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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. "SUMMERTIME ... & THE SERVICE IS BUSY" (To be hummed to the tune of that lazy classic melody, *Summertime and the Livin' Is Easy*). Most CPAs I've talked to lately said that they were really "going crazy" right before April 15th ... you know, tax return filings and all that stuff. You think you were busy? Consider the IRS' web site. During the 3-day period April 13-14-15, the IRS' web site averaged 83 searches per second. (Yes, per second!) That statistic was provided by Bert DuMars, Director of the IRS Office of Electronic Tax Administration at a recent seminar.

In this issue of the *Dealer Tax Watch*, we're going to focus on a number of the IRS activities going on currently and anticipated in the short-term future. Most of these will affect you directly and significantly ... (1) The IRS' more intensive tracking of tax returns filed by flow-through entities, (2) the continual evolution of Schedule M-3 (whose reach will be expanded from corporate filers to others very soon), (3) electronic filing requirements for C Corps and S Corps (most likely affecting the majority of our readers when they file 2006 tax returns for their dealership clients in 2007... .

Here's another interesting statistic... According to another IRS official, the Service has found that individuals reporting $1 million of compensation may be involved with approximately 10 to 15 flow-through entities, reporting (or not reporting) K-1 information in Schedule E and other parts of their tax returns.

To top it off and fit right in, a former Senior Industry Advisor to the LMSB wrote a book on his experiences over his 4-year term of employment. We're also reporting on this because his book provides a good overview of the LMSB operations and its major initiatives.

All you have to do is read the newspapers to get a daily dose of the IRS' ongoing attacks against promoters of, and investors in, abusive tax shelters. And, the Service issued a Revenue Ruling affecting accountable plan providers, the timing of which was certainly a surprise to everybody.

There have not been any really significant tax cases decided over the summer ... with the exception of the *David Taylor Enterprises* case, reported herein. However, there are still a number of developments that reflect a very high energy and activity level within the IRS as it continues to pull together a variety of initiatives to "tighten up" the tax return filing season for 2005 and its audit "currency" objectives.

Summer and fall are the seasons for tax seminars and conferences. And, I've attended my share. There is one conclusion that I want to share with all readers about my impressions of the IRS after hearing many presentations by its representatives ... "They've come a long way, Baby" ... "It's not your father's IRS."

WATCHING OUT FOR

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I recently received a certificate from the AICPA on my 40-year anniversary as a member (that's a lot of dues). But, since I've been in the public practice as a CPA all my professional life, starting with the Big 8, moving to smaller and medium-sized firms and then finally settling in for the last 27 years as a sole practitioner, I've had a lot of contact with the IRS basically at all levels.

After listening to a number of IRS speakers this year, I have been extremely impressed by the competence and broad range of experience evidenced by the leadership. In addition, this staff of very capable individuals is very much of one accord in trying to enhance the reputation of the IRS and to emphasize ("customer") service. This evidences itself in a direction that significantly challenges those of us in tax practice to keep up with it and the accelerating pace that it sets for us to match.

I believe that it is too bad that many really good IRS initiatives that are now ready to be further implemented simply have to wait because of either budget limitations or union resistance.

#2. *CORPORATE TAX AUDIT SURVIVAL ...* A BOOK REVIEW. Another new resource that seems to dovetail nicely with our consideration of IRS - LMSB activities in this issue of the *DTW* is the recently published book by Cliff Jernigan ... *Corporate Tax Audit Survival ... A View of the IRS through Insider Eyes.*

Mr. Jernigan wrote this book after recently completing his 4-year term of employment with the IRS as a Senior Industry Advisor to the LMSB.

The book is a quick read and you can skim it in a few hours if you skip over the detailed charts. If you don't even have that much time to give to it, we've tried to hit some of the high points in our review starting on page 6.

#3. SCHEDULE M-3 ... CONTINUOUSLY EVOLVING. Our update on Schedule M-3 includes the draft of Schedule M-3 to be used for 2005 tax return filings. Note that this year, all 4 columns of Parts II and III will have to be filled in ... The free ride is over.

On June 23, 2005, the IRS released a draft version of the 2005 Schedule M-3 and the related instructions. The draft 2005 Schedule M-3 includes a few new line items and reflects other minor modifications to last year's form. The IRS web site for Frequently Asked Questions is now updated weekly (www.irs.gov) and is a good place to get detail information.

The Service said that it does not anticipate any further changes to the draft Schedule M-3 and the instructions and that it expects the "final version" to be available this fall.

As we noted previously in the *DTW*, it seems that for the typical or straight-forward dealership corporate returns, CPAs should not encounter any major problems or difficulties in completing Schedule M-3. Just to repeat a previous reminder... ***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.***

#4. MANDATORY E-FILING FOR YOUR DEALERSHIP C CORPS ... ARE YOU READY? Get ready for this, it's another IRS LMSB initiative that's going to hit you right between the eyes in a few months. Corporations that file Form 1120 or Form 1120-S for tax periods ending on or after December 31, 2005 will be required to file those tax returns ***electronically***. This requirement applies immediately to a corporation that has assets of $50 million or more and files at least 250 returns, including income tax, information returns, excise tax and employment tax returns ... counting each W-2 and/or each 1099 as one return.

You've just exhaled a sigh of relief because none of your dealership clients have $50 million in assets. But, for the tax year 2006, for tax returns that are due in 2007, the electronic filing requirement will be expanded to include corporations with $10 million or more in total assets that file 250 or more total returns per year. This drop-down to $10 million in assets (as shown on Schedule L) is the requirement that is more likely to hit you in a few months ... January 2007 is coming up fast.

These Regulations were issued January 11, 2005, and the Service has a web page for Frequently Asked Questions devoted to LMSB corporations that will be required to file electronically either sooner or later.

#5. TECHNICIAN ACCOUNTABLE PLANS ... OBVIOUSLY FLAWED PLANS TAKE A HIT ... REV. RUL. 2005-52 EMPHASIZES STRICT COMPLIANCE. The June 2005 issue of the *Dealer Tax Watch* was almost entirely devoted to a discussion of technicians' tool reimbursement plans under Section 62(c). Little did we know at the time of preparing the publication, that the IRS had already drafted a Revenue Ruling which was going through its final approval process at the same time. On August 3, 2005, the IRS published Revenue Ruling 2005-52 ... and it has created quite a stir for some plans and for some plan providers.

The hypothetical fact pattern that the Service considered was too simple to provide any guidance, and it allowed the IRS to tee-up the accountable plan in question and drive it 300 yards into the water.

see **DEALER TAX WATCH OUT**, page 4

e-File	<u>***How to Determine Whether a Corporation Files 250 Returns with the IRS***</u>
Who Is Required to e-File for 2005	• Regulations issued January 11, 2005 require that corporations electronically file any Form 1120 or Form 1120-S for tax periods ending on or after December 31, 2005 if they satisfy two conditions: ◆ They have assets of ***$50 million or more***, and ◆ They file at least 250 returns during a calendar year. • ***"Returns"*** includes … income tax, information returns, excise tax, and employment tax returns.
Who Is Required to e-File For 2006	• This applies for tax year 2006 returns that are due to be filed in 2007. • The electronic filing requirement will be expanded to include corporations if they satisfy two conditions: ◆ They have assets of ***$10 million or more***, and ◆ They file at least 250 returns during a calendar year.
What Is Meant by "250 Returns?"	• All original returns filed by a corporation ***and other members of the organization's controlled group*** during the calendar year are counted. • ***"Returns"*** includes … income tax, information returns, excise tax, and employment tax returns. ◆ Each W-2 filed for an employee is counted as one return. ◆ Each Form 1099 filed for a recipient is counted as one return. ◆ Corrected or amended returns are not counted as returns.
Example 1	• A corporation that has 245 employees must file Form 1120 or 1120-S electronically if it meets the asset criteria ($50 million or more). • This is because each individual Form W-2 as well as the each of the employment tax returns is considered a separate return.
Example 2	• A consolidated corporation with 10 subsidiaries and each subsidiary and parent company has 20 employees must file Form 1120 or 1120-S electronically if it meets the asset criteria ($50 million or more) because: ◆ Each of the 220 Form W-2s are considered a separate return. ◆ Each of the 11 Forms 940 are considered a separate return. ◆ Each of the 44 Forms 941 are considered a separate return.
Example 3	• A consolidated corporation with 5 subsidiaries and each subsidiary and the parent have 25 employees, one of the subsidiaries files 100 Forms 1099 and another subsidiary files 3 Forms 720. Form 1120 or 1120-S must be filed electronically if the group meets the asset criteria ($50 million or more) because: ◆ Each of the 150 Forms W-2 is considered a separate return. ◆ Each of the 6 Forms 940 is considered a separate return. ◆ Each of the 100 Forms 1099 is considered a separate return. ◆ Each of the 3 Forms 720 is considered a separate return.
Example 4	• A controlled group as defined by Section 1563(a) has 10 member corporations and each member has 20 employees. All members of the controlled group are deemed to have met the 250 return threshold because: ◆ Each of the 200 Form W-2s is considered a separate return. ◆ Each of the 10 Forms 940 is considered a separate return. ◆ Each of the 40 Forms 941 is considered a separate return. ◆ Each of the 10 Forms 1120 / 1120-S is considered a separate return. • Each member of the controlled group that also meets the asset criteria ($50 million or more) must electronically file their Forms 1120 or 1120-S.

(Continued from page 2)

Most readers of the *DTW* will think of this Revenue Ruling in terms of its implications for accountable plans for service technicians (and their tools). However, it's important to be aware that this Revenue Ruling could have implications for Section 62(c) plans set up for a variety of other employee expenses.

In short, employees must substantiate everything, and they must return any excess reimbursements to their employer. For more on this, see page 11.

#6. OTHER DEVELOPMENTS RE: SERVICE TECH ACCOUNTABLE PLANS ... THE IRS TIGHTENS THE NOOSE? At about the same time that the Service came out with Rev. Rul. 2005-52, two related developments occurred.

First, the IRS issued ***Notice 2005-59***. In this Notice, the IRS laid down the warning (to service tech plans and others) that it would be much harder in the future for people wanting to get Section 62(c) technician accountable plan issues on the docket for IIR (Industry Issue Resolution) consideration. (See page 14.)

Second, the Service issued its Priority Guidance List for 2005-2006. This seems to indicate that the Service has some intention of addressing accountable plans in some way. But, remember, Revenue Ruling 2005-52 was the result of having the issue on the Service's Priority Guidance List for 2004-2005. Does this suggest the old adage ... Be careful what you wish for, because you may get it ... ?

#7. CLASSIC CARS ARE INVENTORY FOR AN AUTO DEALERSHIP ... LOSSES ON SALES PRODUCE ORDINARY DEDUCTIONS. Many dealers get involved with side activities, hobbies, all-consuming endeavors ... "passions" ... that are natural by-products of their interests in their core business of buying, selling and servicing new and used vehicles.

