Willard J. De Filipps, CPA, PC

www.defilipps.com

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. FALL TAX CONFERENCES. In this issue, I want to pass along the highlights of three presentations I heard at the AICPA National Auto Dealership Conference in Baltimore in late October.

One week later, the AICPA (Federal) Income Tax Conference was held in Washington, D.C. This was immediately followed by the National CPA/IRS Tax Issues Meeting. Both were excellent.

Also in December, I presented a 2-hour dealer update teleconference of my own. An abbreviated version of the discussion outline is on pages 24-27.

#2. THE BEST OF THE BEST. In summarizing one of the Conference presentations that I heard, I've gone out of my way on page 22 to try to convince you to get the tape and listen to it. This session on estate planning for dealers started out with the admonition that the dealer should spend 30 minutes (now) to plan out the next 30 years, writing down what he'd like to do during those years. So that the urgent doesn't overtake the important.

Premised on the strong likelihood that the Estate Tax will not be repealed, this session addressed a wide range of scenarios presented by twin brother dealers, one of whom continued to look to Ed McMahon to satisfy his needs for insurance. Interestingly, every time he met with his CPA at 10 year intervals to discuss his estate planning, his current wife had just celebrated her 41st birthday, and his feeling was that it might be "a little early to be putting assets in his wife's name right now."

#3. WHAT DO YOU DO FOR AN ENCORE? After suggesting that your dealer have a cost segregation study (which saves him a ton of money), what do you do for an encore? I'm going to go out on a limb here. I'm going to venture into a non-tax area in order to call your attention to something you can suggest to your dealers. Much like the idea of a cost segregation study, this might be another no-brainer because the benefits far exceed the costs. Maybe there's even another practice niche in it for you. See page 3 for my suggestion.

#4. THE MOST DISTURBING DEVELOPMENT ON THE HORIZON. If I there were only one development that I could pass along to you, it would be this. And, pardon me, if you've already heard about it.

This "development" is not official yet. But, *when* ... not *if* ... it becomes official, it will significantly complicate all of our lives, as tax return preparers. It will affect not only all dealer clients, but all other clients, as well, and every situation where we are asked to provide copies of our client's tax returns to other parties.

WATCHING OUT FOR

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

At one recent seminar I attended, the discussion of the impact of IRS Notice 2005-93 not only elicited much wailing and gnashing of teeth ... It overshadowed much of the rest of the discussion of other topics that followed.

How many times have you been asked to send a copy of a client's tax return to another party? Sometimes, the request comes directly from a client. Other times, the request comes from a bank or a loan company in connection with a financing application.

In the past, common sense and discretion has been enough to rely on in handling requests for copies of tax returns and in answering (inappropriate) questions or requests for information about our clients' tax affairs. We all have our own means for getting permission from the client first. But, now the IRS wants even more before any tax return disclosures can be made. It's going to tell us exactly what to do, exactly how to do it and exactly how thorough we must be.

There will be more cries of disbelief and "You've got be kidding!" But, remember, dealers face even greater restrictions (in connection with their activities) than we as CPAs and tax return preparers. Have you tried to get medical information about a family member or relative lately, only to be told ... "Sorry, I can't do that ... or tell you that ... because of HIPPA"?

Take a look at pages 6-7 to see what you're now going to have to do to protect yourself (from the IRS). There's a whole new world of red tape standing between you and your client.

#5. SOME ITEMS TO WATCH OUT FOR IN PREPARING 1040s FOR YOUR DEALERS & OTHER CLIENTS. After spending many days at various conferences, a few points struck me as being more important than all the rest. See page 5 for a few of these choice items.

#6. TECHNICIAN'S TOOL REIMBURSEMENT PLANS ... AN UPDATE. Since we've covered this subject so extensively in the last two issues of the *Dealer Tax Watch*, it's worth pointing out that Terri Harris of the IRS did not contradict anything we have previously stated.

