6. If a projection of the current year's change in the LIFO reserve was made, has the projected change amount been reconciled to the actual (finalized) computation of the L/R change?
7. Did the dealership pay the conformity "settlement" payments required by Rev. Proc. 97-44?
   - If not, why not?
   - Are you satisfied that no financial statement conformity violations have ever occurred?
8. Has the dealership changed from C status to S status while on LIFO?
   - If yes, was the appropriate tax paid and the tax basis of the LIFO inventory stepped-up as of the first day of the first S year in accordance with Rev. Proc. 94-61?
   - Was the LIFO election continued using the *special collapsed layer* calculation for all pre-S years?
9. ***Vehicle Service Contracts (VSCs).***
   - In connection with its sale of new vehicles, does the dealership sell service contracts?
   - If so, how is the dealership accounting for these service contract sales?
   - Has the Service Warranty Income (SWIM) Method been elected?
   - If so, are the SWIM computations updated annually, as required?
   - Have you reviewed the *Checklist for VSC Issues & Problem Areas* in the September, 1999 *Dealer Tax Watch* (pages 14-15)?
10. In connection with its sale of new vehicles, does the dealership sell GAP (Guaranteed Asset Protection), A&H (Accident & Health) or credit life or other insurance?
    - If not, why not?
    - ***Planning strategies*** ... If yes, is the dealership using a Producer Owned Reinsurance Company (PORC) type arrangement? Where is the PORC domiciled? How are commissions (front and retro, if any) computed?
    - Considering changes made by the Pension Funding Equity Act (PETA) in 2004,
      - ♦ Has the PORC made an election under Section 831(b)?
      - ♦ If the PORC arrangement were previously exempt from income tax under Section 501(c)(15), will it be able to retain its tax-exempt status? (... Very unlikely.)

Dealer Tax Watch Practice Guide	**DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST** Page 3 of 9	*Yes*	*No*	*Comments*
Used Vehicles ***Inventories & Operations***	1. Has the LIFO method been elected for used vehicles? If not, why not? 2. If on LIFO, is the Alternative LIFO Method for Used Vehicles (Rev. Proc. 2001-23) being used? • If not, why not? • If yes, which *Official Guide* is used to compute inflation index? ___________________ 3. If the dealership has not elected LIFO for used vehicles, describe briefly how writedowns are determined at the end of the year. ____ ____ 4. Should the dealership consider filing Form 3115 for a change in accounting method to correct the way it is making its lower-of-cost-or-market determinations? 5. Where (significant) parts and labor costs are capitalized and included in used vehicle costs, does the amount capitalized exclude the gross profit element that is included in the journal entries? 6. ***Planning strategy*** ... Has the dealer become involved with "buy-here, pay-here" operations? • If not, might the dealership benefit from "buy-here, pay-here" operations? • Has consideration been given to setting up a related finance company (RFC)?			
Parts & Accessories ***Inventories & Operations***	1. ***Parts valuation.*** The valuation of the parts inventory is based on the IRS' acceptance of the use of replacement cost in compliance with the requirements of Rev. Proc. 2002-17? ***(Every dealership must satisfy these requirements, regardless of whether it has elected LIFO).*** • Dealer must determine the cost of the parts by reference to ***manufacturers' standard price lists.*** • Dealer must satisfy a ***book conformity requirement*** set forth in the Revenue Procedure. • There should not be any modifications or adjustments to the results obtained once the ending inventory has been tabulated at replacement cost. This means that a dealer is not permitted to apply any modification technique(s) to adjust/reduce the year-end replacement cost valuations (which are generally higher in inflationary periods) to actual cost. Some dealers do this by factoring in turnover ratios, or by applying arbitrary factors, such as a flat 10-20- or 30% discount. 2. Describe briefly how the dealership values its parts inventory. ____ ____ 3. Does your description above satisfy the requirements of Rev. Proc. 2002-17? • If not, why not? • Should the dealership consider filing Form 3115 to correct its accounting method for valuing its parts and accessory inventories? 4. Has consideration been given to electing LIFO for valuing the parts inventory? If not, why not? 5. How often is a physical inventory taken and reconciled to the general ledger? 6. Where (significant) parts and labor costs are capitalized and included in used vehicle costs, does the amount capitalized exclude the gross profit element that is included in the journal entries? 7. ***Planning strategy...*** Should the dealer be more timely in disposing of some of its obsolete parts?			