Usually, if conducted as a business, the gains and profits realized from these activities are taxable as ordinary income. The other side of the coin is that losses receive similar treatment as offsets against ordinary income.

In a recent case, *David Taylor Enterprises v. Comm.*, decided May 31, 2005 (T.C. Memo 2005-127), the IRS tried to have it both ways. It wanted to collect higher taxes on ordinary income if the classic cars were sold at a profit, but permit only lesser tax benefits (i.e., capital loss treatment) to the taxpayer if sales of classic cars produced losses. So, the question was: Were the classic cars inventory to the dealer, or were they assets held for investment?

The Tax Court said that the classic cars were inventory and the IRS couldn't "have it both ways." As a result of the *Taylor* case, at least we know what factors the Tax Court will consider in evaluating how similar activities, ancillary to the main business of the dealership, should be treated. This case is discussed beginning on page 22.

#8. A HEADS-UP ON THE SEC. 199 DEDUCTION AS IT RELATES TO DEALERSHIPS. In the December 2004 issue of the *Dealer Tax Watch*, we discussed some of the "tidbits for dealers" that might be lodged in the *American Jobs Creation Act of 2004*. One possibility advanced was that there might be a freebie for dealers hidden in the 3%-6%-9% domestic manufacturing deduction. For this discussion see page 3 of the Dec. 2004 *DTW*.

It's starting to look like ... this means somewhat off the top of the head after thinking about it a little more ... that there may not be a whole lot of benefit from Section 199 for dealerships. The only exception may be for dealerships that have significant work done in their service departments or body shops as a result of their installing goods that they have "manufactured."

We'll analyze this some more in a future issue of the *DTW*. For right now, it appears that the Service will narrowly interpret many of the extremely complicated definitions and terms in such a way as to pretty much erase any benefit for the majority of dealerships.

#9. DO "IT" RIGHT BY SEEING HOW OTHERS DID "IT" WRONG ... DEALERSHIP REPORTING ISSUES. Many smaller CPA firms service automobile dealerships and part of their service includes issuing financial statements which are not sent to the manufacturer in the format mandated by the Factory. As the accounting and disclosure complexities increase, a good way to keep up-to-date on the proper accounting and disclosures is, simply, to learn from the mistakes made by others.

There is an excellent, easy way to do this, and if you're issuing financial statements not in the Factory format, you might want to consider the following. Check out the web sites for the PCOAB and for the SEC, and you will find detailed listings of mistakes (i.e., reporting / disclosure errors) that auditors of publicly-held companies have made that were significant enough to cause the restatement of those statements as reported to the SEC. One listing shows the "cause/subject of restatement" matched up with the company/issuer and the financial statements in question.

Here's the suggestion. If you've got some question about how to treat or disclose a particular accounting issue, look at the topical listing for a registrant who did it wrong, and then look at the restated financials to see how it should have been done properly in the first instance.

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FLOW-THROUGH ENTITIES ARE VERY HIGH AND VISIBLE ON THE IRS' RADAR SCREEN

Just because flow-through entities ... partnerships and Subchapter S Corporations ... do not have to complete Schedule M-3 yet, don't think that the IRS isn't paying a lot of attention to them.

A special group within the IRS has been created to coordinate a number of compliance initiatives for "flow-throughs" by working jointly with both the Large and Mid-Size Business (LMSB) and the Small Business / Self-Employment (SBSE) operating divisions.

Basically, there are two reasons for the increasing attention devoted by the IRS to these entities. First, the use of flow-through entities has been integral to the operations of many abusive tax shelter schemes and programs. The IRS' monumental efforts to combat these abusive tax shelter schemes are now moving closer to fruition, and what is clear to everyone is that these entities have long been neglected in previous IRS compliance activities. The IRS seeks to change this dramatically.

The second reason for the increased focus by the IRS on flow-through entities is simply that partnerships are the fastest growing segment of the LMSB population, growing to a population of approximately 76,000 in recent years. S Corporation filings with the LMSB are in the 30,000 range. As a result, according to the fiscal year 2004 LMSB Strategic Assessment, flow-through entities are the largest segment of the LMSB income tax return population, making up approximately 60% of the customer base.

Within the SBSE, the flow-through population for 2004 was almost 2.5 million partnerships, 3.5 million S Corporations and 3.7 million trust returns. That's a lot of returns and K-1s.

According to the Service, the complexity of Subchapter K, in which the partnership rules are found, "is conducive to enhanced compliance risk." Two aspects are very impressive about the newer approaches now being initiated by the IRS flow-through entity group to get a better grasp of the returns and issues involved.

The first is the use of an "enterprise risk" approach that involves multi-entity analysis and visualization concepts. Using complex models and the development of K-1-based tools, the Service is using pattern visualization and link analysis to look into the universe of these reporting entities to seek out similar filing patterns.

Other research tools include queries involving ... pattern research, pattern discovery and pattern similarity, all of which should enable the Service to recognize patterns of control and ownership. These tools and techniques should also help the IRS to recognize patterns that do not necessarily suggest compliance risk. Therefore, these returns can be given less - or no - attention in the examination process.

It was reported recently that the correlation of high income / high risk with the use of multiple flow-through entities is far to large to be ignored. Apparently, the Service has found that individuals reporting over $1 million of compensation may be involved with approximately 10 to 15 flow-through entities.

Another compliance initiative directed at partnerships and S Corporations involves the Service auditing a small sample of filers just to see "what's there."

Based on the findings of the small sample audits, the sample can be expanded if early findings suggest major problem areas. Some major problem areas previously detected in clued (1) invalid shareholders, (2) reasonable compensation issues, (3) involvement with employee stock ownership plans (ESOPs) and (4) Skip/Stop filers. Some partnerships exist only for one year ... and in that year, the tremendous tax shelter losses are reported ... and then the partnership just vanishes.

These compliance audit initiatives for flow-throughs also enable the Service to determine whether problems encountered suggest "compliance issues" or "legislation problems."

Dealer Tax Watch Out

BNA has an excellent summary in its *Accounting Policy & Practice Reports*. This approach and BNA's summaries may save you some research time. It's always interesting to see how other CPAs are handling difficult issues, and this might help you learn from the mistakes of others.

#10. TELECONFERENCES COMING SOON. We're planning to do a few year-end teleconferences

(Continued)

involving various LIFO and auto dealer planning issues. Particulars (time and date) have not been finalized. Location will be your office or wherever you have a good phone. There will be ample time for questions & answers.

If you're interested, please let us know so that we can be sure to provide you with timely advance information.

CORPORATE TAX AUDIT SURVIVAL ... A VIEW OF THE IRS THROUGH INSIDER EYES

BOOK REVIEW

Corporate Tax Audit Survival ... A View of the IRS through Insider Eyes by Cliff Jernigan was published earlier this year, after Mr. Jernigan completed a 4-year term with the Internal Revenue Service as a Senior Industry Advisor to the LMSB (Large and Mid-Size Business) Operating Division.

In his book, Mr. Jernigan discusses the history and operation of the LMSB, as well as providing insights into his experiences as an IRS employee. He did not come up through the ranks, but rather, was recruited by former Commissioner Rossotti to provide leadership for this Division for the period April 2001 through April 2005. After leaving the IRS, Mr. Jernigan formed his own law firm in California.

The book is quick read, if you don't allow yourself to get stuck in some of the organization charts. It can easily be skimmed in a few hours because its 145 pages contain lots of "white space - empty pages" between chapters.

There is quite a bit of overlap, compliments all around by Mr. Jernigan for his peers and overview-type discussions of the history, activities and initiatives of the LMSB.

CPAs and corporate executives involved with filing Form 1120 should at least survey this book to get a sense of how the IRS is currently set up to deal with the universe of larger corporate tax filers.

The title might be a little misleading or "too general." It suggests something more than the text actually delivers. But, for those not too familiar with IRS workings today, there are many insights, bits and pieces of interesting ("useful" might be stretching it a bit) information about the LMSB and perceptions about IRS agents and the IRS "culture."

One way that the IRS has been able to attract individuals like Mr. Jernigan ... competent, high-level executives (who also are not inhibited by years of experience working in the bureaucratic IRS culture) ... is through a special provision contained in the Revenue Act of 1998.

This provision authorized a maximum of 40 "critical pay" employees in senior-level management and technical positions at any one time. The pay structure for employees in this category is closer to compensation levels in private industry, which can be paid to these individuals whose skills are essential to the achievement of the IRS restructuring objectives.

The term of employment for any individual recruited from the outside under this program (which is in place for the years 1998 through 2008) cannot exceed 4 years.

The book is divided into two parts. Part One, consisting of Chapters 1 through 6, relates Mr. Jernigan's experiences in joining the IRS as a new employee and getting acclimated to the IRS culture. Part Two, Chapters 7 through 15, discusses the world of the LMSB Division. These chapters are briefly summarized in the following pages. Of particular interest is Chapter 7, which briefly discusses the IRS initiatives, all of which are intended to result in greater "currency" ... the term describing the Service's objective to shorten the audit cycle for the largest corporate filers.

*10 Ways to Increase Your Tax Audit Survival - Ability**

1. Develop trust and rapport with the IRS team auditing your company.
2. Maintain your credibility at all times.
3. Set aggressive time lines for completion of the audit.
4. Consider using the *Joint Audit Planning Process* program.
5. Request entry into the *Limited Issue Focused Examination (LIFE)* program.
6. Use pre-filing agreements where possible.
7. Avail yourself of the *Fast Track Appeals Settlement* program.
8. Engage the IRS in industry and professional meetings.
9. Know when to engage the IRS for relief.
10. When all else fails, go to the Congress for relief.

* Source: *Corporate Tax Audit Survival* by Cliff Jernigan (page 9).

