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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. A LOT HAS BEEN GOING ON & COMING OUT OF THE IRS. The IRS continued its about-face, giving dealer Producer-Owned Reinsurance Companies (PORCs) a clean bill of health in two Letter Rulings. The long-awaited IRS *Auto Dealership Audit Technique Guide* has been made available. And, the Office of the Motor Vehicle Technical Advisor has issued two *Automotive Alerts*.

The NADA Convention came and went. New Schedule M-3, after over a year of gestation, was finalized, and by now, many of you have already dealt with it in your corporate income tax returns. In addition, significant efforts have been going on to get the IRS to ***more realistically*** consider the accountable plan rules in connection with service technician reimbursement arrangements. Read on and read all about it!

#2. TOOL REIMBURSEMENT PLANS ... AN UPDATE. First, let's take accountable plans for service technicians. Our last update on this topic was in the Sept. 2004 *DTW*. As we reported there, the IRS declined to accept a Private Letter Ruling request on this issue, and it seems the whole problem was "kicked upstairs."

I was personally involved in a meeting at the National Office in late 2004 which was supposed to be an opportunity to provide further background information so the IRS could deal with this subject as part of its 2004-05 Priority Guidance Plan. At that meeting, the Service representatives did not seem to be receptive at all to our efforts to try to familiarize them with the nitty-gritty details and the broad scope of the issue. In fact, at least one IRS attendee was downright hostile.

Since "something" relating to "rental plans" had been placed on the IRS' Priority Guidance Plan, at least–or so it would appear–the IRS came under some pressure to do something. According to our information, after our meeting in November, a proposed Revenue Ruling was drafted ... presumably very negative on plans. But, don't jump to any conclusions yet because no one outside the Service has actually seen that draft. And whatever the draft might say now could be changed as it moves up the chain of command in the National Office and Treasury for review.

The IRS mentality toward these plans seems to be overly influenced by obviously abusive cases like *Shotgun Delivery* and a few others (all discussed in previous *DTW* issues.)

WATCHING OUT FOR

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Worse yet, the "inside the beltway, inside the IRS" mentality seems to barely recognize the millions (yes, *millions*) of technicians out there trying to eke out a living to whom and for whom Section 62(c) plans are a legal way to increase their after-tax income. Also, my misgivings about how the IRS has handled PORCs and its related industry ramifications (discussed in Update #3 below) seem to evidence a tendency on the part of the IRS to use a "shoot first and ask questions later" approach when it comes to issuing guidance.

Right now, quite a lot is going on behind the scenes at the IRS, even though there is nothing tangible to report. Attempts are being made to further educate the IRS, despite its well-documented efforts to ignore our attempts to get it to consider these plans as part of its IIR Program. Hopefully, additional efforts will be undertaken to change these results by convincing members of Congress that the IRS has abused its position of authority in dealing with this matter.

On pages 4-5, I've reprinted, with permission from its author, a letter that has received significant circulation on this subject. This letter/memo attempts to preempt the IRS from issuing any so-called Revenue Ruling on this subject before the June 30, 2005 deadline in connection with its Priority Guidance Plan.

In my opinion, it would be a disaster if the IRS were to issue anything in its haste simply to comply with this "deadline" that was mandated when the "rental plan" broader subject was placed on the Priority Guidance List. It seems doubtful that, given the lack of familiarity the IRS has already admitted to in dealing with this issue, that the Service could even come close to properly dealing with this matter in both its technical and broader policy overtones.

I believe that Congress needs to step in firmly and quickly to rein in these IRS martinets. It's time for the leather loafers and wingtips to be told to yield a little ground to the owners of steel-tipped Redwing work boots who can't even get a job if they don't own their own tools and have them at work every day.

#3. IRS TAMs ON PORCS NOW SAY THEY'RE OK. Following right up on my opinion that often the IRS significantly over-reacts before it has enough facts, consider the case of dealer PORCs. In Notice 2002-70, the IRS scared the daylights out of the industry by throwing all PORC arrangements used by auto dealerships (and others) into the sausage grinder and basically *blacklisting* all such arrangements. Then, the IRS decided it should try to get "more" information about the industry.

Note, again, that the IRS was starting out from a position of relative ignorance on the real world activities involved here ... *it just suspected these arrangements might be or could be set up as shams.* Query: Doesn't almost everything fall into that category these days?

Yes, certainly there are some abuses and the article in *Forbes*, or whatever, became the IRS' poster boy for abuse ... like *William Wright* (and *Shotgun Delivery*, in another context). Based on these suspicions, the PORC industry was in a dither for many months, but collected itself and then challenged the IRS as best it could.

Then eventually two things happened. First, in Notice 2004-65, the IRS completely reversed itself. In this Notice, the Service removed PORC equivalents from "listed transaction" status. (For details, see September, 2004 *DTW*, pages 30-31.)

Second, and more recently, the IRS in Technical Advice Memos ruled favorably on two very complex PORC arrangements that it had under audit.

My first point is that here is another instance where the IRS rushed headlong into "the sky is falling" concern and over-reacted to broad industry issues which, at the time, it had somehow stumbled onto. The IRS presumed an entire industry to be guilty until proven innocent (and the possibility of the innocence of the vast majority was completely disregarded until pure industry perseverance resulted in the IRS becoming better "educated" on the issues). When all the dust settled, after several years, hindsight showed ... or, now shows ... that the Service's broad action in the first instance was not justified or warranted.

Is this beginning to sound a little like the accountable plan reimbursement scenario discussed in #2 above?

It's no secret that the IRS is hard-up for resources and personnel, but the recently increasing practice of the IRS issuing blanket edicts damning the tax practices of entire industries before all (or at least a majority) of the facts are understood, ... in my opinion ... ought to require some investigation by the Senate Subcommittee on Taxation and IRS oversight.

Let's get back to the recent TAMs. The two in question are TAM 200453012 (dated Dec. 29, 2004) and TAM 200453013 (dated Oct. 6, 2004). In these, the IRS ruled that the PORC arrangements in which two different auto dealerships were involved were not shams for Federal income tax purposes. In addition, the IRS ruled that the tax benefits previously challenged by the IRS would have/should have been available to the PORCs.

This seems to be a great, glorious victory for the PORC industry. However, different commentators have different points of view on these developments. The IRS now seems to have satisfied itself that it has

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less to fear in connection with these arrangements, but, it still promises to keep a vigilant eye out for various abuses like non-performing shareholder loans that may accompany or grow out of their use.

Terri Harris, the IRS Motor Vehicle Technical Advisor, was quoted as saying, "We wanted a better understanding of these transactions ... Once we were able to investigate, we were comfortable that PORCs were not being used as tax avoidance vehicles." No reflection on Ms. Harris (or the MVTA office), but shouldn't the IRS have "investigated" a little more before taking Draconian action?

Another PORC industry commentator, Steve Mailho, commented on these TAMs ... "Some very heavy lifting was just completed for our Industry. We can now report results of a 1½ year legal effort ... These TAMs are quite significant and have a very positive impact on the automobile aftermarket and Affiliated Reinsurance Companies (ARCs) industry. In the past, there have been impressive and favorable Private Letter Rulings and Revenue Rulings, ***but these TAMs blaze ground that clear the way for acceptance, at the highest level of the IRS, [of] the validity of ARCs!***"

Mr. Mailho added ... "Significantly, the issues of so-called 'dealer-obligor' arrangements coupled with the suitability of granting Tax Exempt status to ARCs were reviewed under a microscope. These TAMs and Notice 2004-65 (where ARCs are no longer Listed Transactions) are not coincidental–authors of both are one in the same. We believe after all the research, the back-and-forth between Taxpayer's counsel and the IRS, plus the several face-to-face conferences in Washington, DC, nationally the IRS now views ARCs as legitimate business entities and not [as] abusive tax shelters.

These TAMs/Letter Rulings are summarized beginning on page 18. Andrew J. Weill, the attorney who represented the taxpayers in both TAMs, has said that these holdings stand for the proposition that the reinsurance concept is valid and that the particular programs under intense scrutiny by the IRS have been vindicated. Mr. Weill and his associate, Craig Gordon, have authored the followup article appearing on page 24.

#4. SCHEDULE M-3 ... IS IT REALLY A PROBLEM FOR DEALERSHIP CPAs? For all corporate tax returns filed on Form 1120 ... as distinguished from S Corporations filing Form 1120S ..., the new Schedule M-3 is now a requirement if total assets on the balance sheet exceed $10 million. The Schedule and Instructions have been finalized and the IRS has a special web page to which it posts Frequently Asked Questions (with Answers).

There's no question that the new Schedule M-3 is going to require a lot more time for many taxpayers. Schedule M-3 will complicate life for consolidated returns and for SEC filers, as well as for companies with international operations, foreign affiliates and a variety of transactions, which in the past have been hidden from the IRS radar screen.

However, it seems that for the typical or straightforward dealership corporate returns, there should not be too many problems or difficulties. Just expect to spend a little more time and to get into a little more detail. But, if anything, ***properly filling out Schedule M-3 may be the best way for the CPA or the dealership to try to assure that an IRS audit does not take place.*** Several IRS representatives, in discussing this Schedule, have said this in so many words.

The final version of M-3 is not significantly different from the mid-summer draft we analyzed in the June 2004 issue of the *Dealer Tax Watch*. Be extra careful in reporting the details on depreciation, bad debts and other reserve account adjustments.

#5. *AUDIT TECHNIQUE GUIDE* FOR AUTO DEALERSHIPS ARRIVES. Early this year, the IRS *New Vehicle Dealership Audit Technique Guide –2004* became available. The previous version was released in 2000 and we critiqued that publication in the Dec. 2000 issue of the *Dealer Tax Watch*.

Beginning on page 7, we've summarized the current *IRS Dealership Audit Guide*, and in some cases, compared it with the prior version.

#6. ELECTRONIC RECORDS RETENTION REQUIREMENTS FOR AUTO DEALERS. In January, the Motor Vehicle Technical Advisor published a special *"Automotive Alert"* on this subject, which comes up in almost every presentation by an IRS speaker at the AICPA dealership conferences. The key is Rev. Proc. 98-25. There's not a whole lot new in this *Automotive Alert*–or anything that we haven't previously covered in the *DTW*. Nevertheless, we've included this *Alert* in full on pages 30-31.

#7. NADA CONVENTION SUMMARY & DEALER CONCERNS. While walking around the Convention Center in New Orleans and visiting a number of booths, I found out a number of interesting things, and summarized a few of them on page 27.

As we've done in the past, included on pages 28-29, for whatever they're worth, are the biggest concerns that dealers of various makes and stripes voiced at this year's convention. Incidentally, the

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IRS UNFAIRLY ATTACKS THE TOOLS INDUSTRY

By Steven J. Mopsick (April 15, 2005)

The IRS is about to publish a position on "accountable plans" for the reimbursement of employee business expenses which distorts the intent of Congress and will adversely affect blue collar workers as well as their employers' bottom line. At risk are several million American craftsmen who are required to provide and maintain their own tools as a condition of employment. They are mechanics in the airline, automotive, diesel and heavy equipment industries, as well as plumbers, roofers, electricians, machinists, and many other tradesmen. While the IRS proposed ruling is aimed at motor vehicle service technicians, the ruling will be a clear "get tough" signal to revenue agents as they audit tool reimbursement arrangements across the board. Once the IRS is finished, the only reimbursement plans left standing will be the simplest "receipts-based" reimbursement plans.

LEGAL BACKGROUND

While there is no exception in the Code from the definition of "wages" for amounts paid by employers to employees for employee business expenses, the Regulations under Section 62 provide that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes.

Whether amounts are paid under an accountable plan is governed by IRC Section 62 which generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee in connection with his performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of IRC Section 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered. Under Section 1.62-2(c)(1) of the Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of IRC Section 62(c) if it meets "the three requirements" set forth in paragraphs (d), (e), and (f) of Treas. Reg. Sec. 1.62-2: business connection, substantiation, and returning amounts in excess of expenses.

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. The Regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes.

The legislative history on Section 62(c) is brief but it is clear that Congress sought in part, to address a potential abuse of the "two percent floor" rule and secondly, to insure that otherwise allowable employee business expenses are deductible above-the-line as reimbursed expenses as long as they are incurred under an arrangement that requires the employee to substantiate the expenses to the person providing the reimbursement. To be deductible above-the-line such expenses either must be actually substantiated, or must be "deemed substantiated" under the rules relating to per diem and other fixed arrangements.

It is also important to note that the addition of Section 62(c) to the Code also had the effect of leveling the playing field between Schedule C self-employed craftsmen who are able to deduct all of their tool expenses, and Form 1040-filing employee craftsmen who cannot because they are not in business for themselves and must satisfy the two percent floor before they can deduct anything at all.

TOOL REIMBURSEMENT PLANS

Under tool reimbursement plans in place today, employers use various methods to determine the amount paid as reimbursement for tools. Under some arrangements, employees are periodically interviewed, often by third party plan administrators, and are required to provide receipts and detailed inventories of their tools. The plan administrator determines through this interview process and through other substantiation, whether an employee's tools expenses had been previously reimbursed by past employers or depreciated by the employee. From this information, a reimbursable basis is determined. An hourly rate may be computed for each employee and adjusted upwards or downwards as the employee disposes of or acquires new tools. Most responsible plans provide that the employee must return to the employer, any amount in excess of the substantiated expenses covered under the arrangement. An employee may be reimbursed up to his basis in his tools. The reimbursements are paid based on the hours worked by the employee.