Dealer Tax Watch Practice Guide	***DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST*** Page 4 of 9	*Yes*	*No*	*Comments*
Sec. 263A Cost Capitalization (UNICAP)	1. Is dealership exempt from the Section 263A cost capitalization rules? • A taxpayer meets the exception to the application of Section 263A if it a retailer of personal property with average annual gross receipts for the last three (3) years of under $10 million. 2. In most dealerships that are not exempt, generally the costs to be capitalized are • Relatively small in amount, • Computed under one of the Simplified Resale Method variations, and • Disclosed in Schedule M-1 or M-3. • Indicate the amount of Sec. 263A costs capitalized for the current year: $__________ 3. Is there a workpaper showing the computation of Section 263A costs being capitalized? • Does it show how off-site storage, purchasing and handling costs have been computed? • Does it show that the dealership is basically a "retail facility?" ... i.e., over 90% sales on site. • Is this treatment consistent with prior years? 4. Are there any Forms 3115 in the file in connection with Section 263A? (There should be.) 5. ***If the dealership is using LIFO,*** are the Section 263A current-year costs to be capitalized computed with reference to the current year LIFO increments? If there is a current-year LIFO decrement, have previously capitalized Sec. 263A costs been properly reduced?			
Fixed Assets ***Buildings, Property & Equipment*** ***Depreciation*** ***Cost Segregation Studies***	1. Has the dealership elected to use the special bonus and accelerated depreciation provisions in connection with fixed asset purchases during the year? If not, why not? Explain. ___________ • If it is not claiming special depreciation amounts, has a proper election not to do so been made? • If the dealership is claiming these special depreciation amounts, do any states where tax returns are filed ***not*** recognize or allow this special depreciation treatment in full? • If the State does not recognize or allow special depreciation deductions, have appropriate adjustments been made on the State income tax return to decrease the depreciation claimed? 2. Has the dealership claimed the maximum allowable Section 179 depreciation deduction? • If yes, does the State recognize or allow the full Section 179 deduction? • If not, have appropriate adjustments been made on the State income tax return? 3. If the dealership is planning to make (significant) fixed asset purchases during the current year, has consideration been given to special bonus and accelerated depreciation provisions in connection with this year's acquisitions? 4. Has the dealership received any payments from the Factory in connection with franchise termination, relocation, realignment, etc., that have been treated as adjustments affecting the basis of fixed assets ... and not as currently taxable income? If so, explain. ________________ 5. ***Planning strategy.*** Cost segregation studies. • Has the dealership recently constructed or purchased facilities within the last 5 or 6 years? • Has (Have) the dealership's construction and/or acquisition costs been reviewed in a ***cost segregation study***? Was this prepared by a qualified professional? • If a cost segregation study has been prepared, is it likely to stand up as a "quality" study as described in the IRS' *Cost Segregation Audit Techniques Guide* (April 2004)?			

Dealer Tax Watch Practice Guide	***DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST*** Page 5 of 9	*Yes*	*No*	*Comments*
Prepaid Expenses	1. Have you reviewed the Regulations (Reg. Sec. 1.263(a)-4(f)(1)), issued December 2003, that now allow the full expensing of prepaid expense-type expenditures where the benefit does not exceed one year ... the "12 months or 1 year" rule? • Will these expenditures be deducted 100% for tax purposes in the current year? • This may result in Schedule M-1 or M-3 treatment for prepaid expense payments because the Factory accounting manual practice generally requires accrual on a month-by-month basis for these less-than-one-year items. • Should Form 3115 be filed for this change in method of treating these prepaid expenses?			