At A Glance	***LMSB ... IRS Initiatives, Processes & Programs***
PFA ***Pre-Filing Agreements***	• This program is designed to resolve complex factual issues before the tax return is filed. • The program is intended to eliminate tax controversy before the tax return is filed and provides certainty that agreed-upon tax positions will not be challenged during the post-filing examination process.
IIR ***Industry Issue Resolution Agreements***	• Issues for consideration in the IIR program require at least two of the following characteristics: ◆ Uncertainty exists as to the proper tax treatment of a common factual situation. ◆ Uncertainty results in frequent, often repetitive, examinations of the same issue. ◆ Uncertainty results in taxpayer burden. ◆ The issue is significant and impacts many taxpayers either within an industry or across industry lines. ◆ The issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist in determining the proper tax treatment. • The IIR process usually results in the issuance of guidance in a Revenue Ruling or a Revenue Procedure.
LIFE ***Limited Issue Focused Examinations***	• A LIFE audit is a streamlined, issue-focused plan for examining those issues thought to represent the greatest compliance risk. • A LIFE examination applies materiality principles to limit the scope of the examination. • The taxpayer and the LMSB enter into *Memorandum of Understanding* which identifies ◆ The issues to be examined. ◆ The materiality thresholds to govern the expansion and the scope of the audit examination. • If the taxpayer does not meet its commitment in the *Memorandum*, the process may be terminated.
TSSI ***Tax Shelter Settlement Initiatives***	• As a result of the alarming expansion of abusive tax shelter programs, the Service has characterized many of these shelters as "listed transactions" for which special disclosures and reporting are required. • In order to settle a large number of similar cases, the Service has proposed several settlement initiatives for many of these tax shelters. ◆ Generally, the taxpayer must pay most or all of the tax that should have been paid, plus interest. ◆ Often penalties are reduced as an incentive for voluntarily complying with the settlement initiatives.
FTA ***Fast Track Appeals***	• This program is designed to bring the taxpayer, the IRS examiner and an Appeals officer together during the examination process in order to try to settle one or a few contested issues. • Under the program, the taxpayer does not formally go to Appeals ... LMSB retains jurisdiction over the case. • The issues must be significantly developed as to facts and law, and all parties must make a good faith effort to reach settlement. • If settlement is not reached, the taxpayer still has the right to take the issue to Appeals. • Most cases in the Fast Track Settlement program have closed within 60 to 90 days, as compared to a case in Appeals which might take almost a year or two.
JAPP ***Joint Audit Planning Process***	• This program is intended to speed up the audit process by bringing together the key audit participants and taxpayer participants before the audit begins. • The goal is to reduce the items examined on the return to those which are most important from the standpoint of potential tax collection. Communication, trust and candid discussions are vital to the process. • After the discussions are complete, the IRS will furnish a draft audit plan to the taxpayer for review and concurrence. If the taxpayer concurs, the audit is then ready to begin.
M-3 ***Sch. M-3 for the Form 1120***	• Schedule M-3 has been developed to make it easier for the IRS to spot and understand differences between financial accounting net income and taxable income on the Form 1120. • All differences are required to be disclosed in full as either temporary or permanent timing differences. • Currently, Schedule M-3 is required to be completed only by certain corporations filing Form 1120.
CAP ***Compliance Assurance Process Program***	• This program is applicable only to the auditing of publicly-traded corporations. • The IRS works with taxpayers in this program using a variety of third-party information sources, such as filings with the SEC, to identify and resolve controversial tax issues. • Taxpayers and the IRS sign a *Memorandum of Understanding* to ensure commitment on issues such as timely access to records and personnel, transparency and cooperation.
e-File	• For tax year 2005 returns due in 2006, corporations with total assets of $50 million or more will be required to file Forms 1120 and 1120-S electronically. • Beginning in 2007, the e-file requirement will be expanded to include the 2006 tax returns of corporations with $10 million or more in assets. • The electronic filing requirement applies only to entities that file at least 250 returns during a calendar year, including income tax, excise tax, information and employment tax returns. • The Service anticipates that electronic filing will speed tax return processing and reduce audit cycle time.

Chapter Critiques	**Corporate Tax Audit Survival** **A View of the IRS through Corporate Insider Eyes** *Page 1 of 3*
Chapter Contents	***Part One: Joining the LMSB Division*** 1 ... Introduction - Reflections & Insights 2 ... Stand-Up: The History of LMSB from 1999 to Present 3 ... My Move to the Dark Side 4 ... "I Am the CTM SIA from the San Jose POD - I Am from Mars" 5 ... The Secret Society 6 ... Comparing the IRS & Industry - the People & the System ***Part Two: The World of the LMSB Division*** 7 ... IRS Initiatives 8 ... IRS Audit Concerns 9 ... Hints to Conducting a Successful Audit 10 ... Congress & the IRS 11 ... IRS Counsel & the LMSB Division 12 ... IRS Appeals and the LMSB Division 13 ... Advocacy before the IRS 14 ... IRS Alternative - Advocacy before the Congress 15 ... Charting the Future of the LMSB Division
Chapter 1 ***Introduction - Reflections & Insights***	• Quotable ... "Government service can be gratifying, but it can also have its less rewarding features, such as lower pay, greater bureaucracy and more intensive oversight." • Quotable ... "It was soon clear to me that the perceptions of IRS personnel in the field can be quite different from the views of executives based in Washington ... There was often strong resistance in the field to accept change proposed by Headquarters."
Chapter 2 ***History of LMSB***	• This chapter describes how the IRS was restructured to meet the needs of large and medium-sized businesses through the creation of an operating division involved with only taxpayers of that size. ◆ Currently, LMSB has jurisdiction over taxpayers who have total assets of $10 million or more. • Senior Industry Advisors are a class of new "short-term" employees who bring special skills to the Service for 4-year periods. These employees are compensated on a basis closer to private industry levels and bring exceptional skills to the IRS workplace. • The most important challenge faced by the LMSB was probably the proliferation of abusive tax avoidance shelters. These started to appear in the late 1990s. After a few years, the general perception held by many taxpayers was that the Service was not effectively policing this area. As a result, significant resources were employed to combat these activities, as well as this perception. • Another major challenge for the LMSB is its aging workforce. ◆ Many employees are very close to retirement and with their retirement, the Service will lose a significant knowledge and experience base.
Chapter 3 ***My Move to the Dark Side***	• This chapter describes the shocks that Mr. Jernigan experienced during his interviewing and initial employment. • Quotable ... "Moving from the private sector to the government sector is a decision not to be taken lightly ... You will give up your personal and financial privacy ... You will need to sever all financial ties with your private sector employer." Often, this entails exercising significant stock options and triggering other compensation packages which, in turn, result in significant, immediate income tax liability. • Quotable ... "When you join the government at a senior level, the reality is that you should expect to spend a substantial amount of your own money in the job." • Quotable ... "IRS employees joke that the reason the IRS does not audit more of the general public is that its employees are always being audited first, leaving few resources left to carry out other audits."

Corporate Tax Audit Survival
A View of the IRS through Corporate Insider Eyes

Chapter 4 ***"I Am the CTM SIA ..."***	• This chapter describes in the author's own words, "How ill-prepared I was to join the IRS." • Quotable ... "Because of my experiences in the private sector, I sometimes had difficulty fitting into the IRS fabric." • Key topics are ... *Spy/Traitor/Disbelief ... Acronymphobia ... Big Brother ... The System ... I Am from Mars.* ... Some of which describe some of the pettiness and the penny-wise / pound-foolish policies of the bureaucracy. • If you want to know what the acronyms in the chapter title stand for, buy the book.
Chapter 5 ***The Secret Society***	• Despite the enticing title, there is not much (new) in this chapter. • Secrecy ... Every floor is secured space that requires special permission for entrance. • Most IRS employees prefer a well-defined work routine of about 40 hours per week. • Pension at retirement might equal 2/3 or 3/4 of the yearly average of their last few years of annual earnings. • Living costs can be a challenge for government employees. • Quotable ... "IRS employees are a proud group ... There is a good *esprit de corps* in the Service ... There was a noticeable 'circling of the wagons' in defense of what they believed was unfair criticism ... It is easy to see how IRS employees develop a siege mentality of toughness against outside threats and insults."
Chapter 6 ***Comparing the IRS & the Industry ...***	• Job security ... IRS employees, like many in government, are very concerned about job security. • Tenure ... One reason for long tenure is the nature of the government retirement system, which rewards people who stay on the job. • Quotable ... Views on business ... "IRS employees, usually having little real-life business background, tend to be suspicious of people in business, and historically, the IRS management has done little to lessen these suspicions." • Unions ... Union activity has increased ... "Whenever IRS management wants to introduce a new taxpayer program, such as an initiative to reduce taxpayer compliance burden, it must get a sing-off from NTEU (National Treasury Employees Union) that this initiative is acceptable." • Entrepreneurship ... "The IRS is a bureaucratic organization. It operates from top to bottom ... In this environment, creativity can sometimes be stifled. There may be no incentive to think big picture - just think within your job description. Small wage increases add little incentive to excel." • TIGTA, a newly-created Treasury Inspection General for Tax Administration, seems to be intrusive and obstructive. This department was created to audit IRS employees. "TIGTA seems to be everywhere, perhaps because its auditors have enough time on their hands to make unnecessary requests for reports and investigations ... In my view, the TIGTA staff could easily be reduced by one-half." • It's just so hard to make progress ... "Senior managers from industry who join government have a common lament. They wanted to make a difference, but discovered that the constraints of bureaucracy will not let them do so."
Chapter 7 ***IRS Initiatives***	• This chapter briefly discusses nine IRS initiatives undertaken by the LMSB. • See page 7 of this article.

Chapter 8
 	
IRS Audit Concerns
	• ***Length of audit time.*** LMSB is attempting to speed up the audit process in several ways.
	  ◆ Get high audit risk returns to the examining agents faster.
	  ◆ Encourage taxpayers to respond more quickly to information document requests.
	  ◆ Encourage taxpayers to take advantage of the IRS initiatives discussed in Chapter 7.
	  ◆ Expedite older case closings.
	  ◆ Increase the use of Industry Director's Directive to limit certain types of audits.
	• ***Inadequate LMSB coverage of all taxpayers.*** Only a fraction of all LMSB taxpayers are audited.
	• ***The aging of the LMSB workforce.*** In the 10-year period since LMSB was established, as many as 50 to 75% of its workforce will retire.
	• ***Inadequate distribution/imbalance of staff resources.***
	• ***Inadequate training ... especially in the areas of partnership and trust taxation.***
	• ***Avoiding reversals when cases are moved to the Appeals level.***
	• ***Abusive tax shelters.***