If you get the tape and listen to it, or just read the summary of her remarks at the AICPA Dealership Conference, you will note that she simply emphasized that ... assuming that all other conditions are met ... an arrangement will not qualify under Section 62(c) for tax-free treatment if an overpayment is discovered and the employer simply treats that overpayment as additional wages on the employee's Form W-2 at year-end.

As we've said many times before ... if there is any "excess reimbursement" advanced to the employee by the employer, then that excess reimbursement ***must be repaid, returned, given back, surrendered, etc.*** by the employee to the employer. ...It must come back out of the employee's pocket and go into the employer's.

What's so hard to understand about that?

#7. WILL DEALERS BENEFIT FROM THE NEW SECTION 199 DEDUCTION? In a few words, "No, not significantly." This was one item that we mentioned last year that might possibly be a sleeper for dealers in the *American Jobs Creation Act of 2004*. After hearing what the IRS Motor Vehicle Technical Advisor and other representatives of the IRS had to say about the Service's interpretation of Section 199, it seems unlikely that auto dealerships will derive any significant benefit from this provision.

In addition to Ms. Harris' comments on this subject (see pages 12-13), we've included a brief overview of the domestic production activities deduction on pages 15-18. This overview may be of help in case you want to work your way through the more than 200 pages of temporary Regulations that the Service issued in late October.

#8. TRADE DISCOUNTS & LIFO ELIGIBILITY. During Ms. Harris' presentation at the AICPA Dealership Conference, she answered a question on how the requirement that dealers must eliminate trade discounts from inventory cost affects their eligibility to use LIFO. See page 3 for her answer to this question.

#9. FORM 970 HAS BEEN REVISED. Form 970 is the form taxpayers are required to include in the first-year tax return when electing LIFO. For longer than most of us can remember, it has been a relatively innocuous-looking 1-page form. It has been changed slightly over the years, but none of these revisions have been major ... Until now.

New Form 970 has a revision date of December 2005. It is significantly different from its 1-page predecessor. Form 970 is now 2 pages, and it reflects a significant policy change by the IRS towards the use of the dual-index method. In effect, the way the Form is structured, the use of the dual-index methodology is no longer available.

This isn't too significant for auto dealers' LIFO calculations, since most dealers use the Alternative LIFO Method, and this Method contains a built-in disallowance of dual-indexing as one of its features.

The new Form will have to be used to make LIFO elections in calendar year 2005 tax returns. It will be

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ENERGY AUDITS

"... Virtually Any Size Dealership Can Expect to Save 18-25% on Total Utility Costs ..."

I regularly scan several weekly and monthly magazines and periodicals. In one of them, I was struck by an article that reported that a dealership achieved first-year savings of about $44,000 after it had a comprehensive examination of its utility costs and consumption practices. Let's call this an ***energy audit.*** Here are a few excerpts from that article ...

"...With today's technology, virtually any size dealership can expect to save 18-25% on their total utility costs with a good energy management system.

"...It makes so much sense, I can't afford not to do it."

"...The energy management system was installed ... in August of 2004. Since then, the dealership has seen both their consumption and their cost constantly trend downward.

"In order to achieve this much bottom line increase (i.e., saving), we would have had to add one additional experienced salesman along with the overhead and training.

"...Automobile dealerships are truly prime candidates for energy management systems. Lighting, heat and air condition demands combined with the comfort demands of customers and employees often leave dealers immensely frustrated with spiraling energy costs. A solution that allows a dealer to retain control while controlling costs is extremely appealing.

"There are certain nuances of control involved in dealerships that are not found in (other) larger buildings ...."

According to this article, ***any dealership that is spending more than $30,000 per year*** on utility costs should be looking for a control system, as should any dealer planning to build a new facility.

The particulars. The article that I'm referring to appeared in the December 2005 issue of *Auto Dealer Monthly.* Written by Harlene Doane, the publication's editor, it included an in-depth interview with the Director of Operations for Allan Vigil Ford, an Atlanta dealership. Several charts and graphs are included. The energy management system described was put in place by Technology Systems, a Norcross, Georgia organization.