(Continued)

IRS UNFAIRLY ATTACKS THE TOOLS INDUSTRY

By Steven J. Mopsick (April 15, 2005)

THE IRS ATTACK ON TOOL REIMBURSEMENT PLANS

The IRS fired its first warning shot at tool reimbursement arrangements in July of 2000 when it announced unequivocally that "amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements." Rather than attempt to provide industry guidance on how an employer can meet the accountable plan rules and Regulations, the IRS Coordinated Issue Paper ("CIP") just assumed that the arrangements described above were nothing more than tax avoidance schemes designed to avoid employment and income taxes by disguising wages as reimbursements. Despite the fact that the above-described rate-based reimbursement arrangements are directly correlated with, or based exclusively upon the actual tools expenses paid by the service technician, the CIP, apparently out of ignorance of the industry standards, that tool reimbursements are paid regardless of the actual expenses incurred, and that they have no logical connection thereto.

THE IRS HAS TAKEN INCONSISTENT POSITIONS

What is most troubling about the IRS position is that two years after the publication of the anti-tools CIP, and 180 degrees against its rationale, the IRS published a revenue procedure which generously allowed favorable tools expense reimbursement relief to oil and gas pipeline construction industry rig-welder employees. The Rev. Proc. set out the procedures for substantiation, etc. and simply gave the rig welders a "ball park" figure of $13 per hour as the non-taxable reimbursement amount. Yet the facts in the Rev. Proc. are legally indistinguishable from the tool reimbursement plans described above. In both cases, the tool technicians, and rig welders are employees, and not Schedule C self-employed filers. As a condition of employment, both are required to provide their welding rigs and tools in performing services as employees. Presumably, the rig welders have purchased their rigs prior to performing services for a particular employer and it is also presumed that the rig welders have used these rigs in the performance of services for other employers. This is directly in conflict with the anti-tools plan CIP which takes the rigid position that the "business connection" element of the accountable plans rules is breached if an employee were to be reimbursed for an expense incurred prior to employment.

Notwithstanding the Service's attempt to write the accountable plan rules out of the Code in the anti-tools plan CIP, in the rig welders' Rev. Proc. the Service easily declared a "deemed substantiation" ball park figure of $13.00 per hour as a non-taxable above the line reimbursement for the rig welders' employee business expenses. Query whether the deemed substantiation rule here unfairly rewards employees whose expenses are less than $13.00 per hour and penalizes those who can substantiate expenses in excess of that amount.

THE SERVICE SHOULD DEFER ANY FURTHER PUBLICATION UNTIL AFTER THE NEXT INDUSTRY ISSUE RESOLUTION PROGRAM

On March 7, 2005, the IRS announced a new IIR Program in which business taxpayers were asked to submit issues to the Service in areas where the tax treatment of an item is "uncertain, frequently disputed, or burdensome." The objective of the IIR program is to resolve business tax issues common to significant numbers of taxpayers through new and improved guidance. For each issue selected, an IIR team of IRS and Treasury personnel gather relevant facts from taxpayers or other interested parties affected by the issue. The goal is to recommend guidance to resolve the issue. This benefits both taxpayers and the IRS by saving time and expense that would otherwise be expended on resolving the issue through examinations. The next IRS review of submissions will be after August 31, 2005.

The inconsistency between the IRS position with respect to the rig welders and the tool reimbursement issues discussed above make this issue an obvious candidate for the next IIR program. The IRS should not publish anything further on this issue until such time as the tools industry has an opportunity to show the Service that responsible tool reimbursement programs can meet the three elements of the accountable plan rules.

[Note: Extensive footnote citations to Regulations and other sources appear in the original text, but have been deleted from this reprint.]

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February 7, 2005 issue of *Automotive News* included similar bullet point listings of the highlights from various make meetings. You might also want to track this down and discuss these highlights with you dealers as well.

#8. REDUCING DEALERS' PREMIUMS ON LIFE INSURANCE. One of the more interesting conversations I had at NADA was with an old friend, Tony Freeman. I've heard Tony speak at several dealer-CPA group meetings about his unique dealer services. He brought me up-to-date on some of the significant cost savings he has been able to find for a number of dealers when he reviewed their current life insurance situations. I asked him to share a little bit of this, and his article appears on page 26. You may want to contact Tony to see if he can achieve similar benefits for your clients.

#9. PRACTICE DEVELOPMENT OPPORTUNITY BURIED IN ANOTHER RECENT *AUTOMOTIVE ALERT*? The second *Automotive Alert* recently issued by the Motor Vehicle Technical Advisor's Office (dated December 2004) discussed the modification of the phase-out dates for clean-fuel property and certain qualified electric vehicles. These modifications were made as part of the *Working Families Tax Relief Act of 2004.*

Here's the essence... Basically, there are four vehicle groups that may entitle the purchasers to either income tax deductions or credits. These vehicle groups are *Toyota Prius* (model years 2001-2005), *Honda Insight* (model years 2001-2004), *Honda Civic Hybrid* (model years 2003-2004) and *Ford Escape* (model year 2005). If you want a copy of this *Automotive Alert* to get all the details, including citations to IRS Notices, just request it from the MVTA's Office.

Here's your possible practice opportunity... If your dealership clients have sold any of these vehicles to customers, they should check their records because these customers may not have been aware when they filed their tax returns that they could reduce their Federal income tax liabilities as a result of these provisions. For good PR, the sales managers or sales persons could contact these customers to simply remind them that (a) this opportunity should not have been overlooked when they had their tax returns prepared and/or (b) they could contact you, the CPA, for more information or help in filing amended returns. ***Everybody wins!***

Here's the challenge... Assign somebody in your office to handle this as a project and let me know if this really helped ... or if it's just a crackpot idea.

#10. PASSENGER AUTOMOBILES & SUVs ARE "LIKE-KIND" SEC. 1031 PROPERTY. In LTR 200450005, a leasing company had asked the IRS to clarify the treatment of sport utility vehicles in connection with the deferred like-kind exchange program that it had implemented. The taxpayer had structured its vehicle leasing operations with the intention that when it disposed of a vehicle coming off lease to an unrelated party and when it acquired a vehicle recently leased from a dealer (a replacement vehicle), that these transactions would qualify as like-kind exchanges under Section 1031. There are several other complicated taxpayer-specific particulars involved in this ruling, including "qualified intermediaries," various internal account classifications and master assignments under the Exchange Agreement set up for this purpose.

This LTR analyzed (1) the portion of the Regulations dealing with deferred exchanges (Reg. Sec. 1.1031(k)-1(a)), (2) the safe harbors provided for depreciable properties (Reg. Sec. 1.1031(a)-2) and (3) a case in which the like-kind property standard was interpreted more narrowly where exchanges of personal property were compared with exchanges of real property (*California Federal Life Insurance Co., v. Comm.*, 680 F.2d 85, 87 [9th Circuit, 1982]).

The Ruling concluded that "even within the more restrictive parameters of the like-kind standard as applied to personal property, the ***differences*** between an automobile and a sport utility vehicle ***do not rise to the level of a difference in nature or character, but are merely a difference in grade or quality***. Thus, we conclude that the two are like-kind property."

If you have leasing company clients, you may also be interested in the second issue in this Letter Ruling. In this, the IRS concluded that the deferred like-kind exchange program implemented by the leasing company met the assignment safe harbor and notice requirements in Section 6.02 of Rev. Proc. 2003-39.

#11. SPECIAL TAX BENEFITS FOR SERVICE BAYS ... ? I recently received a call from a reader inquiring whether I had heard anything about a new "tax benefit" floating around that related to dealership service bays. Apparently, one of the large CPA firms has come up with something "quite hush-hush", and it doesn't seem to be directly related to cost segregation study results.

Previous issues of the *Dealer Tax Watch* have discussed whether certain depreciable realty, such as service bays, might qualify for a 15-year useful life and the IRS Proposed Coordinated Issue Paper in

see **DEALER TAX WATCH OUT**, page 32

IRS UPDATES ITS AUDIT TECHNIQUE GUIDE FOR AUTOMOBILE DEALERSHIPS

IRS
ATG

In January, the IRS released its updated *New Vehicle Dealership Audit Technique Guide–2004.* The last revision of the *Dealership Audit Technique Guide (ATG)* in September 2000 was analyzed in the December, 2000 *Dealer Tax Watch.*

This *Guide* is intended to assist examiners in evaluating automobile dealerships. It focuses on franchised new car and light truck dealerships, including discussions of books and records, inventory, service contracts and other issues specific to auto dealerships.

Our review of the *Guide* will involve comparing it with the earlier version since some of the changes are of interest to CPAs who have followed the IRS over a period of time.

Our material consists of an *At a Glance* overview and some more detailed technical materials on certain issues, basically reprinted from the *ATG.*

When we analyzed the last *Audit Technique Guide for Dealerships,* we also reprinted some materials from that *Guide.* Those materials were: (1) *Related Entities Flowchart: An Example,* (2) *PORCs & Captive Transactions Exposure,* (3) *Related Finance Company Checklist,* (4) *When PALs Aren't Friendly ... Section 469 Passive vs. Non-Passive Activity Limitation Issues,* and (5) *IRS Agent Initial Interview: Questions & Concepts.* Although these are all still relevant and unchanged, we have not reproduced them at this time. (See Dec. 2000 *DTW*)

The full text of the *ATG* can be obtained on the internet by going to www.irs.gov and selecting *Businesses* from the "Information for:" section on the left side of the IRS home page. From the *Business* page, select *Corporations* under the "Information for:" section. Items on the *Corporation* page are listed alphabetically with the *ATG* listed under "N" for *New Vehicle Audit Technique Guide.*

BASIC OBSERVATIONS

The current version of the *ATG* is slimmed down from the previous *ATG* which had 19 chapters. Part I of the previous *ATG* contained 5 chapters under the general heading "General Focus & Procedure." These 5 chapters have been condensed to 2 chapters, with the significant elimination in the current *ATG* of all materials and specific references to the (controversial and troublesome) audit concept of *financial status.* This concept relates to how IRS agents should plan their audit procedures based on "a determination of whether what is represented on tax returns as true actually has economic merit and substance."

The IRS Restructuring and Reform Act of 1998 had prohibited the use of *financial status* examination techniques to determine the existence of unreported income unless the IRS had a reasonable indication that there was the likelihood of unreported income.

The fact that all specific name references to this concept have been expunged from the current Audit Technique Guide does not mean that the IRS wants agents to forget about it. In the current *ATG,* one can find many references to the advisability of IRS agents using entity flowcharts and applying all the basic ideas and procedures behind *financial status* ... without calling these techniques by that name and thus avoiding its negative semantic implications.

The single greatest change in the *ATG* appears to be the additional coverage it devotes to vehicle service contracts and the more formalized concern over possible "oversubmit" income diversion.

Several chapters have just been recopied with mere cosmetic changes. These include the chapters on *balance sheet items, inventory* (3 chapters) and *passive and non-passive activity considerations.* The chapters that reflect more substantial updating are those on *extended service contracts, PORCs, Related Finance Companies, advertising associations* and *VEBAs.*

The last chapter in the *ATG* is titled *Other Prevalent Auto Practices,* and it includes several new subjects. Overall, there is not much new technical discussion to be found. For example, the 6-pages devoted to *Service Technician Service Reimbursements* are disappointing. The only thing here is a reprint of the 2000 Coordinated Issue Paper and a few comments on gathering information. Similarly, the 8 pages devoted to *Demonstrator Vehicles* consist of nothing more than a reprint of Revenue Procedure 2001-56 and a few comments on gathering information. See the *At a Glance* and *Chapter Critiques* for further comments.

Every important subject, issue, IRS pronouncement and tax case discussed in the current *Dealership Audit Technique Guide* has been discussed in previous issues of the *Dealer Tax Watch.* You can look up all of these topical and/or case references in the *ATG* by going to our web site, which has the updated Index of Articles for all *DTW* issues through December, 2004 listed in the *Publications* section.

ATG
At a Glance

IRS New Vehicle Dealership Audit Technique Guide (ATG) - 2004

Overview

- The current revision of the IRS *Dealership Audit Technique Guide* (*ATG*) updates the last version that was issued as Training Document 3147-120 dated September, 2000.
- The current edition reduces the content and number of chapters to 14 from 19 previously.
  - The first 6 chapters and Chapter 12 are basically the same material from the previous *ATG.*
  - The other chapters reflect various levels of updating.
- In the *Chapter Contents* box below, those chapters that are significantly updated appear ***bold.****

Chapter Contents

1 ... General Focus, Procedure & Getting Started
2 ... Books & Records
3 ... Balance Sheet
4 ... Inventory
5 ... Computing LIFO: Pre-Revenue Procedure 97-36
6 ... Alternative LIFO for Auto Dealers ... New & Used
7 ... Extended Service Contracts & Aftermarket Products *
8 ... PORC - Producer Owned Reinsurance Companies *
9 ... Advertising Associations *
10 ... Sales of Dealerships *
11 ... Related Finance Companies *
12 ... Passive & Non-Passive Considerations
13 ... VEBAs - Voluntary Employees' Beneficiary Associations *
14 ... Other Prevalent Auto Dealership Issues / Practices *

What's Been Deleted ...

- All references to the term *financial status* in discussing IRS audit techniques.
- Discussion of subprime issue concerning how a dealer should report transfers of subprime finance contracts (retail installment agreements) to ***unrelated*** finance companies.
- Several appendices.

What's New ...