Corporate Tax Audit Survival
A View of the IRS through Corporate Insider Eyes

Chapter 9 *Hints for Audit Success*	• Chapter 9, *Conducting Successful Audits*, is very disappointing and too general to be of any real use. • Author's suggestions/hints are listed elsewhere in this review. (See page 6 of this article.)
Chapter 10 *Congress & the IRS*	• This chapter is somewhat disappointing because discussions of the topics covered are too brief and too general. It briefly mentions: ◆ Congress' role in passing new laws every year ◆ IRS budget considerations ◆ Oversight bodies established by Congress (TIGTA) and the GAO/General Accounting Office ◆ The function of the Joint Committee on Taxation
Chapter 11 *IRS Counsel & LMSB*	• There are mainly a lot of organization charts in this chapter. • This chapter discusses the new Division Counsel structure that was put in place "that has a dotted-line" reporting relationship to the LMSB. • There are 5 Area Counsels that report to the Division Counsel and are co-located with the Industry Director.
Chapter 12 *IRS Appeals & LMSB*	• This chapter explains the relationship between the Office of Appeals and the LMSB. • By its nature, Appeals usually looks at the hazards of litigation. • There is quite a bit of animosity between Appeals and LMSB agents ... "IRS examiners do not like to see a case go to Appeals ... Many agents in LMSB were distrustful of Appeals. However, I learned that many agents in Appeals did not think much of LMSB, either." • Issuance of Appeals Settlement Guidelines allows examiners to settle a case on the basis of those guidelines and thereby avoid having the case go to Appeals. • Other procedures intended to improve the relationship between Examination and Appeals include alternative dispute resolution procedures, Fast Track Settlement procedure (which is optional for the taxpayer) and Fast Track Mediation.
Chapter 13 *Advocacy Before the IRS*	• This chapter discusses company advocacy and industry advocacy through professional organizations such as the AICPA, ABA and TEI. • Other topics briefly mentioned: Industry Issue Resolution (IIR) Agreement and Industry Director's Directive (IDD).
Chapter 14 *Advocacy Before the Congress*	• Key topics in this chapter are *Considering the Legislative Route* ... *Timing Is Everything* ... *Introducing your Bill* ... and *Reward for Job Well Done.* • The discussion of each topic is too brief and too general.
Chapter 15 *The Future of the LMSB*	• This chapter restates the four major goals that Mr. Jernigan hoped to accomplish within the LMSB when his employment with the IRS began. ◆ He believes that he made some difference in helping to improve relations between industry and the IRS. ◆ He believes that several IRS initiatives should significantly reduce audit time and cost burden for industry and the IRS. In this regard, he singles out as his favorites ... Fast Track Settlement, Industry Director's Directive and Pre-Filing Agreements. ◆ His third goal was to help U.S. industry become more competitive. This one seems to have been a tougher nut to crack. ◆ His fourth goal was to introduce private industry efficiency to the IRS. While laudable, this goal was probably the one in which he made least progress. • Quotable ... "I am constantly amazed at how many individuals and departments at the IRS get involved in handling the simplest matters ... There are too many sign-off procedures, too many rules, too many penalties for breaking the rules ... Safeguards keep being added to other safeguards, with no end in sight ... In the IRS, a significant portion of the budget goes towards these wasteful activities. • Quotable ... "The National Treasury Employees Union ... is a strong foe to any staff reductions."
Source	• *Corporate Tax Audit Survival ... A View of the IRS through Insider Eyes* by Cliff Jernigan. • Published by Olive Hill Lane Press, 2995 Woodside Road, Suite 100, Woodside, California, 94062

TECHNICIAN ACCOUNTABLE PLANS ... OBVIOUSLY FLAWED PLANS TAKE A HIT AS A NEW REVENUE RULING EMPHASIZES STRICT COMPLIANCE

The June 2005 issue of the *Dealer Tax Watch* was devoted almost entirely to a discussion of technicians' tool reimbursement plans under Section 62(c). Little did we know at the time of preparing the publication, that the IRS had already drafted a Revenue Ruling which was going through its final approval process at the same time.

On August 3, 2005, Revenue Ruling 2005-52 was published by the Service ... and it has created quite a stir for some plans and for some plan providers. As indicted in the June *Dealer Tax Watch*, a coalition of plan administrators had been formed to try to persuade the IRS that some latitude or leeway should be provided to employees who provided their own tools in the workplace. A spokesman for this group responded to the issuance of Rev. Rul. 2005-52 in these words ... "They [i.e., the IRS] have closed the door in our face before we had a chance to educate them about the real world outside the Beltway ... A lot of people feel betrayed by this thing."

At about the same time, the IRS issued Notice 2005-59. In this Notice, the Service warned that it would be much harder for people wanting to get Section 62(c) technician accountable plan issues on the docket for IIR (Industry Issue Resolution) consideration. And recently, the Service indicated that it has hopes of addressing accountable plans in some way by including that topic on its Priority Guidance List for 2005-2006.

The fact pattern for Revenue Ruling 2005-52 is relatively uncomplicated and is set forth on the facing page. This Revenue Ruling is not based on an actual fact pattern. Rather, the fact pattern represents a combination of factors blended from many plans ... and informal discussions ... that the drafters have been exposed to in the past.

Following the presentation of these facts, the Ruling discusses the requirements of Code Sections 61, 62 and the Regulations thereunder as they relate to accountable plans. Following a relatively brief "Analysis," the conclusion expressed is that, *"The arrangement described in this revenue ruling is not an accountable plan."*

Although the IRS had the opportunity to comprehensively address many issues in connection with accountable plans for which there currently is no clarification, the IRS instead issued a Revenue Ruling which basically does nothing more than emphasize the well-known requirements that in order for an arrangement to qualify as an accountable plan, it must satisfy three conditions. These conditions are described unambiguously in both the Code and the Regulations.

In essence, a reimbursement or other expense allowance arrangement satisfies the requirements of Section 62(c) if it meets these three requirements ...

1. Business connection
2. Substantiation, and
3. Returning amounts (received) in excess of actual expenses (to the employer, so that only actual expenses have been reimbursed tax-free).

In the simple fact pattern that the Service chose to establish as the parameters for its ruling, two of the three essential requirements have not been satisfied. ***These failures are given as facts.***

First, the Ruling states that the *"Employees are not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports are issued."* [Rqmt. #2]

Second, the Ruling states that the *"Employer does not require employees to return any portion of the tool allowances that exceeds the expenses they actually incur either before or after the quarterly reports are issued."* [Rqmt. #3]

The Ruling continues ... *"The arrangement [in the facts of this Ruling] does not require employees to substantiate the actual expenses they are incurring ... Reporting hours worked requiring the use of tools is not the equivalent of substantiating actual expenses incurred ... Employer does not cure the absence of substantiation or return of excess by providing employees with the quarterly statement described in this revenue ruling. Employer does not require employees to provide substantiation of expenses actually incurred nor does Employer require employees to return any excess received within a reasonable period of time after receiving the quarterly statement."*

Since the facts in the Ruling indicate that the employer deliberately ignored, or failed to comply with, two of the three essential requirements for accountable plan treatment, the Service could not help but rule the way it did.

see **TECHNICIAN ACCOUNTABLE PLANS**, page 12

 (Continued from page 11)

Therefore, Revenue Ruling 2005-52 provides clarification ... in the negative ... only for those arrangements attempting to masquerade as "accountable plans" and that have been foolish enough to intentionally disregard the well-established and non-controversial requirements for (1) accountability and substantiation of expenses by the technician receiving payments and (2) the return of any excess payments to the employer.

WHAT ABOUT DEPRECIATING THE COST OF TOOL "INVENTORIES?" ... A QUESTION LEFT UNANSWERED BY REV. RUL. 2005-52

Revenue Ruling 2005-52 addresses a situation where an employer is using a "rate-based" plan by which the employees' hourly tool allowance is determined from a combination of database information and questionnaires completed (annually) by service technicians. However, as asserted above, the Service has chosen to avoid many of the real world questions underlying the determination of such rates.

In this regard, the Service states that under the plan in question, there is no reimbursement for ***"expenses paid or incurred for listed property, as defined by Section 280F(d) of the Internal Revenue Code, or depreciation expenses; thus, these expenses are not taken into account in calculating the amount of the annual tool allowance."*** This means that the plan in question is artificially oversimplified, and not further complicated, by attempts to deal with issues involving pre-acquired tools and equipment.

DIFFERING INTERPRETATIONS OF REV. RUL. 2005-52

One commentary on Rev. Rul. 2005-52 concluded, "Tool reimbursement programs that utilize an hourly rate factor are now no longer qualified as an accountable tool reimbursement under the current Tax Code." Another commentary stated (without any qualification) that this Revenue Ruling is consistent with past guidance and reiterates the fact that payments under a tool reimbursement program are not excludable from income as a payment under an accountable plan.

Yet another commentator read into the Revenue Ruling the inference that Section 62(c) accountable plans apply only to tools bought while working for a particular employer rather than to a technician's entire inventory of tools.

Each of these conclusions may be too broadly stated to be considered entirely accurate. But, is anyone who has an "aggressive" reimbursement plan in place willing to step forward for audit, and ultimately litigation, over these issues?

Since the issuance of Rev. Rul. 2005-52, some commentators have concluded that the IRS will now recognize only "receipts-based" plans as qualifying for accountable plan treatment, since a receipts-based plan would avoid the compliance issues related to substantiation and the return of excess payments.

The wording of the Revenue Ruling, per se, does not seem to support this conclusion. Without further clarification, significant problems are inherent in a receipts-based plan, especially in connection with how large dollar amount acquisitions of tools by technicians should be handled.

In addition, there still remain questions over what expenses qualify for reimbursement (tool purchases only?) and the concession by both the employer and the employee to ignore the effect of pre-existing substantial dollar investments in tools. At best, a comparatively conservative receipts-based plan may be only a "partial reimbursement" plan.

IMPACT OF REV. RUL. 2005-52

It is important to recognize that although an IRS Revenue Ruling has precedential value, such value as a precedent applies ***only*** to the fact pattern presented and analyzed in the Revenue Ruling. Thus, if the fact pattern of another taxpayer is not the same as the fact pattern described in the Revenue Ruling, that Ruling does not apply as a precedent for that different situation.

Combined with the Coordinated Issue Paper that the Service released in June of 2002, this Revenue Ruling may result in some employers, and plan administrators, deciding that the course of least resistance is to adopt a simple receipts-based plan.

The Ruling goes a long way to emphasize that substantiation by the employee cannot be assumed ... or ignored ... it is an absolutely critical factor. The same must be said about the accountability of the technician for treating the amount of any "reimbursement" as really being in the nature of a loan which is offset only to the extent of actual expenditures for tools and related costs. Any excess must be returned by the employee to the employer. Many people knew this before the Ruling was ever issued. Apparently, some plan administrators did not.

CPAs for auto dealerships, and for other types of businesses as well, should not overlook the opportunity for their clients to receive the benefits of tax-free treatment of accountable plans under Section 62(c) in other situations where their use is appropriate. Part of the Practitioner's Publishing Company *Tax Action Memo®*, TAM 1109 (August 9, 2005) includes a sample accountable plan for such business expense reimbursements.

Facts in Revenue Ruling 2005-52

The entire text of the "fact pattern" in Revenue Ruling 2005-52 is below.
The holding of the Service in this Revenue Ruling is based only on this (hypothetical) fact pattern.