I contacted Mr. Scott Sargeant of Technology Systems (770-448-3633), and he provided additional information on their installations and a few other dealership customer references. The Company's web site is www.technologysystems.net.

I have not called anyone at the dealership to verify the accuracy of the representations in the article, nor have I done any follow-up with Technology Systems. I'm simply suggesting that, if you haven't already discussed the possibility that the dealer might be able to increase his profits by reducing his utility costs, you might want to start with this information and see where it takes you.

Here's my suggestion. After several years, the newness of cost segregation studies as "the best thing since sliced bread," has worn off. What, if any, ***new*** suggestions do you have for your dealer clients? Might not suggesting an energy audit be a good one?

Some CPA firms found that they were able to conduct cost segregation studies on their own, while others simply acted as facilitators between their dealerships and the professionals rendering the services. Beyond the practical suggestion, might there be another practice niche here for some CPAs?

Ms. Harris on Eliminating Trade Discounts from Inventory Cost & LIFO Eligibility

In the final portion of Ms. Harris' presentation at the AICPA National Auto Dealership Conference in Baltimore, she was asked this question. Is an auto dealer using LIFO to value new vehicle inventories risking the termination of its LIFO election (because of a violation of the cost requirement) if the dealership is not eliminating trade discounts and floorplan assistance payments from its year-end inventory costs?

Ms. Harris indicated that she had discussed this question with someone in the Chief Counsel's Office and that she had received the following informal answer ... The taxpayer would ***not*** be considered as being in violation of the LIFO eligibility cost requirement (listed in Rev. Proc. 79-23 as one of several LIFO eligibility requirements). Ms. Harris did not provide any rationale for this position.

Our comment: We find this answer somewhat illogical and inconsistent. For example, in discussing the accountable plan rules and Revenue Ruling 2005-52, the Service is always pointing out that there are three requirements in the Regulations and that all three of them must be met, not merely one or two. Clearly, there are four eligibility requirements to be on LIFO, and compliance with the cost requirement is one of them. Why, in this area, is the Service more lenient than it is in the accountable plan area? We would caution taxpayers against relying on the informal, undocumented answer to this question conveyed by Ms. Harris.

(Continued from page 2)

analyzed fully in the March 2006 issue of our sister publication, the *LIFO Lookout*.

#10. HEAVY EQUIPMENT DEALERS' USE OF REPLACEMENT COST FOR VALUING PARTS INVENTORIES GETS OFFICIAL APPROVAL FROM THE IRS. For years, the IRS fought with automobile dealers claiming that they could not use replacement cost for valuing their parts inventories. The Service even took one taxpayer, Mountain State Ford Truck Sales, to court ... and the IRS won. Then, the IRS finally came to realize that no dealer could ever do what the IRS wanted ... even though the Tax Court had upheld the IRS.

So, in Revenue Procedure 2002-17, the IRS finally gave up on this and permitted auto dealers to use replacement cost for valuing their parts inventories, subject to certain reasonable limitations, and provided a safe harbor change in accounting method for auto dealers to use.

However, nothing was said about whether this more realistic and practical treatment could be used by other kinds of taxpayers who also were using replacement cost for valuing their parts inventories.

In Revenue Procedure 2006-14, the IRS has extended similar latitude and protection to heavy equipment dealers to value their parts inventories at replacement cost. The Revenue Procedure applies only to a ***heavy equipment dealer***. For this purpose, a dealer will qualify only if it sells new heavy equipment under an agreement with one or more heavy equipment manufacturers or distributors and earns a majority of its revenue from the sale, or sale and lease, of new heavy equipment. "Heavy equipment" is defined as those items that fall within the Bureau of Labor Statistics Producer Price Indices WPU111 and WPU112.

Under this Revenue Procedure, parts which may be valued at replacement costs include only goods held as inventory that are, or could be, used to replace original parts on heavy equipment, are necessary for the proper operation of that heavy equipment, and are not accessories.