- Major emphasis seems to be placed on Vehicle Service Contract issues (Chapter 7).
- In Chapter 3, extensive discussion of remanufactured cores and Rev. Proc. 2003-20.
  - Query: Is this really that common and worthy of a discussion of approximately 8 pages?
- Verbatim reprints of Rev. Proc. 2001-56 (demonstrator vehicles), Rev. Proc. 2001-23 (Used Vehicle Alternative LIFO Method) and the Coordinated Issue Paper on service technician accountable plans.
- Various chapters indicated above reflect varying degrees of updating and rewriting.
- See selected materials and discussions on Vehicle Service Contracts reprinted from *ATG.*
  - *VSC Audit Technique Flowchart* ... Page 13
  - *VSC Tax Issues* ... Page 14
  - *Audit Techniques* ... Page 15
  - *Oversubmit - Overpayment Programs ... Possible Diversion of Income* ... Page 16-17

What's Already "Out-of-Date"

- Discussion in the *ATG* of Notice 2002-70 and its impact on PORCs.
  - Makes no mention of Notice 2004-65 in which IRS removed dealer PORCs from its list of *Listed Transactions* ... Also, no mention of TAMs 200453012 and ...-013 in which PORCs were held not to be sham arrangements.
- No mention of Schedule M-3, which will/should significantly help agents in evaluating possible audit issues on Forms 1120 filed by dealerships with assets in excess of $10 million.
- No mention of MSSP *Guide* on cost segregation studies.

Room for Improvement?

- No discussion in inventory chapters (LIFO and/or non-LIFO) on the proper treatment of trade discounts, which should be reductions of inventory at cost.
  - However, Chapter 9 (Advertising Associations) includes the following oblique reference ... "As stated earlier, vehicle invoices separately state the advertising expense. If this amount is included as part of Cost of Goods Sold, there should not be a separate expense on the return. ***If a dealership is on the LIFO method, advertising fees are not to be included as part of Cost of Goods Sold.***"
- Chapter 3 (Balance Sheet) should include a reprint of at least one manufacturer's financial statement.

Chapter Critiques	**<u>*IRS New Vehicle Dealership*</u>** **<u>*Audit Technique Guide (ATG) - 2004*</u>** *Page 2 of 5*
Chapter 1 ***General Focus & Getting Started***	• This chapter condenses the first 3 chapters of the previous *ATG*. ◆ Eliminates emphasis on *financial status* and eliminates discussion of *SAINs* (account numbering) • Suggests agents use a search engine to look at a dealership's web site before starting an audit to see if it provides any useful background information. • Emphasizes the idea that a manufacturer's financial statements can be utilized to establish confidence in the taxpayer's books early and quickly in the examination process and suggests that reconciliation of the tax return filed to the mfg's financial statements should be made. • Includes extensive discussion of Rev. Proc. 2002-28, which may be used by smaller dealerships to change to the cash method ... but note, inventory still has to be accounted for. • Concludes with comment, "If this initial analysis does not result in indications of unreported income, the scope of the examination may be limited to technical issues."
Chapter 2 ***Books & Records***	• Substantially the same as the previous *ATG*. • Includes discussion of electronic records requirement for dealer software. • Emphasizes the complexity of dealership accounting procedures and recordkeeping. • Previous *ATG* included the following statement ... "In most audit situations, the taxpayer will set aside a room or 'home' for the examining agent out of the mainstream of the business operations with all of the items requested on the original Information Document Request present until the examination is finished." ◆ This statement does not appear in the current *ATG*. Reading between the lines ... the moral might be "don't make working conditions so comfortable for agents so that they feel like they're 'at home'."
Chapter 3 ***Balance Sheet***	• Again, removal of references to "*financial status* concerns" in previous *ATG* are evident comparative reading with the new *ATG*. • Adds a brief, but specific section on Form 8300 filing requirements and compliance. • Adds a brief section on related party receivables (to be distinguished from shareholder loans) • Adds a lengthy discussion of remanufactured cores and Rev. Proc. 2003-20. • Omits a discussion from previous *ATG* on thin capitalization ... No longer much of an issue? • Includes comment reminding agents to consider Section 469 "recharacterization" of active/passive income in situations where dealership leases the building and land from a shareholder. This is covered specifically in Chapter 12. • Discussion on capital stock / capital account reminds agents to examine gift tax returns, but doesn't mention the fact that changes in shareholdings must be approved by the manufacturer and, therefore, inquiry should always be made about any requests in this regard made to the manufacturer.
Chapter 4 ***Inventory***	• Combines Chapters 6 and 7 in the previous *ATG*. • Includes discussion entitled "LIFO Background" which seems to be of little use. • Omits discussion in previous *ATG* [Chapter 6] on Section 263A Uniform Capitalization Rules. (This discussion may be buried somewhere else, and I may have missed it.)
Chapter 5 ***Computing LIFO***	• This chapter is entitled "Computing LIFO: Pre-Revenue Procedure 97-36." ◆ Chapter heading is a little misleading, because what the chapter really discusses are LIFO issues and procedures to be followed in situations where the dealership has not elected to use either the Alternative LIFO Method or the IPIC Method. A better chapter heading might be "Computing LIFO Other Than by Using Alternative LIFO Rev. Procs." • Discusses LIFO concepts in general, and for one generally unfamiliar, this might be a good starting place (if you're not familiar with the *LIFO Lookout*). • Emphasizes the Service's position that if the Alternative Method has not been elected (for new vehicles), then "under full comparability LIFO when a vehicle cannot be compared to a similarly equipped vehicle in the prior year, beginning and ending cost are the same, resulting in an index of 1.00." • Discusses earliest acquisition and latest acquisition methods for valuing LIFO increments. Uses the reference "hidden reserve" in discussing the differences between these methods. *(Continued)*

Chapter Critiques	**IRS New Vehicle Dealership** **Audit Technique Guide (ATG) - 2004** *Page 3 of 5*
Chapter 5 *(Continued...)* ***Computing LIFO***	• ***Financial Statement Conformity Requirement.*** The *ATG* discusses the LIFO conformity requirement on pages 17-19, mentioning both Rev. Rul. 97-42 and Rev. Proc. 97-44 relief. ◆ Agents are told, "At a minimum, (they should) inquire if the taxpayer elected the above relief. If the taxpayer did not elect the above relief, (the agent should) verify (that) the required 3 payments were made. ◆ If the taxpayer did not elect Rev. Proc. 97-44 relief, the agent is instructed to check to see if the taxpayer is in violation of the LIFO conformity requirements. ◆ Even if a taxpayer did elect relief, they are required to continue to comply with the requirements of the Regulations every year. • ***There is no discussion in the inventory chapters on the proper treatment of trade discounts, nor the ramifications of improper treatment, especially on LIFO taxpayers.***
Chapter 6 ***Safe Harbor Alternative LIFO Methods***	• This chapter consists of 3 discussion sections ◆ Alternative LIFO Method for New Vehicles ... Rev. Proc. 97-36 ◆ Alternative LIFO Method for Used Vehicles ... Rev. Proc. 2001-23 ◆ Information to request when examining Alternative LIFO Methods • Discussions of Rev. Procs. for new and used vehicle Alternative LIFO Methods just restate what the revenue procedures say. There is no discussion of many other real interpretative issues. • IDR (Information Document Request) for Alternative Method LIFO Inventories ◆ Copy of Form 3115, *Application for Change in Accounting Method*, and all attachments ◆ Computation of current index workpapers by pool indicating ▪ Current year's ending inventory schedules ▪ Invoices for all items (vehicles) in current year's ending inventory ▪ Prior year's ending inventory schedules ▪ Invoices for all items (vehicles) in prior year's ending inventory ▪ Applicable price lists for items in existence in the prior year, but not stocked in current year's ending inventory ▪ All schedules that group model lines and compute average base cost at beginning-of-the-year and at the end of the year ◆ Computation of LIFO inventory value workpapers by pool ◆ Rebasing computations by pool ◆ If you changed from the IPIC/BLS method for parts and accessories to the dollar-value, index method, provide workpapers to support computations ◆ If you changed from the IPIC/BLS method for used vehicles to the dollar-value, link-chain method, provide workpapers to support computations
Chapter 7 ***Extended Service Contracts & Aftermarket Products***	• ***This chapter is probably the most significantly updated chapter in the ATG.*** ◆ Many discussions are new and/or significantly expanded. ◆ An audit technique flowchart has been added. ◆ A separate section is devoted to discussing oversubmit - overpayment programs by which dealers might possibly divert income to lower bracket or other tax-favored individuals or entities. ◆ Includes updated discussions of *Rameau Johnson* and *Toyota Town, Inc.* • Previous *ATG* included a separate chapter on "dealer reserve accounts." This material has been downsized in the current *ATG*. • ***Special warning ...*** Any dealerships engaging in oversubmit programs should be aware that this is something that the IRS is now specifically looking for.
Chapter 8 ***PORCs***	• Not surprisingly, this chapter has been significantly rewritten to include a discussion of Notice 2002-70, which placed PORCs on list of transactions that are inherently abusive. • Makes no mention of Notice 2004-65 in which Service removed PORC arrangements from "listed transaction" status. • List of potential PORC audit issues is basically what the IRS was concerned about in the TAMs issued by the Service in late 2004 (i.e., LTR/TAM 200453012 and 200453013). ◆ The taxpayers' PORC arrangements in both TAMs were not found to be shams and were/would have been entitled to favorable tax treatment.

IRS New Vehicle Dealership Audit Technique Guide (ATG) - 2004

Chapter 9 ***Advertising Associations***	• This chapter has been revised and reorganized and should be read carefully. ◆ Discussion of treatment of transactions between dealers and advertising associations in the income tax returns of the dealership members may pinpoint accounting treatments that need to be changed. • ***Unreported income issue identification*** ... The *ATG* states that it common for the association to return excess funds not spent within the calendar year to dealerships, and that this rebate should be reported as income in the dealership's return or offset against the advertising expense. Further discussion indicates that the rebate may be in a variety of forms, each of which should be reported as income. • Other matters involving potential double deductions and the timing of deductions are discussed.
Chapter 10 ***Sales of Dealerships***	• This chapter is comparable to the "Covenants Not to Compete" chapter in the previous *ATG*. • The current chapter drops the old case study and is more logically rearranged. • Discusses tax treatment of goodwill, covenants-not-to-compete and consulting agreements. However, discussions are not in any significant detail, but more in the nature of an "overview."
Chapter 11 ***Related Finance Companies***	• This chapter has been extensively rewritten, and it includes "Journal Entries of a Properly Formed RFC" to assist an auditor in understanding what is happening. • Addresses valuation of receivables - i.e., "discounting transactions." • Includes detailed list of initial interview questions and an "RFC Checksheet."
Chapter 12 ***Passive & Non-Passive Considerations***	• This chapter is basically a repeat of Chapter 17 from the previous *ATG*. It deals with Section 469 passive loss considerations in situations where the dealership is a regular C corporation and is leasing its facilities from the individual dealer. • Where the rent is arm's-length or reasonable, these Section 469 considerations really affect the dealer's individual income tax return, rather than the corporation's tax deduction.
Chapter 13 ***VEBAs***	• This discussion is updated from the previous *ATG*, and is included ... "for agent awareness only." • Apparently, some dealers have adopted VEBA arrangements, and they are rather complex in operation. The *ATG* indicates that the actual examination of a VEBA trust must be handled by an agent from the TEGE (Tax Exempt and Government Entities) division. • Major case citation is *Neonatology Associates, PA, et al. v. Comm.*, 115 T.C. 43 (2000) aff'd 299 F. 3d 221 (3rd Circuit 2002).
Chapter 14 ***Other Prevalent Dealership Issues***	• Chapter divided into 3 sections ◆ Income Issues (pp. 1-12) ◆ Compensation Issues (pp. 12-23) ◆ Other Miscellaneous Issues (pp. 23-30) • New issues/topics added appear in ***bold***.* • Income Issues ◆ ***Service Technician Service Reimbursements (pp. 1-6)**** ▪ This discussion reprints the Coordinated Issue Paper dated July 21, 2000, which concluded that, generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements. ▪ There is no other discussion except for a list of documents to request and a list of audit techniques. ▪ Under the caption "Test Compliance," the *ATG* states, "...Determine if expenses were not substantiated nor excess expenses were returned to the employer within a reasonable amount of time. These unsubstantiated or excess amounts are paid to a non-accountable plan subject to Employment Taxes. The taxpayer (employer/dealership) is liable for the withholding taxes unless the employer can show the employee's related income and employment tax liability has been paid." ◆ ***Manufacturer's Incentive Payments to Vehicle Sales Persons (pp. 6-7)**** ▪ This is covered by Publication 3204 which summarizes the tax treatment for these payments. *(Continued)*

IRS New Vehicle Dealership Audit Technique Guide (ATG) - 2004

Chapter 14
(Continued...)