- Employer operates an automobile repair and maintenance business.
- Employer hires service technicians to work in the business as employees.
- Employer requires these employees, as a condition of employment, to provide and maintain various tools needed for use in performing repair and maintenance services.
- Employer pays each employee an hourly wage.
- In addition, Employer pays each employee a set amount for each hour worked as a "tool allowance" to cover costs the employee incurs for acquiring and maintaining his tools.
- Employer sets each employee's tool allowance annually by using a combination of data from
  - A national survey of average tool expenses for automobile service technicians, and
  - Specific information concerning tool-related expenses provided by the employee in response to an annual questionnaire completed by all service technicians who work for Employer.
- Employer does not reimburse expenses paid or incurred for listed property, as defined by Section 280F(d) of the Internal Revenue Code (the Code), or depreciation expenses.
  - Thus, these expenses are not taken into account in calculating the amount of the annual tool allowance.
- Employer uses the data to project the employee's total annual tool expenses.
- Employer then uses a ***projection*** of the total number of hours the employee is expected to work during the year that will require the use of tools to convert the employee's estimated annual tool expenses into an hourly rate for the tool allowance.
  - Thus, ***the hourly tool allowance is an estimate*** of the tool expense projected to be incurred per hour by the employee over the course of the coming year.
- At the end of each pay period, each employee reports to Employer his hours worked requiring the use of tools.
- Employer multiplies the number of hours reported as worked requiring the use of tools by the employee's hourly rate for the tool allowance and pays the resulting amount to the employee in addition to compensation for services performed during the pay period.
- On a quarterly statement furnished to each employee, Employer reports:
  - The amount paid to the employee as a tool allowance during the quarter, and
  - The tool expenses estimated to be incurred in the quarter (i.e., the hours reported worked requiring the use of tools times the tool allowance).
- ***Employees are not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports are issued.***
- ***Employer does not require employees to return any portion of the tool allowances that exceeds the expenses they actually incur either before or after the quarterly reports are issued.***

Note: The last two facts given above stipulate that the plan in question is clearly not in compliance with two of the three requirements required for qualification as an accountable plan under Section 62(c).

In essence, a reimbursement or other expense allowance arrangement satisfies the requirements of Section 62(c) __only__ if it meets all three of these requirements ...

1. *Business connection*
2. *Substantiation, and*
3. *Returning amounts (received) in excess of actual expenses (to the employer, so that only actual expenses have been reimbursed tax-free).*

Two of the three essential requirements have not been satisfied in the simple fact pattern that the Service chose to establish as the parameters for Revenue Ruling 2005-52. ***These failures are given as facts.***

Notice 2005-59

Additional Criteria that Will Be Applied in Considering Proposals Regarding Accountable Plans for the Industry Issue Resolution (IIR) Program

The objective of the IIR Program is to identify frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers that may be resolved through published or other administrative guidance.

*"... **Several submissions to the IIR program have asserted that compliance with various aspects of the accountable plan rules set forth under Section 62(c) are unduly burdensome for businesses in certain other industries and have asked for published guidance providing administrative relief similar to that provided in Rev. Proc. 2002-41.**"*

The Service provided guidance as part of the IIR pilot project for a segment of the pipeline construction industry because the industry had successfully demonstrated that employers could not comply with the existing accountable plan rules given certain fundamental aspects of their industry practice that could not readily be changed, if changed at all.

For purposes of evaluating future IIR submissions raising similar concerns about application of the accountable plan rules in specific industries, the Service will make a comparable assessment as to whether the accountable plan rules are unworkable given aspects of industry practice that cannot be changed at all or cannot be changed without great difficulty.

In addition to the requirements of Rev. Proc. 2003-36, factors to be considered in determining whether there is need for relief as to this issue would include, but not be limited to the following:

- An established industry history showing that high turnover in the labor force or short-term employment with multiple employers is typical,
- Large expenses for maintenance, although infrequent, are predictable relative to the compensation paid to the employees for their services,
- Individual employers are unwilling to reimburse in full for sporadic expenses for equipment maintenance because a significant portion of the reimbursement will accrue to the benefit of a later employer/competitor,
- There is a uniformity of expenses across the workforce or the existence of a uniform objective predictive proxy for measuring the expense, and
- Existing methods of substantiating expenses, such as Rev. Proc. 2004-64, 2004-49 I.R.B. 898 (mileage allowances), do not accurately reflect the expenses incurred by the employees on behalf of the employer.

A claim of burden meriting relief from the requirements of the accountable plan rules will not be supported by the mere cost of

- Collecting records,
- Substantiating expenses, and
- Reconciling the amount of expenses with the amount of reimbursements paid does not support.

Office of Tax Policy and Internal Revenue Service 2005-2006 Priority Guidance Plan

The *2005-2006 Priority Guidance Plan*, issued August 8, 2005, contains a list of tax Regulations and other administrative guidance that the IRS hopes to be able to publish within the next 12 months. Out of the 254 projects listed, the only mention of what might involve guidance on service technician accountable plans is described in the section below.

Employee Benefits

A. Retirement Benefits ...

B. Executive Compensation, Health Care and Other Benefits, and Employment Taxes ...

1. ... (text omitted)
2. ... (text omitted)
3. ***"Guidance on accountable plans and per diem payments"***

Tool Plan Revenue Ruling Doesn't Say Anything New

To the Editor:

I am the "unidentified" writer of the redacted letter to Eric Solomon to which you referred in your coverage (*Tax Notes*, Aug. 22, 2005, p. 897) discussing "tool reimbursement plans."

The enclosure attached to my letter to Mr. Solomon — and to all others who received a copy of the letter — was the June 2005 issue of my quarterly publication, the *Dealer Tax Watch*, which contains an extensive discussion (45 pages) of tool plan and accountable plan issues. Any of your readers interested in this text can get information on it at my Web site (http://www.defilipps.com).

Of course, when I sent my letter to Solomon (July 28), I had no knowledge — or even a hint — that Rev. Rul. 2005-52, 2005-35 IRB 423, *Doc 2005-16556, 2005 TNT 149-3* would be issued by the IRS about a week later. In my opinion, this revenue ruling shows that the IRS still has not said anything meaningful — even though it now may be able to cross off one item from its 2004-2005 priority guidance to-do list.

In the simple fact pattern that the Service imagined for itself in Rev. Rul. 2005-52, the facts include statements that two of the three essential requirements have not been satisfied. *There are no "determinations" in this regard. Those failures are given as "facts."* Since the facts in the ruling are that the employer deliberately ignored, or failed to comply with, two of the three essential requirements for accountable plan treatment, the Service could not help but rule the way it did.

Although the IRS had the opportunity to comprehensively address many issues in connection with accountable plans for which there currently is no clarification, the IRS instead issued a revenue ruling that basically does nothing more than restate already well-known requirements that accountable plans must satisfy three conditions: (1) business connection, (2) substantiation, and (3) returning amounts (received) in excess of expenses (to the employer, so that only actual expenses have been reimbursed tax-free). This ruling could have been written in five minutes on the back of an envelope.

In reading several summaries and/or commentaries on Rev. Rul. 2005-52 within the last week or so, it is my opinion that it has created more misunderstanding and confusion, than clarification or guidance. I'll omit specific examples here for the sake of brevity.

Rev. Rul. 2005-52 provides clarification — in the negative — only for those arrangements attempting to masquerade as "accountable plans" and only for those that have been foolish enough to intentionally disregard the well-established and noncontroversial requirements.

I have previously submitted accountable plan-related requests for consideration under the IRS's industry issue resolution program. All of them have been rejected. In addition, last year I drafted a request for a private letter ruling on behalf of an automobile dealership who adopted a rate-based accountable plan for its service technician employees. We offered the IRS a golden opportunity on a silver platter to analyze in depth a real-world situation. That, too, the IRS declined, saying that those issues were being considered more broadly and would be addressed in the future on a more comprehensive basis. If Rev. Rul. 2005-52 evidences what the Service meant by some type of broad and comprehensive guidance, maybe the commissioner and Congress should reconsider closing the so-called taxpayer assistance centers if all the Service is willing to do is provide guidance on problems that don't exist in the real business world, or if it is just going to regurgitate generalities that are expressed just as clearly in hundreds of other year-end tax guides.

At best, it can be said that Rev. Rul. 2005-52 provides two points of clear guidance on accountable plans.

First, plans that fail by their own faulty construction to meet the requirements of section 62(c) will not qualify as accountable plans. But, did we really need a revenue ruling to say this? Especially, when there are so many more critical issues for accountable plans that require clarification? Attached is the list of the issues that I submitted to Mr. Solomon, Mr. Spires, et al., which I believe the IRS should be addressing at this time to give meaningful guidance on accountable plans. (See "If I Could Write the Rules, Here Are the Points I'd Cover" on the next page.)

Second, the prospect for achieving reasonable, workable interpretations of the accountable plan requirements in connection with auto dealerships and other technician tool-leveraged industries is more likely to happen if there is active involvement and/or oversight by members of Congress (hopefully looking after the best interests of their blue-collar working constituencies), than if it is expected to spring forth naturally from some hoped-for softening of attitude or philosophy within a "kinder, gentler" IRS.

Sincerely,

Willard J. De Filipps, CPA
Mt. Prospect, Ill.
Aug. 24, 2005

Schedule M-3 … Net Income (Loss) Reconciliation for Large Corporations

Sch. M-3 (2005 Draft … June 25, 2005)

Background

- Schedule M-3 was developed as the primary tool to enable the IRS to shorten the period of time that it takes to complete an audit.
- The purpose of Sch. M-3 is to reconcile in greater detail a corporation's financial accounting income or loss with the taxable income or loss reported on its corporate tax return, Form 1120.
- Sch. M-3 is required to be completed by all C Corporations (filing Form 1120) if they have total assets of $10 million or more.
  - This requirement started with taxable years ending on or after December 31, 2004.
- Sch. M-3 reflects a transactional approach and need for line-by-line analysis and reporting.
- See June 2004 *Dealer Tax Watch* for coverage based on Sch. M-3 draft as of July 7, 2004.
  - Coverage included (on pgs 24-25) ***Practice Guide** - Action Plan for Complying with New Sch. M-3.*

Benefits Anticipated from Sch. M-3 Initiative

- Increase transparency while minimizing overall taxpayer burden.
- Provide a consistent reporting format among taxpayers in order to obtain more useful, descriptive information at the time the income tax return is filed. This will assist the IRS in identifying:
  - Tax returns that should or should not be selected for audit
  - Issues that should or should not be audited, and
  - Trends and areas of greater compliance risk.
- Provide a way to more quickly identify those differences that are more likely to arise when taxpayers take aggressive positions or engage in aggressive transactions.
- Reduce the time required to examine tax returns and be in a position to examine the most recent tax returns.
- Focus IRS compliance resources on returns and issues that need to be examined and avoid those that do not.
- Greater ability to observe emerging issues and trends as a result of periodically modify Sch. M-3.
- Facilitate tax return selection and issue identification through electronic filing.
- Encourage greater use of the Limited Issue Focused Examination (LIFE) audit program.

How Will the IRS Use Sch. M-3?