Rev. Proc. 2006-14 gives heavy equipment dealers permission to continue to use the replacement cost method without filing a Form 3115. Heavy equipment dealers that are using mongrel versions of replacement cost are given permission to change to the safe harbor method provided in the Rev. Proc. by filing Form 3115 and following the automatic change in accounting method provisions of Rev. Proc. 2002-9.

The Revenue Procedure generally is effective for taxable years ending on or after April 30, 2005.

The overall conduct of the IRS in this matter, doling out favorable tax treatment only to those taxpayer groups who press upon them the most, is disconcerting. Clearly there are hundreds of other types of taxpayers who, of necessity, use the replacement cost method for valuing their inventories.

#11. WHAT THE SERVICE GIVETH TODAY ... IT MAY TAKETH AWAY TOMORROW. Here's an interesting twist in connection with the Revenue Procedure discussed above. The Service grants heavy equipment dealers the "right" to use replacement cost for valuing their parts, but there's a wringer in Section 4.07, under the caption ... ***"Future reconsideration of the use of replacement cost."***

In this Section, Rev. Proc. 2006-14 provides that ... "If the Service later determines that circumstances have changed so that the replacement cost of heavy equipment parts no longer approximates the actual cost of heavy equipment parts, the Service may reconsider the safe harbor replacement cost method ... and may modify or revoke the method for future taxable years."

Of special note to auto dealerships. Still further down in the Revenue Procedure, Section 8 states that ... Rev. Proc. 2002-17 is also being amended by adding the following new Section to it ... ***"Future reconsideration of the use of replacement cost."*** This Section is identical to that above, except that it substitutes "vehicle parts" for "heavy equipment parts."

Could the IRS be having second thoughts on all of this? ... Heaven forbid!

#12. E-FILING HARDSHIP WAIVERS MAY BE HARD TO OBTAIN ... NOTICE 2005-88. The IRS has warned taxpayers not to expect too much sympathy or relief from the e-filing requirements that are already in place for 2005 tax returns or set to take effect for 2006 tax returns. The Service will approve or deny hardship application waivers based on the facts and circumstances of the particular taxpayer.

Information to be included in a written waiver request includes (1) a discussion of the steps that the taxpayer has taken in an attempt to meet its requirement to timely file its return electronically, (2) why the steps were unsuccessful, (3) the undue hardship that would result by complying with electronic filing requirements, (4) the steps that the taxpayer intends to take to assure its ability to file future returns electroni-

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Watch Out ... !

SOME ITEMS TO WATCH OUT FOR IN PREPARING 1040s FOR YOUR DEALERS & OTHER CLIENTS

Reporting Stock Sales & Other Transactions in Schedule D ... The Great Debate

- Formerly, where taxpayers have a long list of stock sales, etc., to report, especially in situations where the transactions reported are coming off of broker's statements, many CPAs have used the "see schedule attached" approach.
  - Subtotals for capital gains and loss transactions from broker's statements are carried to the appropriate lines on Schedule D, with the notation ... "See schedule attached."
  - Copies of the broker statements showing all of the transactions are included in the return as supporting schedules.
- For 2005 income tax returns, the IRS will no longer accept this practice.
  - Buried in the instructions for Schedule D ... Page D-6 ... is the following...

    "You must enter the details of each transaction on a separate line. If you have more than 5 transactions to report on Line 1 or Line 8, report the additional transactions on Schedule D-1. Use as many Schedules D-1 as you need. ... Do not enter 'See attached' and summary totals from an attachment in lieu of reporting the details of each transaction directly on Schedule D or D-1."
  - Apparently, the IRS wants to be able to more efficiently match information reported by brokers and to better integrate electronic filing procedures.
- Will the IRS reject returns if they are filed using the "See schedule attached" approach?
- Will the IRS assess penalties against preparers who use the "See schedule attached" approach?
- The AICPA (and other organizations) are up in arms over this and are trying to "reason with the IRS" to get them to drop this.
  - Will the AICPA prevail? ... If it doesn't, what will you do anyway?