Intangibles, Goodwill, etc.	1. Are any amounts being deducted by the dealership in connection with acquisition/blue sky payments for goodwill? If yes, describe. ____________ • If yes, have the 15-year amortization requirements of Section 197 been complied with? 2. Are any Schedule M-1 or M-3 adjustments required for differences in the financial statement-book-tax return treatment of goodwill? • If yes, describe. ____________ 3. Have the notes to the financial statements been reviewed to see if they contain any matters that are new this year or require special treatment in the tax return or in Schedule M-1 or M-3?			
Other Expenses ***Including Employee Benefits***	1. Has election been made under Section 461(h)(3) to use the recurring item exception method? • If so, in what year was the election made? ________ • Has the dealership engaged in any new activities since making that election? • If so, has recurring item exception treatment been extended to that activity? 2. Are there any deductions in the tax return to which the rules in the Regulations dealing with ***economic performance*** might postpone the deduction to the following year (i.e., payments for professional fees, etc.)? 3. Professional fees, especially legal expenses ... Have all bills been reviewed to see that legal and other fees billed to the corporation for personal expenses have been properly treated? 4. Corporate-owned aircraft ... Does the corporation own an aircraft? • If yes, have any employees, Officers or shareholders used the plane for personal (i.e., non-business) purposes after October 22, 2004? • If yes, have the limitations on the corporation's deduction for expenses related to this use been computed in accordance with the American Jobs Creation Act of 2004? 5. Are any deductions being claimed for split-dollar life insurance arrangements? • Have these deductions been properly computed in accordance with limitations for various pre-January 28, 2002 collateral assignment ***equity, non-equity, endorsement*** and other plans? 6. Has appropriate Schedule M-1 or M-3 treatment been given to non-deductible Officer life insurance premium payments? 7. ***Planning strategy ... Service Technician Accountable Plans for Tools under Sec. 62(c).*** • Has the dealership considered adopting a Section 62(c) accountable plan to reimburse its service technicians for their tools? If yes, when was the plan adopted? If not, why not?			

Dealer Tax Watch Practice Guide	***DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST*** Page 6 of 9	*Yes*	*No*	*Comments*
Possible Unrelated Business Activities	1. Does the tax return contain any deductions for ... Car racing ... Hunting ... Fishing ... Golfing ... Other Sports ... Ranching ... Farming ... Cattle Breeding ... Horse Racing, Breeding and Showing ... Paintings, Fine Arts and/or Antiques ... Collecting ... etc.? 2. Are you satisfied that all deductions for expenses relate to non-hobby loss activities? 3. Have you completed the *Dealer Tax Watch* checklist for *Unrelated Business Expenses* (September 2002, pages 16-17)?			
Demonstrator Vehicles Provided to Employees	1. Are demonstrators made available to qualified full-time sales personnel and other employees? • If yes, has the dealership complied with all of the requirements of Rev. Proc. 2001-56? • Is the *partial exclusion* method being used for full-time salespeople? If not, why not? • Is the *full inclusion* method being used for other employees? If not, why not? 2. Even though a dealership may not be providing demonstrator vehicles to its salespeople, the dealer, members of his/her family and other selected employees may be given vehicles to drive. • If this is the case at this dealership, are all individuals driving these vehicles reporting income in their individual income tax returns from this benefit? • How are the amounts to be reported for the value of this fringe benefit being computed? • Have the amounts to be reported by the individuals been included on their Forms W-2?			
Deductions For Payments To Shareholders ***Constructive Dividend Exposure*** ***Shareholder Loans***	1. Ordinarily, the amount of dealer compensation is thought to "reasonable." Is there anything that causes you to think that the IRS might challenge as "reasonable" the amount of compensation (salary plus bonus) that is being paid to the dealer? • Does the dealer have a signed Compensation Agreement? If so, have you reviewed it? 2. If the entity leases property from an owner or shareholder ... • Is there a lease or other written, formal arrangement? • Is the rent amount reasonable? • Is there constructive dividend exposure? 3. Have you tied-out the payments made by the dealership with the amounts included by the dealer in his/her individual income tax return? If not, why not? (This has preparer penalty aspects.) 4. Is the entity deducting any (other) payments arising from shareholder transactions? • If so, describe. ____________________ 5. Is the dealership paying any payments for any of the dealer's personal, legal or other expenses? • If so, are these amounts treated as additional compensation, as dividends or in some other appropriate manner? 6. Have you reviewed the Practice Guide *Constructive Dividends Come in All Sizes, Shapes & From All Angles, Dealer Tax Watch*, June 2001, pages 22-23? 7. Loans to/from shareholders • Are all transactions arm's-length, secured and current in terms of interest & principal repayments? • Have you completed the *Checklist for Identifying Possible Loan-Constructive Dividend Problem Areas, Dealer Tax Watch*, June 2001, pages 20-21?			