Maximum Benefit to the IRS Depends on e-filing of Corporate Returns Starting in 2006

- The standardized data from Sch. M-3 will be used to assist the Service in selecting and de-selecting returns and issues for examination.
- Information from Parts II and III will be used by the Service to evaluate and prioritize compliance risk. Forms 1120 filed for 2004 are being reviewed on screen by the LMSB.
- By expanding the completion requirement to include Columns (a) and (d), the Service will be able to measure the amount of differences between book and tax as a percentage of book or tax income.
- The Service reports that it is developing risk assessment programs to be used with electronically filed returns.
  - Over 100 filters have been identified.
  - Over 70 filters rely on the ability to compare amounts in Columns (b) and (c) with amounts in Columns (a) and (d).
  - It will be possible to assign different weighting factors to various filters. In other words, this may be like having a DIF score for corporate book-tax differences.
- ***Coordination with mandatory e-filing requirements.*** Maximum efficiency in the use of information provided on Sch. M-3 will be possible when the requirements that corporations file electronically are fully phased in.
  - Corporations will be required to electronically file any Form 1120 or Form 1120-S ***for tax periods ending on or after December 31, 2005*** (in 2006) if they satisfy two conditions:
    - They have assets of ***$50 million or more***, and
    - They file at least 250 returns during a calendar year.
    - ***"Returns"*** includes … income tax, information returns, excise tax & employment tax returns.
  - The electronic filing requirement for tax year 2006 returns that are due to be filed in 2007 will be expanded to include corporations if they satisfy two conditions:
    - They have assets of ***$10 million or more***, and
    - They file at least 250 returns during a calendar year.

Sch. M-3 Update

Schedule M-3 ... Net Income (Loss) Reconciliation for Large Corporations

Sch. M-3 (2005 Draft ... June 25, 2005)

Evolving the Sch. M-3 Format

- *January 28, 2004* ... IRS released the first version of Schedule M-3
- *March 10, 2004* ... IRS released preliminary *Instructions for Schedule M-3*
- *April 30, 2004* ... Last day for practitioner comments on Sch. M-3 and Instructions
- *July 7, 2004* ... IRS released the "draft of the final version" of Schedule M-3
  ... IRS released 23 *Frequently Asked Questions* with answers
  ... IRS released Revenue Procedure 2004-45 to streamline disclosures for some taxpayers involved with book-tax differences in excess of $10 million
- *October 25, 2004* ... IRS released the third draft version of Sch. M-3. See pages 16-18 of Dec. 2004 *Dealer Tax Watch.*
- *January, 2005* ... Final Sch. M-3 released by IRS ... Same as Oct. 25, 2005 version.
- *June 23, 2005* ... IRS released draft of Sch. M-3 for 2005 filings

Instructions & IRS Guidance

- ***Instructions*** ... Basically, instructions are lengthy (in excess of 20 pages) and contain detailed, line-by-line directions.
  - For 2004, Instructions differentiate between "specific instructions for" completing Parts II & III and "reporting requirements" for Parts II & III.
  - For 2005, completion of all 4 columns in Parts II & III is required.
- ***Frequently Asked Questions (FAQs) for Form 1120 Sch. M-3***
  - IRS web site (www.irs.gov) has a special section for Frequently Asked Questions.
  - Arranged and keyed to correspond with Sections and line items on Sch. M-3 and Instructions.
    - General instructions
    - Specific instructions for Part I
    - Specific instructions for Parts II & III
  - FAQs are updated weekly. A link is provided at the top of the page entitled "New this week," to highlight questions that have been most recently posted to the FAQ web site.

Expansion of Sch. M-3 Filing Requirements ... 2006 & Beyond

- For years ending on or after December 31, 2006, the IRS anticipates expanding Sch. M-3 filing requirements to
  - Partnerships filing Form 1065
  - S Corporations filing Form 1120-S
  - Life insurance companies filing Form 1120-L
  - Property and casualty insurance companies filing form 1120-PC
- Special attention may be given to partnerships filing Forms 1065
  - Partnerships are a rapidly growing portion of the filing population for which LMSB has oversight.
  - Additional conditions may be set to make the filing of Sch. M-3 mandatory for partnerships.
    - $ 10 million in total assets
    - $ XXX million in total receipts
    - $ XXX million throughput (i.e., dollars flowing through) partner capital accounts
    - Any partner who owns more than a 20% interest in the partnership, if that partner is owned 50% or more by another taxpayer required to file with the LMSB
- Public comment and discussion periods will be provided in connection with the expansion of Sch. M-3 filing requirements to the above classes of entities.
- It is likely that modified reporting will be permitted in the first year (i.e., requiring the completion of only Columns (b) and (c) in the first year and deferring the requirement that all 4 Columns (a, b, c, d) be completed until the second year).
  - This will enable companies to develop whatever internal reporting procedures that they will need to develop in order to gather information to be reported in Column (a).

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

If consolidated return, check applicable box: (1) ☐ Consolidated group (2) ☐ Parent corporation (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corporation

Name of subsidiary (if consolidated return)	Employer identification number

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

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

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

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

If consolidated return, check applicable box: (1) ☐ Consolidated group (2) ☐ Parent corporation (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corporation

Name of subsidiary (if consolidated return) | Employer identification number

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

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

Schedule M-3 (Form 1120) 2005

Sch. M-3 Update	**Schedule M-3 ... Net Income (Loss) Reconciliation for Large Corporations** **Sch. M-3 (2005 Draft ... June 25, 2005)** *Page 3 of 4*
What's New for 2005?	• Taxpayers are required to complete all four columns of Part II (Page 2) and Part III (Page 3). • No major changes to Sch. M-3, just minor tweaking of line items. • No change to Part I (Page 1), *Financial Information Questionnaire* and *Net Income (Loss) Reconciliation.*
Part I (Page 1) Changes	• The face of Part I (Page 1) has not been changed. • The instructions for Part I clarify the following: ◆ Line 2 ... Information to be reported related to restatements ◆ Line 4 ... The amount to be entered on this line ◆ Line 8 ... The amount to be entered on this line
Part II (Page 2) Changes	• A line has been added at the top of Page 2 to be used by members of a consolidated return group to indicate (by checking the appropriate box) whether the information provided is for ... (1) consolidated group, (2) parent corporation, (3) consolidated eliminations or (4) subsidiary corporation. • Line 17 ... The description for this line has been changed to ***"Cost of goods sold"*** ◆ Formerly, ***"Inventory valuation adjustments"*** on the 2004 form. • Line 20, ***"Unearned - deferred revenue"*** ... The instructions clarify what is to be reported on this line. • Line 35, ***"Other expense/deduction items with differences"*** ... The instructions clarify what is to be reported on this line.
Part III (Page 3) Changes	• Similar to Part II, a line has been added at the top of Page 3 to be used by members of a consolidated return group to indicate (by checking the appropriate box) whether the information provided is for ... (1) consolidated group, (2) parent corporation, (3) consolidated eliminations or (4) subsidiary corporation. • Line 8 ***"Interest expense"*** ... This line item description has been added. • Line 9 ***"Stock option expense"*** ... This line item description is new. ◆ On the 2004 Sch. M-3, Line 8 was for ***"Incentive stock options"*** and Line 9 was for ***"Other equity-based compensation."*** By combining these two items, to ***"Stock option expense"*** in 2005, the line that was freed-up by this combination was taken over by the interest expense category. • Line 13 ***"Judgments, damages, awards and similar costs"*** ... This is the terminology used to replace the description in the 2004 Sch. M-3 which was ***"Punitive damages."*** • Line 21 ***"Charitable contribution limitation/carryforward"*** ... This is the terminology used to replace the descriptions in the 2004 Sch. M-3 which combined the charitable contribution limitation on Line 21 and the charitable contribution carryforward used in the tax return on Line 22. The elimination of one line from the 2004 Sch. M-3 enables the Service to add a new line on the 2005 Sch. M-3 for the Section 199 ***"Domestic production activities deduction"***. • Line 22 ***"Domestic production activities deduction"*** ... This new line item description has been added to the 2005 form without changing the overall total number of lines in Part III ... 36 lines each year. • Line 18 ***"Deferred compensation"*** ... The instructions clarify what is to be reported on this line, which includes accrued salaries, bonuses and vacation pay. • Line 35 ***"Other expense/deductions with differences"*** ... The instructions clarify what is to be reported on this line.

Sch. M-3 Update	**Schedule M-3 ... Net Income (Loss) Reconciliation for Large Corporations** **Sch. M-3 (2005 Draft ... June 25, 2005)** *Page 4 of 4*
Auto Dealerships ***Line Items Frequently Encountered***	• ***Temporary*** differences ... Column (b) ◆ Depreciation ◆ Accrued expense/income items to shareholders ◆ Gain or loss on disposition of assets ◆ Reserve adjustments ◆ Deferred revenues ◆ Section 263A inventory cost capitalization amounts ◆ Section 481(a) adjustments ◆ Goodwill amortization ◆ Deferred taxes ◆ Pre-paid expenses ◆ • ***Permanent*** differences ... Column (c) ◆ Travel and entertainment ... Section 274(d) ◆ Officers life insurance expense ◆
Do It Right ... ***Selected Reminders***	• For 2005, completion of all 4 columns in Parts II & III is required. ◆ Over one-half of the IRS selection filters depend upon completion of Column (a) - Income (Loss) per Income Statement. • ***Partial Completion of Sch. M-3 for 2004 only*** (i.e., in the first taxable year the corporation is required to file Sch. M-3). The corporation is required to complete only certain sections. ◆ Page 1, Part I ***must be completed.*** ◆ Page 2, Part II, Columns (b) and (c) ***must be completed*** ... *temporary* and *permanent timing difference identification* related to **income (loss)** items. ◆ Page 3, Part III, Columns (b) and (c) ***must be completed*** ... *temporary* and *permanent timing difference identification* related to **expense/deduction** items. ◆ For 2004 only, taxpayers have the ***option*** to complete Columns (a) and (d) of Parts II and III in order to present a complete reconciliation. • ***The IRS Has Made No Concession to "Materiality"*** ... *de minimis* amounts cannot be combined or netted in completing Sch. M-3. • There is no such thing as a *de minimis* amount ... Nothing is considered to be *immaterial.* ◆ No *de minimis* exclusions based on (immaterial) dollar amounts. ◆ No *de minimis* exclusions based on (immaterial) percentage of assets. ◆ No *de minimis* exclusions based on (immaterial) percentage of income. • ***Every item of difference must be separately stated and adequately disclosed*** on Sch. M-3.
Current Articles	• Ackerman, Joel E. *"Common Schedule M-1 Adjustments."* In the *Tax Clinic* section of *The Tax Adviser.* October, 2005. pp. 586-588. • Antognini, Walter G. *"New Schedule M-3 Expands Reporting for Large Corporations." The CPA Journal.* August, 2005. pp. 44-49. • McGowan, John R. and David Killion. *"Schedule M-3: Closing the Corporate Book-Tax Gap." The Tax Adviser.* July, 2005. pp. 408-416. • Carman, Paul. *"New Rules for Reporting Book-Tax Differences." The CPA Journal.* May, 2005. pp. 48-49. • Gurene, Linda. *"New Schedule M-3 Will Play a Role in Audit Selection." Practical Tax Strategies.* April, 2005. Pages 208-222.