6 Months Extensions for Tax Returns Made Easier ... But Watch 709s

- In temporary Regulations issued November 4, 2005, the IRS now provides automatic 6-month filing extensions, thus freeing preparers from having to file successive extension requests on a variety of forms.
- ***Individual income tax returns*** can now receive an automatic 6-month extension by filing Form 4868.
  - It is no longer necessary to file Form 2688 for an additional extension from Aug. 15th to Oct. 15th.
- ***Gift tax return extensions ... Caution:*** Extensions of time for filing gift tax returns on Form 709 are not covered by the individual extension Form 4868 (as they were in the past).
  - Extensions for gift tax returns are required to be requested/filed using Form 8892.
- This year's Form 7004 has been expanded to include automatic 6-month extensions for returns filed by
  - Partnerships ... Form 1065
  - Limited Liability Companies electing to be taxed as partnerships ... Form 1065
  - S Corporations ... Form 1120-S
  - Estates and Trusts ... Forms 1041
  - Information from all of these tax forms feeds into individual returns via Schedules K-1.

Still Waiting for K-1s on 1040 Filing Date?

- Notwithstanding more liberal 6-month extensions for filing "flow-through" entity returns, an individual may find that he/she has not received K-1s when the 1040 extension date draws near.
- Many practitioners will file the individual income tax return with no K-1 information on it or including a reasonable estimate of the K-1 information,
  - Be sure to include ***Form 8275 Disclosure Statement*** with the return and state on it that, as soon as the K-1 is received from the entity, a Form 1040-X, Amended Return, will be filed by the individual.

Repairs to Your Hard Drive

- Confidentiality of information concerns are everywhere and now extend to "computer repairs."
- Have you had any (major) work done on your computer hard drives lately?
  - If so, was there any information relating to individual (or other) taxpayers on the hard drive?
  - If so, have you received written assurance or confirmation from the repair agency (or individual technician) that they will not extract or otherwise use/misuse any information on the hard drive?

Section 199 Domestic Production Activities Deduction

- The deduction for Section 199 will appear on the face of only two types of tax returns
  - Individual returns ... Form 1040 ... Line 35 as a deduction in arriving at Adjusted Gross Income
  - C Corporations ... Form 1120 or Form 1120-A
- Other entities may be engaged in activities that qualify to some extent for the Section 199 deduction. If they do, Sec. 199 information will "flow-through" or "pass-through" in proportion to the ownership percentages on Schedules K-1 issued by
  - S Corporations ... Form 1120-S
  - Partnerships & Limited Liability Companies, electing to be taxed as partnerships ... Form 1065
  - Estates & Trusts ... Form 1065