Other Prevalent Dealership Issues

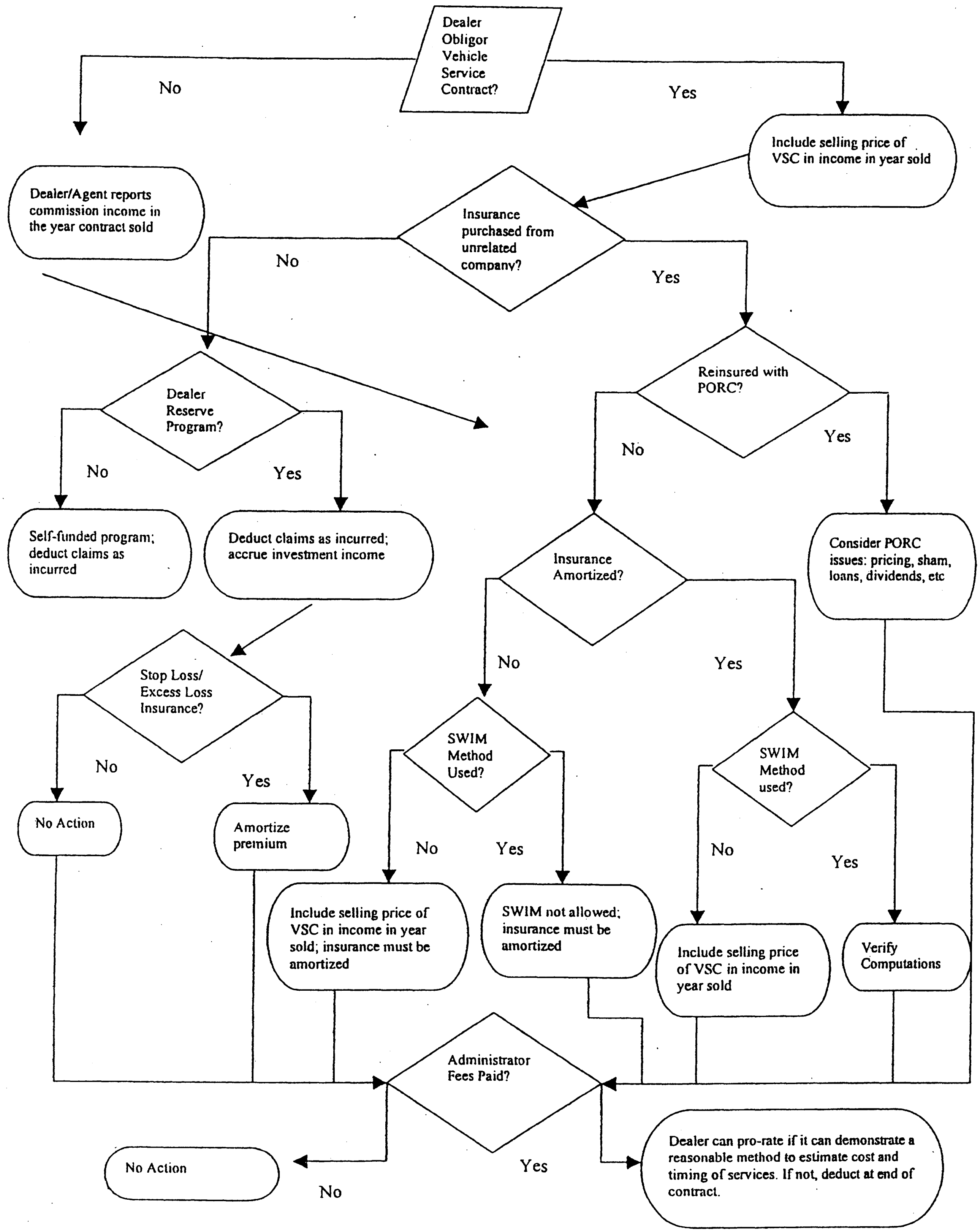
- Income Issues *(Continued...)*
  - ***Shuttling Services & Drivers/Shuttlers (pp. 7-8)****
    - This is basically a worker classification issue involving whether shuttlers (hikers) are to be treated as employees (wages included on Form W-2 and subject to employer-employee payroll taxes) or as independent contractors (compensation payments included in Form 1099 and subject to individual self-employment taxes).
  - Holdback Charges (pp. 8-10)
  - Warranty Advances (pp. 10-11)
  - Finance Reserves (pp. 11-12)
- Compensation Issues
  - ***Auto Demonstrator Vehicles (pp. 12-19)****
    - This section simply reproduces Revenue Procedure 2001-56, which provides safe harbor rules for determining the amount of taxable income to be reported for the personal use of demonstrator vehicles by various dealership employees.
  - Fringe Benefits (pp. 12-20)
  - Working Condition Fringes (p. 20)
  - Unreasonable Compensation ... C-Corporations (pp. 20-23)
    - This section has been significantly downsized from the previous *ATG*. However, the reduction in text is basically the result of dropping the discussion of many cases that are so old as to be irrelevant citations in any current compensation issue with the Service.
    - The *ATG* includes a more concise (one paragraph) listing of 12 cases that have addressed auto dealership compensation issues.
- Other Miscellaneous Issues
  - Enrollment Fee (p. 23)
  - Pool Capping Fee (pp. 23-24)
  - Servicing Fee (p. 24)
  - Mark-to-Market (p. 24)
  - Change in Accounting Method (pp. 24-25)
  - ***Used Car Donation Programs (pp. 25-26)****
    - This section has been included as a result of the considerable press recently given to advertisements concerning used car donations to charities and IRS concern over taxpayer abuse resulting from the (significant) overvaluation of many used vehicles purportedly donated to charities. In some instances, dealers (or used car dealers) have become more significantly involved in a variety of promotions and/or the creation of exempt organizations to act as conduits.
  - ***Credit for Qualified Electric Vehicles (p. 26)****
  - ***Clean-Fuel Vehicles: Hybrid Vehicles: Mfg's Certification of Incremental Cost (pp. 26-28)****
  - ***Cost Segregation (pp. 28-29)****
    - Not much coverage is given to this issue which involves the re-allocation of building costs from 39-year to 5-, 7- or 15-year MACRS property. The brief discussion of this subject concludes with the statement, "This methodology is being promoted by tax consultants, manufacturing industries and accounting firms; and [is] under study by the Large and Mid-Size Business division."
    - The discussion makes no mention of (or cross-reference to) the *Cost Segregation Audit Techniques Guide* dated April 30, 2004.
  - ***Oldsmobile Dealer Franchises & Involuntary Conversion (Sec. 1033) Treatment (pp. 29-30)****
    - This section is rather brief. It mentions LTR 200218034 (which was analyzed in the March 2002 *Dealer Tax Watch*), and it also mentions a proposed Ruling, intended only for the automobile industry, under which capital gain treatment might be allowed for the cancellation of a distributor agreement.

Citation

- Publication 4435 (01-2005) Catalog No. 39491F

VSC AUDIT TECHNIQUE FLOW CHART

Source: *New Vehicle Dealership Audit Technique Guide*, Chapter 7, Pg. 19



VSCs ... ESCs At a Glance	***VSCs - ESCs - DEALER AGENT & DEALER OBLIGOR PROGRAMS TAX ISSUES & IRS AUDIT TECHNIQUES***
In General	• When the extended service contract (ESC) is between the vehicle purchaser and the dealership, the dealership is the "obligor" or "principal" on the contract. When a dealership acts as obligor or principal, it may purchase an insurance policy that insures its liability under the service contract. Thus, there are two transactions ... (1) one between the dealer and the customer, and (2) one between the dealer and an insurance company. • All contracts related to the service contract plan indicate whether a dealership is an agent or principal/obligor. Proper tax treatment of extended service contracts is determined by whether the dealer is the agent or obligor. • ***Extended Service Contracts - In General ...*** Dealerships frequently offer extended service contracts to their customers in connection with the sale of a vehicle. Extended service contracts provide for repairs to covered vehicle components during a designated term. The term runs parallel to the manufacturer's warranty coverage and for an extended period beyond the manufacturer's warranty term. In other words, the customer is paying an additional amount for an extra two to seven years beyond the manufacturer's prescribed term. • ***Dealer "Agent" Extended Service Contracts ...*** If the extended service contract is between the vehicle purchaser and an administrator, insurance company or other party, the dealership acts as an agent and earns a commission. Generally, the dealership determines the selling price of the extended service contract and forwards a portion to the administrator based on a "cost schedule." The commission income must be accrued when the contract is sold. The commission amount is the difference between the extended service contract selling price and the amount the dealer forwards to the administrator, insurance company, or other party. • TAM 9218004 provides guidance on determining agent vs. principal and the proper tax treatment of the commission income.

Issues	• ***Dealer Agent programs***
	  ◆ Commissions must be included in income in the year the VSC is sold.
	• ***Dealer Obligor programs***
	  ◆ Selling price of the VSC must be included in income in the year the VSC is sold.
	    ▪ Service Warranty Income Method (SWIM) may be elected.
	  ◆ Insurance premiums must be amortized over the term of the contract.
	  ◆ Administrative fees can be pro-rated if the taxpayer can demonstrate a reasonable manner in which to estimate the amount (cost) and timing of services.

Documents Needed, etc.	• Request a listing of all VSC/maintenance plans sold to the dealership during the year(s) under audit.
	• For each program sold, request the following information:
	  ◆ Copies of actual, executed vehicle service contracts
	  ◆ Copies of any promotional material
	  ◆ Copies of any and all agreements and documents including all endorsements, amendments, and schedules between the dealership and other parties to the program.
	    ▪ Documents may include but are not limited to: dealer agreements(s), administrator agreements(s), contractual liability insurance policy, service contract reimbursement insurance policy, consulting agreement(s), management agreements(s), reinsurance agreements(s), and warehouse agreements(s)
	  ◆ Request that the dealership provide, in writing, samples of all accounting entries for all income and expenses.
	• Request a written statement from the owner of the dealership concerning:
	  ◆ Payments made by any party to the program, directly or indirectly, to the dealership owner, any relative of the owner, or entity owned (all or in part) or controlled by the owner.
	• Do not be afraid to ask questions about the dealership's programs.
	  ◆ Do not limit questions to the dealer's representative, controller, or employees.
	    ▪ The dealer principal (dealer/owner/shareholder) may be the only one fully informed regarding the details of the programs.

Aftersale Market Products Issues	• Dealer Obligor Contracts - Insurance Purchased (No PORC involved*)
	  ◆ Include selling price of VSC in income in the year sold.
	  ◆ Cost of insurance must be amortized over the life of the contract.
	• SWIM (Service Warranty Income Method) allows the qualified advance payment amount (including a provision for interest) to be deferred provided that certain conditions are met including:
	  ◆ SWIM must be properly elected and applied ... See Rev. Proc. 97-38.
	    ▪ To properly elect SWIM, the dealership **must** purchase insurance from an unrelated party.
	  ◆ Insurance premiums **must** be amortized.
	• Administration fees can be amortized if the taxpayer can demonstrate a reasonable manner in which to estimate the amount (cost & timing of admin. services). If not, deduction should **not** be allowed until the end of contract.
	* If a PORC (Producer-Owned Reinsurance Company) is involved, see Chapter 8 on PORCs.

Dealers Must Report "Gross" ... Not "Net"	• Dealerships that sell dealer obligor contracts and purchase insurance to cover their risks often report the income in a manner similar to a dealer agent contract, i.e., report only the commission income. • To properly account for a dealer obligor contract, the dealership must include in income the *entire* sales price of the service contract.
Source	• *IRS New Vehicle Dealership Audit Technique Guide*, Chap. 7, IRS Pub. 44305 (01-2005) ... Catalog No. 39491F

At a Glance

IRS AUDIT TECHNIQUES
VSCs & SUSPECT OVERSUBMIT SITUATIONS

Audit Techniques

- Determine by review of the **vehicle service contract** language whether the VSC is dealer obligor or dealer agent.
  - Generally, dealer obligor contracts state that the VSC is a contract between the vehicle purchaser and the dealership.
  - Dealer agent contracts are typically between the vehicle purchaser and an administrator or insurance company.
  - Dealer obligor contracts contain a provision naming an administrator and/or insurer and may contain terms similar to the following:
    - The agreement is not an insurance policy.
    - The dealer is financially responsible for all repairs under the VSC.
    - The dealer's obligations under the contract are insured by "Insurance Company."
    - The administrator is not obligated under the contract.
- For dealer obligor contracts:
  - Analyze the **administrator agreement** to determine the dealership and administrator's responsibilities under the program. (Note: Some dealerships participate in multiple programs that apply to the same VSC. For instance, one program provides basic program administration and claims handling while a second program simultaneously provides for the establishment of the dealership's PORC. As a result, the dealership may have multiple administrative agreements, insurance policies, etc. To determine the proper tax treatment on the sale of the VSC, the ***entire*** transaction must be analyzed.)
    - The administrator agreement may include a provision for a reserve or escrow account, the establishment of a PORC, payment of various fees to parties related to the dealership or administrator, etc.
  - Review amendments, endorsements, and schedules for clues to other agreements, payments to related parties, etc.
  - Analyze the **insurance policy** to determine the coverage and to determine the "name insured".
    - Generally, dealer obligor programs provide for a contractual liability policy naming the dealership as the insured.
    - Determine if there is any common ownership between the dealership and the insurance company.
    - Determine if the dealership or other party related to the dealership provides indemnification to the insurance company.
    - If the dealership purchased insurance from an unrelated insurance company and did not enter into a reinsurance agreement, determine if the selling price of the contract is included in the income in the year the contract is sold.
      - ★ Determine if the cost of insurance was amortized over the contract life.
      - ★ Determine if the dealership properly elected and applied the Service Warranty Income Method (SWIM) of reporting income.
      - ★ Determine how the dealership accounted for administration fees.