Dealer Tax Watch Practice Guide	DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST Page 7 of 9	Yes	No	Comments
Shareholder Equity	1. Is the corporation required to complete new Schedule M-3? • Businesses filing Form 1120 with more than $10 million in assets at year-end are subject to this requirement. If yes, has Schedule M-3 been properly completed? 2. Are any positions being taken in the tax return, or are any deductions claimed in the tax return such that the IRS might have a basis for asserting penalties against either • Shareholders and/or Officers • Tax return preparers • If so, has the taxpayer been advised of these possibilities and is there documentation in the files to this effect? • Describe. ____________________ 3. ***Retained Earnings ... Accumulated Earnings and Profits.*** • If the dealership is a C Corp., has consideration been given to the distribution of taxable dividends so that the shareholders can benefit from the lower 5%-15% preferential tax rates on qualified dividend income? • Similarly, if the corporation is an S Corporation, are there any pre-S election accumulated earnings and profits from which distributions may be made so that the shareholders can receive comparable treatment? 4. Has the dealership received any payments from the Factory in connection with relocation, franchise realignment, etc.? Have any of these payments been treated as contributions to capital (and not as current income) or otherwise affecting the capital accounts of the dealership? • If so, explain. ____________________ 5. ***Capital Stock Transfers.*** • Have any shares of stock in the corporation (or other units of ownership, if the entity is an LLC) been transferred, sold, exchanged or gifted to others during the year? ♦ What were the circumstances? ♦ Was the disposition to a family member or to an unrelated person? ♦ If the transfer was to facilitate dealership continuity and/or estate planning, was the transfer approved by the Factory, as required by the Franchise Agreement? ♦ How was the value of the shares transferred determined? Who prepared the valuation? • If gifted, will a gift tax return be filed by the donor? Will we prepare or review the gift tax return?			
Alternative Minimum Tax ***Form 4626***	1. Is the dealership subject to the Alternative Minimum Tax or is it exempt from the AMT? • The Alternative Minimum Tax was repealed for ***small corporations*** after 1997 that ... ♦ Have 3-year average annual gross receipts not exceeding $5 million for its first taxable year beginning after 1996, and ♦ Do not have 3-year average annual gross receipts in excess of $7.5 million for any later year. 2. Are separate depreciation computations maintained for AMT purposes? 3. Has the appropriate adjustment for the current-year change in the LIFO reserve been made on the ACE (Adjusted Current Earnings) worksheet that is carried to Form 4626? 4. If multiple corporations are involved, has the allocation of the AMT limitations been reviewed?			

Dealer Tax Watch Practice Guide	***DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST*** Page 8 of 9	*Yes*	*No*	*Comments*
Net Operating Losses	1. If the dealership has incurred significant operating losses, has consideration been given to all of the choices for net operating loss carryback treatment ... 2-year, 3-year and 5-year? • Which carryback period has been selected? ________Why? ______________________ 2. Has Form 4466 been filed for a quick refund of current-year estimated tax deposits?			