IRS Notice 2005-93	**_BEFORE DISCLOSING ANY TAX RETURN INFORMATION, YOU'D BETTER READ NOTICE 2005-93 FIRST_** ***Page 1 of 2***
Intro	• In Notice 2005-93 (dated Dec. 27, 2005), the IRS released the text of a proposed Revenue Procedure that would provide guidance to tax return preparers regarding the format and content of consents to use and consents to disclose tax return information. ◆ Written comments are requested by March 8, 2006, after which the finalized Rev. Proc. will be issued. • The Notice and the Code Section refer to two situations. ◆ ... "Consent to use" ... refers to using taxpayer information for another business purpose. ◆ ... "Consent to disclose tax return information" ... refers to providing copies of tax returns and answering questions about the taxpayer's particular situation.
Penalties for Misuse	• Section 7216(a) prescribes a ***criminal*** penalty ***for tax return preparers*** who knowingly or recklessly disclose (or use) tax return information for a purpose other than preparing a tax return. ◆ A violation of Sec. 7216 is a misdemeanor, with a maximum penalty of up to one year imprisonment or a fine of not more than $1,000 or both, together with the costs of prosecution. • Section 6713(a) prescribes a related ***civil*** penalty for disclosures that constitute a violation of Sec. 7216. ◆ $250 for each disclosure, not to exceed a total of $10,000 for a calendar year.
Oral Permission from Client Is Not Enough	• ***The basic rule ...*** A tax return preparer may not ***disclose*** or use a ***taxpayer's tax return*** information prior to obtaining a consent from the taxpayer. ◆ The consent must be knowing and voluntary. ◆ The IRS Commissioner may, by Revenue Procedure, prescribe the form and content of the consents. • When the Rev. Proc. becomes effective, more formal consents will be prescribed.
Layout of the Form of the Consent	• Taxpayer must consent to each separate disclosure on a separate written document which can be furnished on paper or electronically. • Multiple disclosures within a single consent form are permitted, but they are subject to special requirements (Section 4.05). • A consent on paper must be provided on one or more sheets of 8½ inch by 11 or larger paper. • All of the text on each sheet of paper must pertain ***solely*** to the disclosure or use that the consent authorizes. • The sheet or sheets, together, must contain all of the elements described in Sec. 4.04 and, if applicable, Sec. 4.06 (relating to disclosure of the entire tax return). • All of the text on each sheet of paper must be at least 12-point type (or 12 characters per inch). ◆ Note: The size font that you are reading right now is too small. • Special rules are provided for electronic consents relating to content, computer screen layout, etc.
Information to Be Included on Every Consent ***Sec. 4.04***	• Name of the tax return preparer • Name of the taxpayer • Date on which taxpayer signs the consent • Clearly stated disclosure ... The consent must identify the recipient or recipients of the tax return information and the intended purpose of the disclosure. • Clear statement that the information may not be used for any purpose not specifically prescribed in the consent. • Identification of tax return information to be disclosed, specifying the particular items of tax return information to be disclosed to each recipient. • Contact telephone number for suspected violations of Section 7216. ◆ The consent must include the contact telephone number for the Treasury Inspector General for Tax Administration (TIGTA), 1-800-366-4484. ◆ This telephone number allows taxpayers to report suspected unauthorized uses or disclosures of tax return information. • Mandatory statements in prescribed formats ... These are detailed below. • Additional mandatory statements in any consent to disclose ***outside of the United States***. • Affirmative consent ... A consent that requires the taxpayer to remove or "deselect" disclosures that the taxpayer does not wish to be made, i.e., an "opt-out" consent, ***is not permitted***. • Taxpayer's signature ◆ For consents on paper, the consent to disclose tax return information must be signed by the taxpayer. ◆ For electronic consents, a taxpayer must sign the consent by any one of the methods prescribed in the Revenue Procedure.

IRS Notice 2005-93	***BEFORE DISCLOSING ANY TAX RETURN INFORMATION, YOU'D BETTER READ NOTICE 2005-93 FIRST*** *Page 2 of 2*
Prescribed Text for 3 Paragraphs that Must Be Included in Every Consent to Disclose ***Sec. 4.04(6)***	• Text of first required paragraph ... ***"We generally are not authorized to disclose your tax return information for purposes other than the preparation and filing of your tax return. We may disclose your tax return information to third parties only if you consent to each specific disclosure. Your consent is valid for one year."*** • Text of second required paragraph ... ***"Warning: Once your tax return information is disclosed to a third party per your consent, we have no control over what that third party does with your tax return information. If the third party uses or discloses your tax return information for purposes other than the purpose for which you authorized the disclosure, under Federal tax law, we are not responsible for that subsequent use or disclosure, and Federal tax law may not protect you from that disclosure."*** • Text of third required paragraph ... ***"If you believe that your rights have been violated. If you have any questions or concerns about your rights regarding the use or disclosure of your tax return information, visit www.irs.gov/advocate for more information, or contact the Taxpayer Advocate Service of the Internal Revenue Service at 1-877-777-4778.*** ***"If you believe we have used or disclosed your information without your permission, you may contact the Treasury Inspector General for Tax Administration at 1-800-366-4484."***
Disclosure of Entire Return	• If the consent authorizes the disclosure of all information contained in a return, the consent must contain an explanation of the reasons why a consent authorizing a more limited disclosure of tax return information would not satisfy the purpose of the consent.