CLASSIC CARS ARE INVENTORY FOR AN AUTO DEALERSHIP ... LOSSES ON SALES PRODUCE ORDINARY DEDUCTIONS

In a recent case, *David Taylor Enterprises v. Comm.*, decided May 31, 2005 (T.C. Memo 2005-127), the Tax Court held that where an auto dealership bought, restored and sold classic cars over a period of years, the classic cars were inventory to the dealership. Therefore, losses incurred on the sale of these classic cars were deductible as ordinary losses because the cars were held primarily for sale to customers in the ordinary course of business.

Classic cars were cars whose model years were generally 1970 or before. The dealership applied for exhibition license plates for these cars, indicating that they were at least 25 years old. The cars were insured in a policy that covered "all owned antique, classic and special interest cars held for sale by the insured." These cars were taxed by local property taxing authorities as "motor vehicle inventory."

THE FACTS

Some of the facts are simplified in this retelling in order not to get carried away with details that don't really affect the conclusion.

Cars were Mr. Taylor's love and passion. No question about it. He was involved in the car business throughout his life. When he was a child, his father was an Oldsmobile-Cadillac dealer in Port Arthur, Texas.

From 1975 until his untimely death in 1997, Mr. Taylor was a car dealer engaged in the trade or business of selling cars. In 1975, Mr. Taylor acquired the right from General Motors to open a Cadillac dealership in Houston, Texas, known as David Taylor Cadillac. This dealership became one of the largest Cadillac dealerships in the world.

The dealership owned new, used, and classic cars. The new and used cars were located in Houston, Texas, while the classic cars were located in Galveston, Texas.

The dealership began to acquire classic cars in 1979. Initially, the dealership purchased a 1931 Cadillac Roadster for $40,000. The dealership then purchased two classic cars in the mid-1980s, a 1934 Ford Roadster and a 1932 Ford Victoria, that came as kits and required assemblage. After the initial purchases, the dealership acquired additional classic cars, either by purchase, exchange of one classic car for another, or as trade-ins from new car customers to reduce the purchase price of a new Cadillac or Buick. The dealership's purpose in acquiring the classic cars was to enhance their value by restoring them and selling them at a premium price.

The dealership viewed potential buyers of the classic cars as a select group of mostly wealthy classic car enthusiasts. The dealership's strategy to reach this elite involved building the dealership's reputation as a source of high quality classic cars by entering the cars in auctions, auto shows, classic car competitions, and displaying them at promotional events for the dealership or third parties.

The classic cars were often displayed at events frequented by wealthy individuals. The classic cars were also prominently advertised in brochures, booklets, newspapers, and magazine articles, and a placard describing each car was also placed on each vehicle.

Potential buyers of the classic cars were directed to Mr. Taylor or a broker the dealership hired after Mr. Taylor died. Until his death, Mr. Taylor personally negotiated the sales of the classic cars.

To command a premium price for the classic cars, these vehicles had to be restored to classic condition, maintained, and drivable at any time by potential customers. Restoring the cars involved a long process of fundamentally rebuilding the car to near perfection. After the cars were fully restored, the dealership carefully maintained them by setting the cars on jack stands so the tires maintained air pressure, starting the engines every 6 weeks, and changing the oil every 6 months.

In addition, the dealership kept the classic cars indoors to protect them from inclement weather. Initially, the classic cars were kept at the dealership or in Mr. Taylor's garage, and later were moved to a building the dealership bought that was located across the street from its main showroom. The cars were eventually moved to three adjacent buildings in Galveston, Texas that the dealership purchased to provide the classic cars with a climate-controlled environment and to expose them to the public.

The Galveston property was operated as a museum (the *David Taylor Classic Car Museum*) to which admission was charged. Operating the property as a museum allowed the dealership to recoup some of the overhead costs for maintaining and storing the cars, while still holding them for sale. The museum was open to the public from 1989 through 1999.

see **CLASSIC CARS**, page 24

How David Taylor Enterprises Treated its Classic Cars

- The dealership accounted for the new, used, and classic cars consistently.
- Every car was treated as inventory and assigned an individual stock number.
- Costs associated with the purchase and restoration of the classic cars were posted to the car's stock number. This posting allowed a running total of the dealership's cost basis in each car.
- The dealership did not deduct any costs as they were incurred, nor did the dealership depreciate any of the cars.
- No part of the dealership's cost basis in any classic car was recognized except upon sale or other disposition of the vehicle.
- The dealership included the sales price of the car (whether new, used or classic) in the dealership's gross receipts and included all accumulated costs of each specific car in the costs of goods sold.
- Whenever a car was sold (whether new, used or classic), the dealership reported the gain or loss on the sale at ordinary income rates.
- For all years prior to 1999, the dealership reported sales on 11 classic cars at ordinary income rates. During the years 1999 and 2000 (the years at issue), the dealership reported sales on 69 cars, also at ordinary income rates.

Revenue Ruling 75-538 (1975-2 C.B. 34) Presumption that Motor Vehicles Are Held by Auto Dealers Primarily for Sale to Customers (and Not as "Property Used in the Trade or Business")

In general. Whether a motor vehicle is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business is a question of fact that must be determined from all of the facts and circumstances in each case.

Presumption. A taxpayer engaged in the trade or business of selling motor vehicles is presumed to hold all such vehicles primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

How the presumption may be overcome. To overcome this presumption, it must be clearly shown that

- the motor vehicle was actually devoted to use in the business of the dealer, and
- the dealer looks to consumption through use of the vehicle in the ordinary course of business operation to recover the dealer's cost.

A vehicle is ***not*** property used in the business if

- It is merely used for demonstration purposes, or
- It is temporarily withdrawn from stock-in-trade or inventory for business use.
- See *Duval Motor Co. v. Commissioner*, 264 F.2d 548 (5th Cir. 1959), aff'g 28 T.C. 42 (1957); *Luhring Motor Co.*, 42 T.C. 732 (1964); and *R.E. Moorhead & Son, Inc.*, 40 T.C. 704 (1963).

Income derived from the sale of a motor vehicle that constitutes property used in the trade or business qualifies for Section 1231 treatment, except to the extent that the (depreciation recapture) provisions of Section 1245 are applicable.

A depreciation deduction (under Section 167) is allowable with respect to any motor vehicle used in the trade or business of the taxpayer.

 (Continued from page 22)

The dealership intended to recoup its costs of restoring the classic cars by selling them at a profit. For example, in 1989, the dealership acquired a 1939 *Packard*, which it sold in 1994 for $330,000. The dealership had total accumulated costs of $160,260. After paying a commission of $26,400 on the sale, the dealership reported an ordinary gain of $143,340 in its 1991 tax return.

The dealership made three more sales that year, and three in the succeeding year. After that, the dealership strategically began acquiring more classic cars and increasing its participation in promotional events to generate interest, win competitions, and service the wealthy clientele the dealership hoped would follow.

Unfortunately, Mr. Taylor died in 1997, within a month after being diagnosed with cancer. Mr. Taylor's shares in the dealership represented most of the value of his estate. To raise money for the estate tax, Mr. Taylor's estate participated in a Section 303 stock redemption which the dealership helped to fund by selling all of the classic cars to raise the necessary capital. Accordingly, the dealership hired a broker and sold approximately 69 classic cars during 1999 and 2000.

As might be expected, the sales prices under these circumstances were not as high as they might have otherwise been, and these sales produced losses, which the dealership deducted as ordinary losses.

Over the years, some sales of the classic cars had produced significant gains, which the dealership had reported as ordinary income. And, the IRS never objected to this treatment. However, when losses on sales in 1999 and 2000 were treated as ordinary deductions, the Service disagreed with that treatment.

WILLIFORD PROVIDES THE GUIDE

There is another tax case, *Williford v. Comm.* (T.C. Memo 1992-450), in which the Tax Court was presented with a somewhat similar situation.

The taxpayer in *Williford* was a part-time art dealer and bought some paintings for resale and others for investment. The taxpayer kept separate his private art collection and the paintings for resale. The taxpayer classified the paintings in his private collection as capital assets and reported capital gains on the sale of these paintings. The Commissioner objected to the capital treatment, arguing that the taxpayer was an art dealer and derived the sales proceeds in the ordinary course of business.

In that case, the Tax Court looked at eight factors to analyze whether an art collection was held primarily for sale to customers in the ordinary course of business, or whether these assets were held for investment. If held for investment, then gains on sale would be capital gains and losses on sale would be capital losses. In *Williford*, the Tax Court agreed with the taxpayer and held that the paintings were capital assets held for investment.

In the *David Taylor* case, the Tax Court applied seven of the eight factors and found that almost all of them favored the taxpayer.

SHIFTING THE BURDEN OF PROOF

One interesting aspect of this case is that the taxpayer was able to shift the burden of proof to the IRS/Commissioner. The taxpayer succeeded here because it had complied with substantiation requirements, maintained required records and cooperated with the Service's reasonable requests for witnesses, information and meetings.

In addition, the taxpayer introduced credible evidence with respect to the relevant factual issues. This was done through witness testimony and business records of the dealership, sufficient (in the absence of evidence to the contrary) to prove that the classic cars were inventory held primarily for sale to customers in the ordinary course of business. Specifically, the taxpayer produced evidence that it advertised the classic cars for sale, sold a substantial number of classic cars, and consistently reported the sales at ordinary income rates and consistently treated the classic cars as inventory on its corporate books.

THE CLASSIC CARS WERE INVENTORY

The Tax Court observed that the IRS was apparently content to collect tax at ordinary income rates on gains from sales of the dealership's classic cars in prior years.

The Court focused on Section 1221(a)(1). This Section provides for the exclusion from capital asset treatment of property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The Court said that although its analysis of the *Williford* factors clearly favored the taxpayer, those factors, per se, are not dispositive.

The Court was impressed by the dealership's continuous and consistent treatment of the classic cars as inventory being held for sale. From the date the dealership first acquired a classic car, the dealership had been in the business of selling cars. The dealership's classic cars were consistently treated for book purposes and tax purposes as held for sale. All of these factors favored the taxpayer and impressed the Court.