Corporate Minutes & Recordkeeping	1. Are the Minutes for this corporation (or other entity) up-to-date? • When were the Minutes last updated? • Are all major business decisions that should be reflected in the Minutes included in them? 2. ***Electronic recordkeeping requirements for dealerships with over $10 million in assets*** • Is the dealership in compliance with Rev. Proc. 98-25 requirements for electronic data storage? • Is the dealership in compliance with Rev. Proc. 97-22 requirements for document imaging? 3. When is the last time the dealership upgraded its computer system? • Did this upgrade involve a change in vendors? • Was any information or files lost when this change occurred? • Is a (major) upgrade in the dealership's accounting system under consideration? 4. ***Record retention*** ... Does the dealership have adequate record retention policies? If not, why not? • Have you reviewed the *NADA Management Guide: Federal Records Retention & Reporting* to see if records are being retained for the appropriate periods of time? 5. What is your assessment of the abilities of current dealership controller/CFO to handle his/her responsibilities? 6. Safeguarding customer information ... *Gramm-Leach-Bliley Act* • Has an employee of the dealership been designated as the dealership's Compliance Officer? • Name of Compliance Officer and date appointed: ______________________ • Have you reviewed *Requirements for Compliance Summary* in the September 2003, *Dealer Tax Watch*, pages 4-5?			
"Retroactive" Tax Planning For Last Year	1. ***Planning strategy*** ... Many changes to more favorable accounting methods may now be made after the end of the year if they are made before the tax return is filed. These changes are made by filing Form 3115 with the tax return and also filing a notification copy of the Form 3115 with the IRS in Washington, D.C. The dealership will receive the benefit of an immediate tax deduction (computed under Section 481(a)) as a result of making these changes. 2. Changes that may be made after year end include • Removal of trade discounts (floorplan assistance payments) from inventory cost • Additional depreciation resulting from cost segregation studies and analyses • Expensing of previously capitalized intangibles which the IRS has now indicated do not have to be capitalized • Accounting accruals for certain prepaid expenses if the benefit does not extend beyond 12 months 3. See appendix of Revenue Procedure 2002-9 and/or Instructions to Form 3115 for a complete list of "automatic approval" changes in accounting method.			

Dealer Tax Watch Practice Guide	***DEALERSHIP TAX RETURN COMPLIANCE & PLANNING OPPORTUNITIES CHECKLIST*** ***Page 9 of 9***	*Yes*	*No*	*Comments*
Other Planning Considerations ***(Not Covered Elsewhere)***	1. Creation of multiple S Corporation groups … with QSSS elections for subsidiaries 2. Is the dealership being taxed as a C Corp.? … Or as an S Corp.? If so, why? • If currently a C corp., has consideration been given to changing from C to S status? ♦ What, if any, are the built-in gains considerations … Sections 1363(d) and 1374? • If currently an S corp., ♦ What is the status of the exposure to Section 1374 built-in gains tax? ♦ Has this been adequately tracked and reported since the year of change to S status? ♦ If the dealership was a C corp. not on LIFO when it elected to change to S, how was any built-in gains tax liability determined for the new vehicle inventories that were not on LIFO? 3. ***Multi-state operations*** • In what states are income tax returns required to be filed? • Are there any allocation of income or deduction issues in connection with these state returns? 4. ***Internet activities*** • If the dealership is involved in any significant internet selling activities, do these give rise to any special Federal or state income tax reporting issues? 5. Does the dealer have a specific and viable succession plan or exit strategy in place? • Describe ______________________________ • Are all of the family members involved fully aware of these plans? • Is a successor dealer named on Paragraph 3rd? • Has this individual been approved by the Factory? 6. Does the dealer have a shareholder purchase agreement in effect? If not, why not? ________ • If there is, is it adequately funded? • If funded by insurance policies purchased in prior years, have these policies been "reproposed" recently to see if the anticipated levels of coverage have actually been realized to-date? Has the investment performance to-date been consistent with the original "assumptions?"			
Action Plan	1. ***Immediate Action Required.*** Are there any areas of ***vulnerability or exposure*** which should be discussed immediately with the dealer/dealership? If so, list them in order of priority below. • ______________________________ • ______________________________ 2. What three major ***planning strategies or opportunities*** has the dealer/dealership not yet implemented or pursued? • ______________________________ • ______________________________ • ______________________________ 3. What timetable have you established for addressing items #1 and #2 above? ______________________________ ______________________ *Preparer's Signature & Date* ______________________ *Reviewer's Signature & Date*			

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income, gift and estate tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $475 plus shipping and handling. Back issues available for $80 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073 or by email to cpawjd@aol.com. © Copyright 2004 Willard J. De Filipps.
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