Dealer Tax Watch Out

(Continued from page 4)

cally and, of course, (5) a statement under the penalties of perjury that all of the information contained in the request is true, correct and complete.

In discussing its anticipated "undue hardship," the taxpayer must explain in detail the incremental costs that it expects to incur in complying with the e-filing requirement. For this purpose, incremental costs are those costs that are above and beyond the costs to file on paper. This discussion must be supported by a computation detailing the costs to file on paper and the costs to file electronically.

Lots of luck.

#13. SCHEDULE M-3 RECONCILIATIONS RELEASED IN DRAFT FORM FOR 2006 PARTNERSHIP & S CORPORATION <u>RETURNS</u>. There's probably more than enough for you to deal with in the way of current-year changes and new developments. However, you should be aware that the IRS has already released its drafts of the multi-page Schedule M-3 reconciliations that will have to be completed starting with 2006 tax returns filed by Partnerships (Forms 1065) and S Corporations (Forms 1120-S). More about these in a future issue.

#14. <u>INCREASE IN USER FEES ... WAY, WAY UP</u>. In IR-2005-144, dated December 19, 2005, the IRS announced increases in selected user fees to become effective February 1, 2006.

Included on the list of user fees that are going up are fees for requests for changes in accounting methods (Forms 3115 filings) which will increase from the previous $1,500 to $2,500.

Also, the fee for Private Letter Rulings from IRS Chief Counsel will increase from $7,500 to $10,000. However, taxpayers earning less than $250,000 can request a Private Letter Ruling for a reduced fee of $625 and taxpayers earning between $250,000 to $1 million will pay a fee of "only" $2,500.

Summary	FALL TAX CONFERENCES ... AN UPDATE

2005 AICPA National Auto Dealership Conference. This AICPA conference was held in Baltimore, Maryland on October 24-25 at the Baltimore Marriott Waterfront. This Conference afforded a potential 17 hours of CPE in the areas of accounting, auditing, management, tax and specialized knowledge.

Three presentations are summarized in more detail on the following pages. In connection with the tax minimization strategies presentation, I have substituted *"Dealership"* for the year reference *"2005."*

- ***IRS Update*** ... See pages 10 to 14.
- ***Strategies to Minimize Your 2005 Tax Burden*** ... See pages 19 to 21.
- ***Estate Planning: Securing Tomorrow's Success Today*** ... See pages 22 to 23.

Of course, attending the IRS Update session is mandatory. Regarding the other two presentations, I found the session on strategies for minimizing dealership taxes to be disappointing because it was too basic and general. The presentation on dealer/dealership estate planning was an unexpected delight.

As in the past, this Conference tries to satisfy a number of special interests and possibly loses some of its appeal by spreading itself across too broad a range of topics. The list of Conference subjects is on the facing page, and you can order Conference related materials and tapes if any of these appeal to you. In my opinion, the quality of the Conference audio tapes is very poor, and I don't understand why the AICPA has not changed providers, as this has been a continuing problem with tapes for this Conference over the years. Tapes can be ordered from *Conference Copy, Inc.*, (570) 775-0580, 8435 Route 739, Hawley, PA 18428, www.conferencemediagroup.com.

AICPA National Conference on Federal Taxes. A week later, I returned to the same general area for the AICPA National Conference on Federal Taxes, which was held October 31 - November 1 at the J. W. Marriott Hotel Pennsylvania Avenue in Washington, DC.

This 2-day Conference was outstanding and provided a much broader and useful range of information that could be applied to dealers and dealerships even though many of the Conference presentations were "outside of that general area." My recommendation to any firm handling dealerships is that it invest some time in this Conference sooner or later as a way of increasing its overall tax competence, notwithstanding the fact that there is a ample supply of one or two-day seminars available locally on how to fill out forms and tax returns.