Definitions ... Terms

- ***Administrator:*** An administrator is usually an unrelated party. They are responsible for administering service contracts for the dealership.
- ***Agent:*** If the dealer is an agent of the administrator, insurer, or other party, the contract will contain language that indicates that the contract is between the vehicle purchaser and the other party, not the dealership. The contract administrator is also named in the contract.
- ***"Principal"/"Obligor":*** If the dealer is the principal, the contract will contain provisions indicating that the contract is between the dealer and the vehicle purchaser.
- ***Vehicle Service Contract:*** (VSC) also known as an extended service contract primarily for vehicles, new or used.
- ***Administrator Agreement:*** An agreement between the dealership and administrator's responsibilities provided to the extended service contract program. (Note: Some dealerships participate in multiple programs that apply to the same VSC. For instance, one program provides basic program administration and claims handling while a second program simultaneously provides for the establishment of the dealership's PORC. As a result, the dealership may have multiple administrative agreements, insurance policies, etc.)
- ***Service Warranty Income Method (SWIM):*** An election under Revenue Procedure 97-38, previously 92-98, which provides for an alternative Income reporting method, the "Service Warranty Income Method" (SWIM). Taxpayers who elect SWIM may spread a portion of the service warranty contract income over the life of the contract. The amount of income that can be deferred is equal to the amount that is paid by the taxpayer to an unrelated third party to insure the taxpayer's obligations under their contracts. The amount qualifying for deferral is called the "Qualified Advance Payment Amount." The SWIM method only applies when insurance is purchased from an unrelated party.
- ***Service Contract Overpayment Programs:*** Also known as Dealer over-submit, Dealer Override, Dealer Remit or Management Programs. This is a supplemental program that may be included in the vehicle service contract. This calls for a voluntary supplemental agreement to pay an administrator a fee in addition of the contractually required amount.

Source

- *New Vehicle Dealership Audit Technique Guide*, Chapter 7
  IRS Publication 44305 (01-2005) ... Catalog No. 39491F

"Oversubmits" At a Glance	POSSIBLE INCOME DIVERSION BY OVERSUBMIT PROGRAMS TAX ISSUES & IRS AUDIT TECHNIQUES
Overview	• The sale of vehicle service contracts (VSC) continues to be a popular source of additional income for automobile dealerships. Vehicle service contracts are available in a variety of formats, with an assortment of options, and may name the dealership or another party as the obligor. • ***The Big IRS concern - issue ...*** This section of the *ATG* discusses only the ***possible diversion of income using an "overpayment" agreement.*** ◆ Proper tax treatment of the transaction will vary depending upon the specifics of the VSC program. ◆ This issue presents an opportunity for confusion, inconsistent tax treatment, and possible widespread non-compliance. • ***More to come ...*** The Motor Vehicle Technical Advisor (MVTA) is evaluating this issue to determine the scope of the noncompliance. This section is the first step in a program to provide guidance to IRS and industry personnel of the proper treatment of the issues and the possible effects of noncompliance.
Different Names	• The programs may vary slightly in operation. • they can be identified by various names such as "oversubmits, dealer override agreements, over remit programs, or management contracts" and are found in non-dealer obligor programs and dealer obligor programs for new and used vehicles.
Example 1 *No Overpayment Arrangement*	• *Facts ...* In conjunction with the sale of a vehicle, the dealership also sells the customer a vehicle service contract. The price of the vehicle service contract is $800. The dealership is required to pay the obligor/administrator $400 under the contract. • *Discussion ...* The dealership retains $400 as commission (retention amounts will vary by program) and submits the remaining $400 to the obligor/administrator. ◆ Depending upon the program, the amount submitted to the obligor/administrator may be used to purchase insurance, be placed into a trust or escrow account, or be used for other purposes. Assuming that the program is a pure dealer agent program, the dealership reports $400 as income. ◆ The tax treatment will vary significantly if the program is a dealer obligor program or contains other features such as escrow or trust accounts. Generally, there is no unreported income issue.
Example 2 *Overpayment Arrangement In Existence*	• *Facts ...* In conjunction with the sale of a vehicle, the dealership also sells the customer a vehicle service contract. The price of the vehicle service contract is $800. The dealership is required to pay the obligor/administrator $400 under the contract. • *Discussion ...* The dealer executes a voluntary supplemental agreement to pay to the obligor/administrator an amount in excess of the contractually required amount. For example, rather than retaining $400 and submitting $400 as in the example above, the dealer may submit $550 to the administrator and retain only $250. • The supplemental agreement between the dealership and the obligor/administrator allows the dealership to determine the amount of the overpayment and to designate a "beneficiary" to receive the overpayment amount. The designated "beneficiary" may be an individual, e.g. the dealership shareholder, spouse, child, etc., a corporation, e.g. the dealership, a related corporation, or another entity e.g. reinsurance company or a related S corporation. • The supplemental agreement may require the inclusion of the beneficiary's Federal Tax Identification number or Social Security number and the obligor/administrator may issue Forms 1099 if the beneficiary is an individual, partnership, or sole proprietor. If the beneficiary is a corporation, a Form 1099 is not required. On a periodic basis, generally monthly, the obligor/administrator aggregates the over submitted amounts and remits the total amount to the beneficiary. • By reducing the amount retained by the dealership from $400 to $250, the overpayment effectively reduces the income reported by the dealership by the $150 over submitted amount. The $150 over submitted amount might be reported as income by the "beneficiary," however if no Form 1099 is filed, there is no tracking of the beneficiary. Even if the beneficiary reports the income, the overpayment amount represents income to the dealership.

<table>
<tr><th>"Oversubmits" At a Glance</th><th>POSSIBLE INCOME DIVERSION BY OVERSUBMIT PROGRAMS
TAX ISSUES & IRS AUDIT TECHNIQUES</th></tr>
<tr><td>Discussion</td><td>• Regardless of why a dealership engages in the over payment program, it is vital that the program be treated properly for tax purposes. There are many reasons, in addition to reducing reported income why a dealership might execute an over payment agreement.
◆ Reducing the profit on the sale of a vehicle service contract may reduce the base amount on which the Finance and Insurance Manager's sales commission is based.
◆ The overpayment programs may allow an individual to redirect capital to another entity that enjoys a more favorable tax treatment.
• Preliminary analysis indicates that the proper reporting of vehicle service contract overpayment amounts rests on the definition of gross income and the principle of assignment of income. By making an overpayment to the obligor/administrator and designating a "beneficiary' to receive the over payment amount, the dealership assigns income to the beneficiary.
• Section 61 defines gross income as income from whatever source including compensation for services such as fees and commissions. Dealerships earn income on the sale of vehicle service contracts. Ordinarily, the difference between the selling price of the vehicle service contracts and related expenses represents income to the dealership.
• When a dealership makes a payment to the obligor/administrator in excess of the amount ordinarily required, the dealership artificially reduces the income reported on the sale of the service contract.
• Overpayments made to the VSC obligor/administrator represent income earned by the dealership and assigned to the beneficiary.
◆ Depending upon the relationship of the beneficiary to the dealership owner, the overpayment may be characterized as a non-deductible dividend to the dealership owner or in some other fashion.
◆ Case cited in ATG as precedent is Lucas vs. Earl 281 U. S. 111 (1930), which requires income to be allocated to the dealership that earned the income.</td></tr>
<tr><td>Issues</td><td>• Is the overpayment amount income to the ultimate recipient (dealer/obligor/shareholder/owner)?
• Is the overpayment a deductible expense?
• Is the overpayment a dividend?</td></tr>
<tr><td>Documents Needed & Audit Techniques</td><td>• List of Documents Needed for "Oversubmit" situations is the same as that for VSCs with one modification and with one additional item ...
◆ Modification... Request a listing of all VSC/maintenance plans sold by the dealership during the year(s) under examination.
◆ Added... Request a listing of all Dealer over submit, Dealer Override, Dealer Remit or Management Programs
▪ Request copies of all voluntary supplemental agreement to pay an administrator a fee in addition of the contractually required amount
• Listing of Audit Techniques for "Oversubmit" situations is the same list that is provided for Vehicle Service Contracts.</td></tr>
<tr><td>Source</td><td>• New Vehicle Dealership Audit Technique Guide, Chapter 7
IRS Publication 44305 (01-2005) ... Catalog No. 39491F</td></tr>
</table>

TAMs 200453012 & 200453013

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

Overview

- In TAM 200453012 (dated Dec. 29, 2004) and in TAM 200453013 (dated Oct. 6, 2004), the IRS recognized the tax legitimacy of two VSC arrangements which had been under intensive scrutiny.
- These taxpayer-favorable rulings by the IRS seem to mark the complete about-face in which the IRS retreated from having concern that dealer PORC arrangements might be/could be abusive to accepting them as legitimate business arrangements, which provided significant tax benefits for the PORCs and their owners.
- Notwithstanding the fact that both TAMs are taxpayer-friendly, they have been criticized (in private) by some observers as being less analytical than they should have been.
  - The feeling by some is that the IRS really blew it on these TAMs and that the Service may have created problems for state insurance regulators because these arrangements should not be treated one way for IRS purposes (i.e., as insurance for Federal income tax purposes), but not treated as insurance for state regulatory purposes.
- ***Defects in agreements were not fatal.*** In several respects, the various parties did not follow all of the requirements of their respective agreements. However, the IRS did not view the substance of these failures to do everything according to the letter of each agreement as fatal to the overall arrangement.

Facts

- The facts in these nearly identical TAMs almost defy comprehension.
  - Out of 15 pages of solid text, the "facts" portion of each ruling requires 6 full pages.
- Differences between TAMs 200453012 and ...-013
  - In ...-012, there were three (3) individuals involved as shareholders of the dealership (an S Corporation), and two of them also were Directors of the PORC.
    - As a result, the VSC PORC program in ...-012 is designated as "Program E."
  - In ...-013, two (2) individuals are involved, and the PORC program is designated as "Program D."
  - Even the IRS had trouble keeping all the parties and redaction designations straight, as evidenced in its reference in TAM ...-013 to "Program E" when Program E is part of ...-012, and not ...-013.

Parties & Agreements

- Parties
  - Auto Dealership (In TAM redaction, referred to as ("Taxpayer 1")
  - Dealer-owned reinsurance company ... the PORC ("Taxpayer 3")
  - Direct writer insurance company ("Company 2")
  - Several other domestic and off-shore entities set up in different jurisdictions
  - Individual owners & Directors
- Agreements
  - The PORC program agreement ("Program E" in ...-012 and "Program D" in ...-013)
    - Designed to be a comprehensive program facilitating the sale and administration of vehicle service agreements implemented through several pre-arranged steps. These programs afforded purchasers, subject to certain limitations, with protection against economic loss for certain expenses related to the repair of vehicles that had been purchased which were identified in the agreement and which repairs were not covered by the manufacturer's warranty.
    - Both TAMs involve ***dealer obligor*** programs
  - Various administration agreements
  - Dealer agreement
  - Liability reimbursement agreement
  - Administrative agreement
  - Protection against loss agreement

Issues & Holdings

- If the dealer-owned PORC, were a domestic corporation, would it have qualified as an insurance company under Part II of Subchapter L for the year involved?
  - ***Answer: Yes, the PORC would have qualified.***
- Was the dealer-owned PORC, eligible to elect under Section 953(d) to be treated as a domestic corporation? If not, how is the income of the PORC to be accounted for under Subpart F and other provisions that apply to foreign corporations?
  - ***Answer: Yes, the PORC was eligible to elect favorable tax treatment under Section 953(d).***
  - Based on the PORC's eligibility, there is no need to discuss the second part of the issue.
- Are the arrangements at issue (i.e., presented and discussed in the TAM) a sham for federal income tax purposes?
  - ***Answer: No, these arrangements were not shams.***

TAMs 200453012 & 200453013

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

Issues Not Covered by the TAMs

- Whether the dealer-owned PORC might be entitled to the benefit of Section 501(a) for the year involved as an organization described in Section 501(c)(15).
- Whether the method of accounting used by the dealership, the direct writer insurance company, and the PORC was proper to reflect their involvement in the VSC / PORC program.
- The proper treatment, for tax purposes, of any of the transactions described in the TAM as constituting distributions by the PORC or as compensation of the individuals.
- Any other legal issue other than the three issues specifically addressed in the TAM.

The Ultimate Question

- This case is ultimately about whether ... the PORC would be eligible for the benefit of Section 501(a) tax exempt status because it was an organization described by Section 501(c)(15) for the year involved. If the PORC were eligible, its income would be exempt from Federal income taxation; if not, its income may be taxable to its shareholders under Subpart F.
- The PORC's eligibility for the benefit of Section 501(a) turns on whether it satisfies the criteria for qualification as an insurance company for Federal income tax purposes. (Issue #1 below)

Issue 1

Insurance Company Qualification

General Principles & Precedents

- ***Primary & predominant business activity.*** For Federal income tax purposes, an insurance company is a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.
  - Section 816(a) provides that a company will be treated as an insurance company for Federal income tax purposes of that definition only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. See also Reg. Sec. 1.801-3(a)(1).
- ***Actual activities are important.*** While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. (Citations omitted)
- To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." (Citation omitted)
- All of the relevant facts will be considered. Relevant facts include, but not limited to,
  - The size and activities of any staff
  - Whether the PORC engages in other trades or businesses
  - All sources of income
- The PORC's primary and predominant business activity ... was performing under the Protection Against Loss Agreement.
- The PORC's qualification as an insurance company depends on whether this activity constituted issuing an insurance contract or reinsuring the risks underwritten by an insurance company.
- ***Neither the Code nor the Regulations define the terms "insurance" or "insurance contract."***
- ***"LeGierse" is the precedent.***
  - The bedrock for evaluating whether an arrangement qualifies as insurance is *Helvering v. LeGierse* (312 U.S. 531, 539 (1941)) In *LeGierse*, the Court stated that "historically and commonly insurance involves risk-shifting and risk distributing."
- Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for Federal income tax purposes to three elements applied consistently with principles of Federal income taxation* ...
  - Involvement of an insurance risk,
  - Shifting and distribution of that risk, and
  - Insurance in its commonly accepted sense.