7 "Williford" Factors	**Classic Cars as Dealership Assets** **Determination of Whether an Asset is Held for Investment or as Inventory** *Page 1 of 3*
#1 ***Frequency and Regularity of Sales***	• ***In general.*** The frequency and regularity of sales are among the most important factors in determining whether an asset is held for investment or as inventory. • Frequency of sales alone is not sufficient to establish a taxpayer is engaged in selling assets as a business. The inference, generally, is that frequent sales serve as an indicium that the assets are being held for sale, while infrequent sales serve as an indicium that the assets are being held for investment. • Whether the number of sales was sufficiently frequent must be viewed in the context of the particular industry at issue. • ***Application to* David Taylor.** The Service and the taxpayer have provided us with no caselaw concerning the sale of classic cars, or cars in general. Each case turned on the unique facts at issue, and we can discern no standard from the caselaw to apply here. We [i.e., the Tax Court] therefore view the frequency of sales factor in the context of our own facts and apply no standardized test to determine whether the sales were sufficiently frequent. • Taxpayer sold 80 cars over approximately 12 years. The parties focus on different time periods to support their arguments. Taxpayer focuses upon the higher number of sales in the years at issue to argue that the cars were held for sale as inventory. In contrast, the Service focuses upon the smaller number of sales between 1989 and 1998 to argue that the cars were held for investment purposes. The holding purpose inquiry begins at the time the property is acquired and spans the entire course of ownership. • We first note that sales increased in the years at issue for understandable reasons. Mr. Taylor died unexpectedly at age 60, and Taxpayer's board agreed to redeem the shares of David Taylor Enterprises under Section 303 that Mr. Taylor owned before his death. The increase in sales does not negate a finding that the cars were previously held for sale. Taxpayer explains that the dealership sold fewer classic cars in the earlier years because it was in the nascent phase of building inventory, restoring the cars, establishing a reputation, and publicizing the classic cars to potential clientele, but that the cars were nonetheless held for sale at all times. • We found testimony for the dealership compelling, and find the total number of sales, 80 sales over 12 years, and 69 sales over the 2 years at issue, sufficiently frequent to support a finding that the classic cars were held for sale.
	This factor favors the taxpayer.
#2 ***Substantiality of Sales***	• ***In general.*** Courts generally view frequent sales generating substantial income as tending to show that property was held for sale rather than for investment. Where substantial profits result from capital appreciation, however, and not from the taxpayer's efforts, infrequent sales generating large profits tend to show that the property was held for investment. • ***Application to* David Taylor.** While the cars in this case appreciated in value, most of the gains from the sales were due to the dealership's efforts in restoring and refurbishing the cars. Further, the dealership consistently sold the classic cars before the years at issue for a profit, with the exception of two sales. The dealership reported all sales at ordinary income rates, as it did for sales of new and used cars.
	This factor favors the taxpayer.
#3 ***Duration of Ownership***	• ***In general.*** Longer holding periods suggest that an asset is being held for investment. • ***Application to* David Taylor.** The Court in *Williford* found that holding periods of 19 years and 13 years served as indicia that the paintings were held for investment. The classic cars in this case were held 7 to 10 years. Of the classic cars sold prior to the years at issue, seven were held less than 2 years, one was held less than 4 years, and one was held less than 10 years. None of the classic cars were held for as long as the periods set forth in *Williford.* • In *Williford,* the paintings did not require work akin to the extensive time and effort the dealership devoted to refurbishing and restoring the classic cars. The attendant length of ownership is therefore longer in the case of value-added classic cars. In comparison, the dealership's new and used cars were held shorter periods for readily apparent reasons. The Service's argument comparing the shorter periods for the new and used cars vis-à-vis the classic cars, therefore, is not dispositive. • The value of the new and used cars, as Taxpayer explained, depreciated quickly, demanding quicker turnover. In contrast, the classic cars appreciated in value over time and, consequently, did not necessitate the same rapid turnover period. We find, therefore, that the holding period for the classic cars is consistent with finding the dealership held the classic cars for sale.
	This factor favors the taxpayer.

7 "Williford" Factors	**Classic Cars as Dealership Assets** **Determination of Whether an Asset is Held for Investment or as Inventory** Page 2 of 3
#4 ***Segregation of Classic Cars from New and Used Cars***	• ***In general.*** Property held for sale and property held for investment must be separately identified. This factor suggests property segregated from other property may indicate some assets are held for investment while others are held for sale. • In *Williford,* the Court found that the paintings held as inventory were kept in a location separate from those held for investment. • ***Application to*** **David Taylor.** While the classic cars were physically segregated from the new and used cars, we find the physical segregation of the cars of no moment. A dealership could have numerous physical locations. The fact remains that the classic cars were on display to the public at all times in contrast to the paintings the taxpayer held in his home that were not on display to the public. Moreover, the classic cars were held separately in buildings on the Galveston property because they required protection from the elements, unlike the new and used cars. • Nor do we find segregation of the cars for book purposes significant. Taxpayer explained that it grouped the classic cars as "other assets" because "current assets" were those that could be converted to cash within a year. Because the classic cars were not typically sold within a year, they were listed under "other assets." This method is consistent with generally accepted accounting principles. • Overall, we do not find the segregation of the dealership's classic cars relevant to our determination of whether they were for investment or for sale.
	This factor is neutral ... it favors neither the taxpayer nor the IRS.
#5 ***Purpose of Acquisition***	• ***In general.*** This factor relates to whether the taxpayer intended to hold the property for sale or to hold the property for investment. • An important way of determining the taxpayer's intent in holding the property is how the property was handled on the taxpayer's books and records. • ***Application to*** **David Taylor.** The Service argues that the dealership's application for "exhibition" license plates indicates that the dealership did not hold the classic cars for sale. Instead, the Service argues that the exhibition plates essentially meant the classic cars were not for sale. As Taxpayer countered, the exhibition plates did not restrict the cars from being sold but merely were a means of informing the public that the classic cars were at least 25 years old. • The Service also argues that the dealership acquired the classic cars to hold them for investment because Mr. Taylor was "passionate" about cars in general and classic cars in particular. Testimony established that every classic car that the dealership owned was acquired so it could be sold for a profit. We do not find it relevant whether Mr. Taylor was passionate about classic cars. • The dealership's accounting treatment of the classic cars was no different from the new or used cars. Each car, whether new, used, or classic, was assigned a stock inventory number. Any costs associated with the car were added to the basis of that car, and no depreciation or current deduction was claimed. The dealership reported each car sale, whether new, used, or classic, as a sale of inventory at ordinary income rates. • The dealership's argument (that its purpose was to hold the classic cars for sale) is bolstered by two facts. ◆ The dealership reported sales at ordinary income rates in the 10 years prior to the years at issue. ◆ The dealership consistently held the classic cars out to third parties as inventory. • Further, we cannot accept the Service's assertion that the primary holding purpose of the classic cars was merely to exhibit them as "museum pieces." We question whether the dealership would expend effort to acquire, rebuild, and maintain the classic cars if the purpose were merely to display them, stationary, at a museum. • On the contrary, each car was rebuilt to near perfection, and the dealership maintained standards so that each car could be drivable at any time and therefore command the highest price. The dealership started the car engines every 6 weeks and changed the oil every 6 months to maintain them in driving condition. Designating the Galveston property as a museum made business sense as a means to gain exposure for the classic cars specifically and for the dealership in general. It also helped to cover overhead. • We found the testimony that the classic cars were acquired as inventory to be honest, forthright, and credible.
	This factor favors the taxpayer.

Classic Cars as Dealership Assets

Determination of Whether an Asset is Held for Investment or as Inventory

#6 Sales and Advertising Effort

- ***In general.*** Sales and advertising efforts indicate that the assets are being held for sale, and not for investment.
- ***Application to* David Taylor.** The Service argues that the dealership did not advertise the classic cars for sale and compares the advertising strategies the dealership used to market the new and used cars with the less overt methods the dealership used to market the classic cars. Again, we find this analogy artificial. The holding period was shorter for new and used cars, and the advertising methods consequently more immediate. The dealership could be selective in its sales so long as its activity was consistent, overall, with its treatment of the classic cars as inventory for sale.
- The dealership used various advertising methods and strategies to market the classic cars for sale. These advertising methods included:
  - Entering the cars in auctions and auto shows,
  - Displaying the cars at numerous events frequented by wealthy individuals,
  - Hosting events at the Galveston property for wealthy car enthusiasts,
  - Designing and printing brochures featuring the cars,
  - Arranging for newspaper and magazine articles about the cars,
  - Displaying the cars at the dealership and promotional events, and
  - Publishing a large booklet on the cars.
- We find that the dealership made efforts to advertise and sell the classic cars in years before those at issue. Mr. Taylor personally negotiated these sales, and he would often accompany potential customers on test drives of the cars. If a potential customer ever expressed an interest in a classic car, testimony established that personnel would direct the potential customer to Mr. Taylor or the broker appointed to sell the classic cars after Mr. Taylor's death.
- Personnel of the dealership testified that they referred serious inquiries regarding the classic cars to Mr. Taylor, or to a broker retained by the dealership after Mr. Taylor died. There was also testimony that Mr. Taylor was frequently on the Galveston property negotiating with interested buyers.
- We find that the dealership always held the classic cars as inventory for sale. The dealership was merely more flexible regarding the classic car's price during the years at issue because of the immediate need for capital.
- Even though, as the Service contends, the dealership did not market the classic cars in the same way that it marketed the new and used cars, the record is replete with evidence that the dealership held the classic cars as inventory for sale. Mr. Taylor frequently stated that every classic car was for sale. In fact, the dealership's general manager testified that Mr. Taylor said everything was for sale for the right price.
- Testimony also indicates that Mr. Taylor rejected a suggestion to form a foundation to own the classic cars. Mr. Taylor rejected the suggestion when he learned that the profits from selling the classic cars would go to the foundation, rather than the dealership. Mr. Taylor wanted the profits to flow to the dealership.

This factor favors the taxpayer.

#7 Time Devoted to Sales Activity

- ***In general.*** That a taxpayer devotes little time or effort to the selling of assets may suggest that the assets are held for investment purposes. A taxpayer does not hold property for sale if the taxpayer does not initiate sales, advertise, have a sales office or spend a great deal of time on the transactions.
- ***Application to* David Taylor.** We find that the dealership here devoted substantial time to the sales activity. This includes the time spent coordinating advertising and promotional events, and the time Mr. Taylor spent at classic car shows and auctions negotiating with potential customers, as well as the time the broker spent negotiating sales following Mr. Taylor's death.

This factor favors the taxpayer.

Notes & Citations

- *David Taylor Enterprises v. Comm.*, decided May 31, 2005 (T.C. Memo 2005-127)
- *Williford v. Comm.*, T.C. Memo. 1992-450
- Citations to other tax cases within the Tax Court's discussions have been omitted.
- All uses of the word "We" refers to the Tax Court in *David Taylor Enterprises*.

De Filipps' DEALER TAX WATCH **First-class**
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