  * These principles of taxation include...
    - Respecting the separateness of corporate entities
    - The substance of the transaction(s)
    - The relationship between the parties
- ***Risk transferred*** must be risk of economic loss. The risk must contemplate the fortuitous occurrence of a stated contingency, and must not be merely an investment or business risk. (Citations omitted)
- ***Risk shifting*** occurs when a person facing the possibility of economic loss transfers some or all of the financial consequences of the potential loss to the insurer. (See Rev. Rul. 92-93, 1992- C.B. 45)

(Continued)

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

Issue 1

Insurance Company Qualification

General Principles & Precedents

(Continued...)

- ***Risk distribution*** incorporates the statistical phenomenon known as the law of large numbers.
  - Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim.
  - Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums.
    - Risk distribution necessarily entails a pooling of premiums, so a potential insured is not in significant part paying for its own risks. See *Humana v. Comm.*, 881 F.2d 247, 257 (6th Cir. 1989).
- ***"Commonly accepted sense" of insurance.*** This derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance.
  - Court opinions identify several nonexclusive factors bearing on this,
    - The treatment of an arrangement under the applicable state law
    - The adequacy of the insurer's capitalization and utilization of premiums priced at arm's length
    - Separately maintained funds to pay claims
    - The language of the operative agreements and the method of resolving claims
- A contract providing benefits in kind, rather than in cash, may constitute an insurance contract for Federal income tax purposes.
  - But not all transactions which involve shifting and distributing an element of insurance risk qualify as insurance. See Rev. Rul. 68-27, 1968-1 C.B. 315 and Rev. Rul. 80-95, 1980-1 C.B. 252.
- Interrelated contracts must be considered together. Where separate agreements are interdependent, they must be considered together so that their overall economic affect can be assessed. (Citations omitted)

Issue 1

Insurance Company Qualification

Analysis

- ***Interrelated & interdependent agreements.***
  - There is no dispute that the following three agreements are interrelated ... (1) the Program Vehicle Service Agreement, (2) the Liability Reimbursement Agreement and (3) the Protection Against Loss Agreement.
  - Without the latter two, the auto dealership would not have issued the vehicle service agreements.
  - Considered together, the effect is to shift to PORC the risk of loss from the purchasers of the Program D/E Vehicle Service Agreements.
- ***Shifting of risk can be effected only if genuine obligations are created.***
  - Under the facts presented, there were a series of defects in the execution of the Liability Reimbursement Agreement which call its enforceability into question.
    - No defects were noted in connection with the Protection Against Loss Agreement entered into between the direct writer insurance company and the PORC.
  - The applicable choice of law rules result in the application of the laws of State A to evaluate the validity and to interpret the Liability Reimbursement Agreement.
    - State A law recognizes implied contracts on terms manifested by the conduct of the parties.
    - In this case, despite the defects noted, the parties conducted themselves as though the Liability Reimbursement Agreement were valid and enforceable.
      - ★ The direct writer insurance company made no effort to disavow the Liability Reimbursement Agreement.
      - ★ Rather, the dealership paid premiums and the direct writer insurance company performed as called for by the Liability Reimbursement Agreement.
    - Once the parties became aware of the defects, the parties corrected them.
    - Based on the foregoing, the Service presumed that a legally enforceable contractual relationship existed between these two parties.
- ***Insurance risk exists.*** The nature of the risk assumed by the dealership from the purchasers of the Program D/E Vehicle Service Agreements is an insurance risk.
  - The purchaser bore a risk of economic loss for the cost required to repair (or replace) a specified failed component of the identified vehicle.
  - Though this risk is shifted from the purchaser to the dealership and distributed in a manner commonly accepted as insurance, because the Vehicle Service Agreements (VSA) obligate the dealership to perform this service work directly, the VSA is akin to an agreement not characterized as an insurance contract for Federal income tax purposes. (Rev. Rul. 68-27; Johnson, 108 T.C. 448, 472 n7)

(Continued)

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

- ***Rev. Rul. 80-95 distinguished.*** Regardless of whether the Program D/E Vehicle Service Agreements are characterized as insurance contracts for federal income tax purposes, the nature of the risk covered is the same.
  - In Revenue Ruling 80-95, the insurance risk arising from an employee's injury was initially covered by the employer's disability benefit plan.
  - The ruling suggests that this plan was not insurance nor was the employer an insurance company for Federal income tax purposes.
  - The ruling's holding that the indemnification arrangement qualified as insurance reflects the economic substance of the arrangement: that the employees' insurance risk arising from injury was shifted and distributed.
- ***Risk was shifted from customer to the PORC.*** Considering collectively or together the Vehicle Service Agreement, the Liability Reimbursement Agreement and the Protection Against Loss Agreement, the effect is to shift the risk of loss to the PORC from the purchasers of the Vehicle Service Agreements.
  - For each Program D/E Vehicle Service Agreement sold, the auto dealership remitted to direct writer insurance company (via the Sponsor) the amount indicated on the "authorized rate chart," reduced by the fees of the Administrator and the Insurance Company.
  - The language of the Liability Reimbursement Agreement suggests that direct writer insurance company's liability to the auto dealership was limited to the amount indicated on that chart.
    - The applicable state law required that an insurance contract is to be interpreted so as to provide the greatest possible protection to the insured.
  - A substantial portion of the amount on the rate chart is not paid to the direct writer insurance company.
  - Examples have been produced of individual Program D/E Vehicle Service Agreements under which the amounts paid in claims exceeded the initial premium paid by the customer.

Issue 1

Insurance Company __Qualification__

__Analysis__

- ***Insurance risk exists.*** The risk of loss which is shifted ultimately to the PORC and distributed among the large number of similar purchasers is an insurance risk, and the coverage provided to the purchaser is in accord with the commonly accepted sense of insurance.
  - The primary and predominant business activity of the PORC is the issuance of insurance contracts.
  - The fact that the PORC's operations are sparse does not negate this conclusion. See *Alinco Life Ins. Co. v. United States*, 178 Ct. Cl. 813, 837-38 (1967).
  - The PORC would have qualified as an insurance company were it a domestic corporation for the year involved.
    - The PORC would have qualified (as an insurance company taxable under Part II of Subchapter L) ***because the insurance coverage provided is other than life insurance.***
    - One argument contrary to this conclusion is the argument that the arrangement at issue involves only one insured (i.e., the auto dealership), and that the arrangement therefore cannot constitute insurance for Federal income tax purposes because there is insufficient risk distribution.
    - However, the risks in the present case originated not with auto dealership but with the large number of unrelated customers who purchased vehicles from that dealership.
    - The amounts paid by those customers to purchase Program D/E Vehicle Service Agreements were pooled, and those customers were indemnified for the repair of specified components of identified vehicles, either in cash or in kind.
    - Had the PORC issued the Vehicle Service Agreements directly to the customers, the agreements collectively would constitute a block of insurance business for Federal income tax purposes.
- If the auto dealership were an insurance company, the PORC's role as a reinsurer would not be challenged.
  - The instant case is most analogous to Revenue Ruling 80-95, which characterized as insurance an arrangement between a single employer and a foreign insurer, based on the disability risks of a large number of unrelated employees.
- The conclusion (that the risk of loss is shifted ultimately to the PORC, etc.) is also consistent with the legal analysis the IRS National Tax Office previously expressed in a related Determination Letter.
  - The differences between the facts represented to the Service in support of the Determination Letter and those presented in this case do not in themselves alter the legal conclusion that the PORC qualified as an insurance company for Federal income tax purposes.

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

Issue 2 ***Eligibility of the PORC to Elect to Be Treated as a Domestic Corporation***	• Subpart F of the Internal Revenue Code applies to foreign corporations that qualify as controlled foreign corporations (CFCs). ◆ A controlled foreign corporation is defined as a foreign corporation of which ***more than 50%*** of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by United States shareholders (Section 957). ▪ A United States shareholder is defined as a U.S. person who owns ***10% or more*** of the total combined voting power of all classes of the corporation's stock entitled to vote (Section 951(b)). • A U.S. shareholder of a CFC is required to include in gross income such shareholder's pro rata share of the CFC's Subpart F income for the year (Section 951(a)(1)(A)(i)). • The definition of Subpart F income includes ... insurance income, as defined by Section 953, and foreign base company income, as defined by Section 954 (Section 952(a)). • Under Section 953(d), a foreign insurance company is permitted to be treated as a domestic corporation if it satisfies four tests ... 1. The foreign corporation is a CFC defined by Section 957(a) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under Section 953(c)(1)(A), 2. The foreign corporation would qualify under Part I or Part II of Subchapter L of the IRC for the taxable year if it were a domestic corporation [***Note: This is the critical test ... See analysis below***], 3. The foreign corporation meets such requirements as the Secretary prescribes to ensure the taxes imposed by Chapter 1, Subtitle A of the Code are paid, and 4. The foreign corporation makes an election under this paragraph and waives all benefits to the corporation granted by the United States under any treaty. • ***Analysis*** ◆ The parties represent that three of the above requirements are met ... Section 953(d)(1)(A), (C), and (D). Therefore, the PORC will be treated as a domestic corporation for the year involved if it would qualify under Part I or Part II of Subchapter L. ▪ Part I deals with life insurance companies (Section 801 et.seq.) ▪ Part II deals with insurance companies other than life insurance companies ... i.e., property, casualty, etc. ... where PORCs must fall for favorable tax treatment (Section 831 et.seq.) ◆ In Issue #1, it was held that if the dealer-owned PORC, were a domestic corporation, it would have qualified as an insurance company under Part II of Subchapter L for the year involved. ◆ For the same reasons explained in Issue #1 of these TAMs, the Service concluded that the PORC would have qualified as an insurance company under Part II of Subchapter L. ▪ Therefore, the PORC is treated as a domestic corporation for the year involved, thus satisfying the second test above (Section 953(d)(1)(B)).
Issue 3 ***The Infamous Case of "William Wright" Distinguished***	• The conduct of the parties in this TAM (i.e., these TAMs) is different from that of the taxpayer in *Wright v. Comm.*, (T.C. Memo. 1993- 328, 66 T.C.M. (CCH) 214). • ***What William Wright did wrong*** ... in *Wright* there were many defects. ◆ The purported insurance arrangements lacked formality. ◆ The taxpayer was careless in implementing and operating a purported reinsurance structure. ◆ Excess income was diverted to the purported reinsurance company and that company's funds were co-mingled with the taxpayer's. ◆ The purported reinsurance company's reserves were not computed using appropriate actuarial techniques and the company reported a negative surplus. ◆ The purported reinsurance company did not retain documents evidencing transactions entered into. • ***What the taxpayers did right in ...-012 and ...-013.*** ◆ Accounting and corporate formalities were observed in the transactions involving the PORC. ◆ The arrangement was not used to create or manipulate insurance reserves for the purpose of inappropriately sheltering income. ◆ Though distributions of the PORC's funds were made, *it does not appear* that the PORC was treated like a "personal bank account." ▪ Comment ... The use of the term "*It does not appear ...*" seems to be inconsistent with the Services' more definitive tone in dealing with PORC issues more broadly elsewhere.

PORC & INSURANCE ARRANGEMENTS IN TWO TAMs ... ARE NOT SHAMS

Issue 3 ***The Nature of Shams ...*** <u>***Two Kinds***</u>	• There are two kinds of shams ... shams ***in fact*** and shams ***in substance.*** ◆ A sham ***in fact*** is a transaction that was created on paper but did not actually occur. ◆ A sham ***in substance*** is a transaction that actually occurred but which lacks the substance suggested by its form. (*Kirchman v. Comm.*, 862 F.2d 1486, 1492 (11th Cir. 1989)) • Where a transaction ***in fact*** occurs, if it lacks *economic substance*, it will not be recognized for Federal income tax purposes. (*Gregory v. Helvering*, 293 U.S. 465, 469 (1935)) ◆ The evaluation of the *economic substance* of an arrangement focuses on two related factors... ▪ Economic substance apart from tax consequences ▪ Business purpose (Extensive citations omitted) ◆ In considering these factors, the arrangement must be viewed as a whole.
Issue 3 <u>*Analysis*</u> ***Were the PORC Arrangements Shams?*** ***... No, They Were NOT*** <u>***Shams***</u>	• ***Real, actual transactions did take place ... therefore, there was no sham in fact.*** ◆ Notwithstanding the defects in executing some of the documents and agreements at issue, the facts establish that the ***transaction(s)*** between the auto dealership, the PORC and the direct writer insurance company ***did, in fact, occur.*** ◆ Customers unrelated to the dealership paid amounts for the Program D/E Vehicle Service Agreements which indemnified them for the repair of specified components of their identified vehicles. ▪ Some portion of these amounts remained with the dealership. ▪ The PORC received the remainder (after payment of the fee owed the Administrator and the premium owed Insurance Company). ▪ ***Arm's length pricing.*** The pricing of the amount paid to the PORC is not at issue in this case ... nor is the fact that the PORC bore the cost of covered repairs under the net-remit system. ◆ When the defects in (document/agreement) execution were discovered, none of the parties to the affected agreements attempted to disavow them. ▪ The parties continued to perform under the terms of the agreements and cured the defects as appropriate. ▪ Under the applicable state law, a party's failure to perform would have been held a to constitute a breach. ▪ Under these circumstances, the Service said it could not conclude that the insurance transactions did not take place. Therefore, the arrangement is not a sham in fact. • ***Business purpose & economic substance were present ... therefore, there was no sham in substance.*** ◆ The arrangement between the three little pigs ... (i.e., the auto dealership, the PORC and the direct writer insurance company) has both a business purpose and economic substance. ▪ The ***business purpose*** of the PORC is to allow the auto dealership to enter into the market with vehicle service contracts on which it is the obligor (i.e., dealer obligor VSCs), while providing a mechanism to facilitate and ensure the performance of the dealership's obligations thereunder. ▪ The ***economic substance*** is to provide for the insurance risk covered under the Program D/E Vehicle Service Agreements by creating a separate source of funding (i.e., insurance) to ensure those obligations can be met. ▪ The situation presented in this TAM (i.e., these TAMs) is like that in *United Parcel Serv. of Am., Inc. v. Comm.*, 254 F.3d 1018-19 (11th Cir. 2001). ★ The *UPS* case concluded that the creation of a genuine obligation in the nature of insurance has economic effect and an arrangement figuring in a bona fide, profit-seeking business has a business purpose. ▪ The situation presented in this TAM (i.e., these TAMs) is unlike that in either *Winn-Dixie Stores, Inc.*, 254 F.2d 1313, or in *ACM Partnership*, 157 F.3d 231. ★ The substance of the arrangement - ultimately, providing insurance to the customers of the auto dealership - comports with its form. ◆ The arrangement satisfies a business need of the dealership and provides it with the opportunity to derive a pretax profit. • The arrangement involved contractual relationships with unrelated third parties and did not involve the circular flow of cash. • ***William Wright distinguished.*** ... See bottom of page 5 of 6.

FAVORABLE RULINGS ON REINSURANCE PROGRAMS BY THE IRS

By Andrew J. Weill, Esq. and Craig Gordon, Esq.

How would you react to the following call from one of your automobile dealer clients?

Hi, this is Bob from Target Automotive. We just got some papers from the IRS, seems they want us to answer some questions about our reinsurance company. At least I think we have a reinsurance company. I'm not sure, but that's what I was told. They are also asking for a bunch of documents. Who's supposed to handle this stuff? Well, they are asking about some loans from the reinsurance company to Target here. That's okay, isn't it? They said they want to come this Friday. Call me so we can sort this out.

Lots of auto dealers participate in reinsurance programs. Sometimes the dealer's accountant is aware of the program from its inception; sometimes the first clue the accountant has is getting one of these calls. Either way, don't panic. The proper handling of reinsurance company audits is a great opportunity for tax professionals to provide valuable service to their clients. If you are familiar with the key issues and get on top of the facts, responding to the IRS should be relatively easy and the process goes smoothly.

Does Your Client Have A Reinsurance Program?

Surprisingly enough, this is often a difficult question for your clients. You need to be familiar with the ways car dealers sell insurance products and how they can get compensated before you can ask the right questions.

Car dealerships may sell a variety of insurance products issued by insurers: extended service agreements, credit life insurance, accident and health insurance, and GAP insurance are most frequently seen. Car dealerships, naturally, are selling these products for profit. There are many varieties of programs, but three of the most common models are:

- Pure commissions, where the dealership is compensated with a set percentage for each contract sold,
- Retrospective or "retro" programs, where the volume and quality of the contracts sold are reviewed periodically and the dealership is compensated according to the levels achieved, and
- Reinsurance programs, where the insurer reinsures the risk to a reinsurance company, typically one affiliated with the owners of the dealership in some fashion, such as owners of the dealership, family members, or key employees.

  Such reinsurance companies have frequently referred to as "producer-owned reinsurance companies", or PORCs. This acronym is misleading, because the reinsurance company is **not** owned by the dealership; at most, it may have overlapping ownership. This author's preferred acronym is ***"Affiliated Reinsurance Company"***, or ARC.

Although the preceding explanation may give the impression that it is easy to distinguish a reinsurance program from other programs, it isn't always simple. Several financial services companies compare their retroactive commissions or other products to a true reinsurance program. Some even appear to use the phrase "reinsurance," despite the fact that they are not actually reinsuring anything.

So if your client raises questions about his reinsurance program, be sure to get the correct information and documentation from the program in which your client participates. If it's a reinsurance program, there will be incorporation papers for the reinsurance company and separate tax returns for it.

Why Do Dealers Use Reinsurance Programs?

From your client's point of view, a reinsurance program represents an excellent opportunity for persons affiliated with the dealership to share in the underwriting profits and investment income from the sale of after-market financial products.

Equally attractive to the dealership owner, the reserves to satisfy his customer's claims are more directly under his control and supervision. Even if the initial insurer fails – which has happened – the reinsurance company has assets available to satisfy claims.

Also, these reinsurance companies typically are relatively small and potentially qualify for favorable treatment under Internal Revenue Code sections 831(b) or 501(c)(15).

Why Does the IRS Scrutinize Reinsurance Programs?

The past couple of years were tough on reinsurance programs. Subscribers to these programs saw attacks from the IRS on several fronts as they were swept up in the IRS crackdown on any perceived "tax shelter".

Several years ago, a *Forbes* article (http://www.forbes.com/forbes/2001/0305/122.html) explained how an individual set up an insurance company as a tax exempt entity under IRC section 501(c)(15) and used it to shield millions from taxation. This caused the IRS to target all companies who were claiming a similar exemption. Auto dealer reinsurance companies were one such group of companies. The IRS issued Notice 2002-70 specifying that such programs were "listed transactions," requiring mandatory disclosure under tax shelter rules. It also launched investigations of major programs and individual dealers and reinsurance companies.

Reinsurance structures now approved by IRS

After two years of fighting these issues, we have experienced a significant turnaround. Earlier this year, the IRS published two definitive Taxpayer Advice Memoranda (TAMs) that stated that the reinsurance programs involved were legitimate. In these rulings, the IRS detailed the comprehensive analysis of both companies and determined that their operation as reinsurance companies was not a sham for tax avoidance purposes. The rulings demonstrated to the industry that a well-run program is permissible under the most intense scrutiny of the IRS.

These TAMs should be the starting point for any practitioner confronted with an examination of a reinsurance company. Although the TAMs are of course not binding on other examinations, they provide considerable guidance to the field. To the extent your client's reinsurance program matches up to the situation in those TAMs, you have a strong position.

Equally importantly, the IRS has backed off its position that reinsurance programs are tax shelters. In Notice 2004-65, it rescinded the designation of these as "listed transactions."

In light of the favorable rulings, the tax practitioner should view the IRS inquiry as an opportunity: to review the client's reinsurance business and help ensure that his operations fall within the safe harbor that the IRS created with its recent rulings.

What to Look For Within Your Client's Reinsurance Operations

The recent vindication for reinsurance programs is extremely helpful, but this presumes that these programs are run well and maintained in accordance with IRS regulations. There are several ways to run afoul of IRS rules and regulations. Some of these include: improper access to the reserves; improper pricing of financial products; questionable loans, investments, or withdrawals; and a variety of other issues. Be sure to work with the program's representatives; the well-run programs are familiar with these issues and should have the records showing your client's compliance.

In our experience, the key is the same as always: documentation. Be sure the journals have been properly maintained. Get copies of all relevant agreements. Look at the minutes. Be sure any loan was properly documented and that payments were accrued and made accordingly. None of this is unfamiliar work, but with reinsurance companies, you may find it necessary to find the documentation in several places. Someone at the dealership may have a portion of the records; the direct insurer may have part of the puzzle; and the program provider is likely to have the most useful information.

Every examination is different and can raise unexpected complications. If so, be sure to encourage the client to engage tax counsel with specialized experience in this area.

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HOW TO REDUCE DEALERS' PREMIUMS ON EXISTING LIFE INSURANCE POLICIES ... A SERVICE YOUR DEALER CAN USE

By Anthony A. Freeman

Most individuals, businesses and trusts pay a substantial amount each year to maintain their life insurance coverage. So what options are available when it becomes necessary to reduce the annual premiums? Traditionally an agent or broker would suggest moving the coverage to another company or reducing the death benefit. The ***Life Insurance Expense Reduction Analysis*** reduces the cost of maintaining existing life insurance without policy replacement or decreased financial protection. This cost reduction technique provides three advantages.

- There is no need to apply for a new policy from a different carrier or change agents.
- The premium reduction does not result in the assessment of surrender charges that may occur when an existing policy is terminated.
- The premium reduction can normally be accomplished regardless of the insured's age or medical history.

Why are life insurance companies willing to reduce premiums?

Life insurance companies require sufficient income from both premiums and investments to meet their contractual obligations to their policy holders. Unfortunately during the last 15 to 20 years their return on investments have been much lower than expected, which has resulted in the need to maintain their current cash flow from premium payments. The pressure to maintain cash flow has led insurance carriers to be more willing to negotiate premium reductions.

Additional savings can be provided on new policies

The ***Dealers Participation Program***, introduced at the 1999 AICPA National Auto Dealership Conference, enables the dealer and his/her key employees to purchase personal, estate planning and corporate owned life insurance themselves, without an agent. The use of this proprietary program permits the dealership to sell the insurance and receive all commissions, bonuses and renewals.

How successful has the technique been?

Over 90% of the clients that have utilized this service have experienced a reduction in the cost of maintaining their existing life insurance coverage. Those savings can be expected to continue for the life of the policy.

Recently completed projects

The Proposal Review. A 61-year-old dealer needed $10 million of personal life insurance. He had taken the required medical exam when his accounting firm called Premium Advisors to review the agent's proposal. The resulting analysis revealed the proposed premium of $110,000 misrepresented the true cost of providing the coverage. Premium Advisors requested a re-proposal, which showed the actual premium to be $197,000, nearly twice the amount quoted by the agent. The client canceled his application and retained Premium Advisors to design a new program which resulted in a $78,000 annual savings.

Negotiation Strategies. An agent recently replaced an existing $5 million life insurance policy with a new $5 million "investment grade" policy. Both policies required the same annual premium of $132,000. The dealer incurred a loss of $110,000 in surrender charges to terminate the original policy. Premium Advisors reviewed the transaction and recommended the reinstatement of the original policy to recover the lost $110,000 and then negotiated a new, more cost effective policy with the original insurance carrier. This approach reduced the annual premium to $73,640, for an annual savings of 58,360.

Beware of strangers bearing gifts

With fewer life insurance policies being sold nationwide, insurance agents are looking for new ways to drum up business at your expense. One of the latest marketing techniques is the buying and selling of existing insurance policies, but the practice could have significant privacy and identity theft ramifications.

For example, let's say a father turns the family business over to his son, and son decides to carry on the old life insurance policy...until someone suggests he can sell Dad's policy and use the proceeds of the sale to buy a new, less expensive policy. Sounds like a deal, doesn't it? The problem is, there is some question about whether it is even legal to buy and sell policies like it's just another commodity. And even if it is legal, consider this: who is it that is buying these policies? When you sell a policy, that means that there is some stranger out there who is essentially waiting for you to die.

Beyond that creepy thought, however, there are very real privacy and identity theft issues at stake. When you sell a life insurance policy, you are asked for a lot of information (Social Security Number, Driver's license number)... all the information a would-be thief needs to steal your identity. How can you be sure where that information is ending up and how it will be used?

Tony Freeman (312-807-3700) is the Managing Member of Premium Advisors, LLC, a fee based life insurance advisory firm in Chicago, IL. Comments or questions can be directed to him at his website: www.pa-llc.com or email tony@pa-llc.com. Mr. Freeman also speaks to CPA and Legal professionals who focus on the auto industry.

WANDERING AROUND ... AT THE 2005 NADA CONVENTION

The 2005 NADA Convention was held January 29 through February 1 in New Orleans. As per my usual practice, I spent a few days walking around and talking to various exhibitors and CPAs to find out as much as I could about what's going on in the industry. If you asked me, "What did I 'learn' during my time at NADA?" ... Here's what I'd say ...

1. ***The IRS had an Exhibitor Booth at NADA.*** This was the first NADA Convention at which the IRS had a booth and was an exhibitor. As part of the Federal Regulatory Outreach, the IRS shared exhibitor space with several other agencies including the FTC, FCC, OFAC, DOT, NHTSA, DOL, OSHA and the EPA. If you're in tune with your dealership clients, we don't have to explain which agencies these acronyms represent.

   I spent a bit of time talking with representatives from several of the other agencies, as well as visiting with Terri Harris, the IRS Motor Vehicle Technical Advisor. All of the agencies distributed pamphlets and brochures, and it seemed like every time I passed by or was within eyeshot, there were many people talking to the various agency representatives.

2. ***Audit Technique Guide for Auto Dealerships.*** One of the "goodies" that the IRS was giving out at its "booth" was its *New Vehicle Dealership Audit Techniques Guide - 2004*. This Guide is available as Publication 4435 (01-2005), Catalog Number 39491F. In addition to the paper copy, the IRS was also distributing the Guide on CD format. (See separate article in this issue which analyzes the new Guide.)

3. ***IRS Audit Hearsay.*** The juiciest tidbit I heard about IRS audits was from a very reliable CPA. Apparently, two IRS agents walked into the dealership unannounced, identified themselves and said that they were only there to do "an 8300 audit." That's all they did. They found 8 violations and assessed the dealership $25,000 per violation ... Total assessment = $200,000. Not a bad return on a few hours of IRS audit time.

   On a similar note, the same CPA told me that he was in another dealership, and when he inquired about their Form 8300 reporting compliance, the controller told him words to the effect, "We don't have any problems with that because we don't take any cash." The CPA asked, "Well, what do you take if you don't take cash?" The controller's reply ... "We only take cashier's checks." !!!!!

   The moral of the story ... You can't be too careful with cash transaction reporting.

4. ***Little Going on in the Way of IRS Audit Activity Right Now.*** Other than the comment above, there seems to be virtually ***NO IRS audits of income tax returns going on***. I spoke to over a dozen CPAs at the Convention, and they were unanimous in reporting nothing significant in the way of audit activity ... or even signs of an IRS auditor. Reading between the lines, it seems that, at the present time, the IRS is tremendously understaffed and under-budgeted.

5. ***Accountable Plan Reimbursement Programs for Technicians.*** Only one member of this industry had a booth at NADA. I spoke at length with Tom Lower of Pro-Check National, Inc, and he indicated that Pro-Check was continuing to very active in trying to obtain guidance from the IRS on accountable plans.

6. ***NADA Publications.*** One of my subroutines at the convention involves stopping by the NADA bookstore to see what's new. There are at least 3 publications that probably should part of every dealership CPA's reference library. These publications are in the form of Dealer Guides and include the following:
   - *Valuing an Automobile Dealership: Update 2004* ... This Guide was originally published in 1995 and updated in 2000. The current revision during 2004 is authored by Diane T. Anderson with Moss Adams Advisory Services and David A. Duryee, a retired Principal of the Moss Adams Valuation Services Group.
   - *Business Succession Planning Guide*. This Guide contains a lot of basic information and worksheets and is relatively current (2003). It is authored by Sid Tobiason and David Duryee of Moss Adams.
   - *Federal Tax Treatment of Demos*. This Guide was written in 2002, and it basically details the IRS safe harbor Revenue Procedure (RP 2001-56) on this subject.

7. ***Reducing Costs for Dealer Personal Insurance.*** At the Convention, I "bumped into" Tony Freeman, and he told me about some of the work he is doing consulting with dealers in this specialized area. He has been able to accomplish significant cost reductions because in many situations, the dealer purchased his insurance from a fraternity brother or a golf buddy a long time ago, and no one has ever looked at it since. I asked Tony to prepare a short article for the *Dealer Tax Watch*, and his article appears on page 26.

8. ***Dealer PORCs.*** Another interesting person I "bumped into" was Andy Weill, the attorney who represented the dealerships and PORCs in the Letter Rulings (TAMs 200453012 and ...-013) described elsewhere in this issue of the *DTW*. I've written previously about Andy's comments at the PORC Conference in Dallas (these are reported in the December, 2004 *DTW*). Andy prepared a short article for this issue the *DTW* which appears on pages 24-25.

9. ***Lease-Here, Buy-Here.*** In talking with Ken Shilson, the Buy-Here, Pay-Here guru, he told me that in some states, Lease-Here, Pay-Here is becoming very popular. This popularity comes about in part because of the opportunity it affords the dealer to repossess the vehicle should that become necessary. I hope to prevail on Ken in the future for some information for our readership.

10. ***New Association of Attorneys.*** An association has been formed whose membership consists of attorneys who represent auto and other vehicle/vessel dealers. This will provide a forum for members to share information and common experiences relating to a multiplicity of issues. The name of the association is the National Association of Dealer Counsel (NADC) and information may be obtained by going through its web site (www.dealercounsel.com). Associate memberships may be available for non-attorneys.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION ... LAS VEGAS ... JAN. - FEB., 2005	
ACURA	1. Get more products. 2. Produce more *RLs*. 3. Persuade Acura to build a convertible.
AUDI	1. Bring dealers to profitability with attractive pricing, marketing and incentives. 2. Launch the *A4, A3* and *A6* successfully. 3. Stabilized the franchise.
BMW	1. Maintain profitability. 2. Launch the *3 series* successfully. 3. Get adequate training.
BUICK	1. Increase profitability. 2. Boost volume. 3. Intensify marketing to raise awareness.
CADILLAC	1. Create an upgraded retail standard for all *Cadillac* dealers. 2. Simplify incentives. 3. Eliminate constraints in manufacturing.
CHEVROLET	1. Get to 3 million sales. 2. Maintain quality in production. 3. Lower inventory levels.
CHRYSLER-JEEP	1. Boost dealer profitability 2. Retain more customers. 3. Work out the formula on which vehicle bonuses are paid for meeting store sales quotas.
DODGE	1. Increase dealer profitability. 2. Deal with fierce competition. 3. Launch and price new products properly.
FORD	1. Improve dealer profitability. 2. Push for future product. 3. Promote vehicle engineering and styling advances.
HONDA	1. Maintain a 2-channel selling system. 2. Make sure dealers are profitable. 3. Ensure timely communication among dealers, dealer council and manufacturer.
HUMMER	1. Get more advertising dollars. 2. Stay true to the *Hummer* heritage. 3. Add products.
HYUNDAI	1. Control dealership expenses. 2. Train new dealership people. 3. Expand Hyundai Motor Finance to handle our needs in loans and floorplanning and buying our retail paper.
INFINITI	1. Enhance dealer profitability. 2. Add products. 3. Make sure product quality stays high.
ISUZU	1. Decide how to market the *Ascender*. 2. Increase parts and service business. 3. Focus on *Isuzu* franchise.
JAGUAR	1. Increase dealer profitability. 2. Make sure the United Kingdom knows that the U.S. market has its own style. 3. Bring new products to market faster.
KIA	1. Improve sales. 2. Improve customer service. 3. Improve the value of the franchise.
LAND ROVER	1. Improve quality. 2. Boost dealer profitability. 3. Launch new *Range Rover Sport*.

TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS AT NADA CONVENTION ... LAS VEGAS ... JAN. - FEB., 2004	
LEXUS	1. Meet customer expectations while launching 3 new vehicles. 2. Communicate information from the customer and the dealer to the factory. 3. Continue to increase *Lexus* business while maintaining top sales satisfaction scores.
LINCOLN MERCURY	1. Improve dealer profitability. 2. Push for future product. 3. Promote continued quality improvement.
MAZDA	1. Make sure dealers are profitable. 2. Improve the relationship with Mazda American Credit. 3. Increase dealers' role in product development.
MERCEDES-BENZ	1. Keep improving quality. 2. Make parts available quickly. 3. Shorten the product life cycle.
MITSUBISHI	1. Get additional marketing dollars. 2. Get additional product. 3. Increase dealer profitability.
NISSAN	1. Get a *Scion*-type vehicle. 2. Improve the certified use-vehicle program. 3. Increase dealer profitability.
OLDSMOBILE	• None provided.
PONTIAC - GMC	1. Make sure dealers are profitable. 2. Leave the selling to the dealers. 3. Don't shift costs from the manufacturer to the dealer.
PORSCHE	1. Make a smooth transition between old and new vehicles. 2. Make sure all dealers are selling the entire range. 3. Provide more and timely training for entire dealership staff.
SAAB	1. Expand product line. 2. Build dealer profitability. 3. Receive sufficient marketing resources.
SATURN	1. Establish an accurate pricing structure for new products. 2. Maintain a consistent marketing message. 3. Train dealers for new product.
SUBARU	1. Limit product sharing with *Saab* and other brands. 2. Make sure all dealers establish a premium image. 3. Maintain communication among dealers, Subaru of America and Fuji Heavy Industries.
SUZUKI	1. Get more *Suzuki* dealers actively engaged in selling *Suzukis*. 2. Increase dealership floor traffic. 3. Improve product awareness.
TOYOTA	1. Produce more hybrid vehicles. 2. Improve customer satisfaction. 3. Maintain dealer profit and franchise values.
VOLKSWAGEN	1. Successfully launch the new *Jetta* and *Passat*. 2. Continue to improve product reliability. 3. Improve dealership profitability.
VOLVO	1. Maintain a flow of new products. 2. Offer competitive captive financing deals. 3. Keep a consistent management team.

IRS

Revenue Procedure 98-25

1998-1 CB 689, (Feb. 26, 1998). 1998-11 I.R.B. 7

Electronic Records Retention Requirements for Auto Dealerships

Automotive Alert

The Motor Vehicle Technical Advisor (MVTA) program is engaged in a joint project with IRS Computer Audit Specialists (CAS) to identify and resolve concerns regarding compliance with Rev. Proc. 98-25. Historically, automobile dealerships have not been compliant in maintaining records as required under the revenue procedure.

Rev. Proc. 98-25 is not specific to auto dealerships and applies to any taxpayer with assets ≥ $10 million. Requirements of Rev. Proc. 98-25 include the maintenance of electronic records that:

- are capable of being processed
- can be retrieved, manipulated, printed
- contain sufficient transaction level detail

In addition, taxpayers must provide, as necessary, resources to process records including hardware, software, terminal access, computer time, and personnel.

Auto dealerships generally utilize computer systems that must meet the manufacturers' requirements and that are designed specifically for their businesses. In many cases, the systems do not meet the requirements imposed by Rev. Proc. 98-25. Several factors contribute to the auto dealership industry non-compliance, such as:

- Dealerships have a limited number of hardware and software vendors from which to choose.
- The transfer of data from one vendor's product to another is difficult or impossible.
- Information systems are typically relatively small and do not store information from prior cycles.
- Back up tapes might be made but typically are not retained for an extended period.
- If back up information is available; it generally cannot be loaded back onto the dealer's system without removal of the current activity.
- Information systems contain proprietary software that usually cannot be accessed by a Computer Audit Specialist.

In order for dealers to evaluate whether or not their system in compliance, IRS CAS have developed a list of common files necessary for most IRS audits. If you have any questions regarding your dealerships' compliance, contact your software vendor. For questions regarding the requirements of Rev. Proc. 98-25, contact the MVTA team. We will be happy to discuss the issue with your and if necessary put you in contact with IRS computer specialists.

Motor Vehicle Technical Advisor

January 12, 2005

	Generic Listing of Computer Files Necessary for Most IRS Examinations

Types of Files:	Although not all-inclusive, the following list indicates files most used by an IRS Computer Audit Specialist.
	• Files are in a sequential/ fixed-length, or delimited, or print file, record format--ASCII.
	• Documentation would include the file layouts outlining:
	    o Field names and description;
	    o Data formats (character, text, numeric, packed decimal, etc.);
	    o Length of each field;
	    o Total record length.
	    o Each file retained on magnetic media should have a label that contains file name, record length, and number of records.

General Ledger Master File	• Contains the complete General Ledger Account number, Account Name Description, and Prior 12-month Debit or Credit Ending GL Balances.

General Ledger Transaction File	• Contains the complete 12 month (including post-closing entries) detail journal voucher transactions.
	• Fields that may be contained in this file would be:
	    o General Ledger Account Number;
	    o Corp. Number;
	    o Plant Number;
	    o Journal Reference Number;
	    o General Ledger Account Name Description;
	    o Transaction/posted date(s) in a MM/DD/YYYY format (Y2K compliant date fields);
	    o JV Number, JV Description, Posted JV Debit/Credit Amounts.
	• There must be enough information contained in this file for IRS examiners to request specific JV source documents.
	• This file may also contain detail accounts payable entries. If so, a Vendor Number, Vendor Name, and Invoice Number should be included.

Accounts Payable Distribution File	• Contains the complete 12-month booked detail postings of accounts payable transactions. Data formats same as GL or other files.
	• Fields contained in this file would be:
	    o General Ledger Account Number;
	    o Plant Number and Corp. Number;
	    o Transaction/Posted Date(s) in Y2K compliant format;
	    o Invoice Number;
	    o Vendor Number and Name;
	    o Transaction Amount.
	• There must be enough information contained in this file to pull invoice source documents.

Vendor Master File	• Contains the Vendor Number, Vendor Name, and Vendor Full Address.
LIFO/Inventory Files	• In general, the records should contain inventory-costing information necessary to calculate the LIFO index.

Miscellaneous	• Files that may be necessary to administer other IRS provisions including:
	    o W-2 and 1099 files;
	    o Fixed Asset Files;
	    o Excise Tax Files;
	    o Corp Tax or Fast Tax Files
	    o Any other records pertinent to the examination.

(Continued from page 6)

March of 2000. This CIP concluded that most buildings and service bay operations would fail to meet other special 50% tests which are involved. (See September 2000 *DTW*–pages 18-22, December 1999 *DTW*–page 8 and September 1999 *DTW*–page 4.)

The caller said that the benefit being touted did not relate to the 15-year useful life issue. My question is simply ... Have any of you become aware of a special tax benefit out there related to dealership service bays? If so, we'd like to know about it.

#12. DEDUCTING PREPAID EXPENSES UNDER "12-MONTH" RULE ... A ONE-TIME DEFERRAL BENEFIT THAT MAY BE WORTHWHILE. Revenue Procedure 2005-9 now provides the special rules to be followed in filing Form 3115 for the purpose of making a change in accounting method to deduct prepaid items which do not have a useful life of more than one year. When we mentioned this several times previously, these Form 3115 procedures had not been finalized ... now they have been in Rev. Proc. 2005-9.

A recent publication, *Tax Action Memo*–1080 dated March 1, 2005 (Thompson / Practitioner's Publishing Company), discusses the prepaid expenses Regulation and includes a filled-in sample Form 3115 for making the change under Reg. Sec. 1.263(a)-4(f) for the 12-month rule for prepaid expenses of accrual taxpayers.

This *Tax Action Memo* also includes a good discussion of the interaction of the 12-month rule with the economic performance rules of Reg. Sec. 1.461-4(d)(2) and Reg. Sec. 1.461-4(g).

If you have not yet made this change for your dealer clients, you might want to get this PPC *Memo* and study it.

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 2005 Willard J. De Filipps.
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