Although some sessions don't relate exclusively to dealer applications, those that do would make this high-level Conference very much worthwhile.

National CPA/IRS Tax Issues Meeting. One of the many benefits associated with attending the AICPA Tax Conference was the post-Conference optional meeting on the following day (Wednesday, November 2). I attended this full-day session for the modest additional fee of $100. All of the speakers at this meeting were all high-level IRS employees representing the various IRS divisions. Since I registered early enough for this session (attendance was limited to the first 100 or so registrations), I was able to hear presentations by Commissioners of various Divisions and other Directors (see below).

I highly recommend the AICPA Conference on Federal Taxes ... the following optional post-Conference program ... and urge you to consider attending them next year.

NATIONAL CPA / IRS TAX ISSUES MEETING *J. W. Marriott Hotel, Washington, D.C. • Nov. 2, 2005*	*Topics & Speakers*
• Appeals	• Andrew E. Blanche, Jr., Director, Appeals Field Operations - East
• Large & Mid-Size Business Division (LMSB)	• Bruce Ungar, Deputy Commissioner
• Wage & Investment Division	• Richard Morgante, Commissioner
• Small Business / Self-Employed Division (SB/SE)	• Kevin Brown, Commissioner
• Office of Electronic Tax Administration	• Bert DuMars, Director
• Panel on Flow-Through Entities	• Marsha Ramirez, Director, Examination, SB/SE Division • Paul Cordova, Director, Field Operations, LMSB Division • Danny Snow, Thompson Dunavant PLC, Memphis, TN
• Tax Exempt & Government Entities Division	• Steven T. Miller, Commissioner
• Taxpayer Advocate Program	• Nina Olson, National Taxpayer Advocate

AICPA NATIONAL AUTO DEALERSHIP CONFERENCE - 2005

Baltimore, Maryland • October 24-25, 2005

Topics & Speakers

- *Fire & Rain - An Updated Irreverent Look at Auto Industry Trends & Events* ... James A. Ziegler
- *An Insiders Look at the Automotive Industry* ... Steve Finlay
- *The Pros and the Cons - Protecting Yourself from Both - Fraud Prevention in the Dealership* ... Kenneth Rosenfield
- *Data Extraction from Your Computer System - A Practical Approach* ... Wayne A. Fortier
- *The Best Ideas from NCM 20 Groups* ...Kevin Cunningham
- *Houston, We Have a Problem - What Your Financial Statement Can Tell You* ... Deb Gammon
- *Accounting& Auditing Update for Dealerships* ... Paul Munter
- *Key Profit Performance Areas in Service & Parts* ... Lloyd Shiller
- *What Do You Mean I Paid Too Much? - A Practical Look at Goodwill Impairment* ... Diane Anderson-Murphy & J. Scott Swearingen
- *Dealership Pay Plans that Work* ... Mike Bowers
- *Turning the Key on a New Automotive Golden Age* ... Irv Miller
- ***IRS Update* ... Terri Harris, IRS Motor Vehicle Technical Advisor**
- *Controller's Workshop* ... Moderator: Jay A. Goldman, Panelists: Diane Mohieldin, Steven P. Noble & Kerry J. West
- ***Strategies to Minimize Your 2005 Tax Burden* ... Gregg Hamm & Tom Taricani**
- *Financing Alternatives for Dealers - What's New and What's Hot* ... Pete Kantor, Dennis Stough & Mark Wolpert
- *HR Legal Updates - Traps for the Unwary* ... Joseph J. Vicinanza
- *Turbo-Charging Your Auto Dealer Niche* ... Gale Crosley
- *Strategies for Maximizing Value of Dealership Insurance Programs* ... Scott M. LeMay
- ***Estate Planning: Securing Tomorrow's Success Today* ... Anthony Allison & Marvin Hills**
- *Audit Quality & Efficiency - Finding the "Keys"* ... Joseph P. "Bo" Fitzpatrick

AICPA NATIONAL CONFERENCE ON FEDERAL TAXES

Washington, D.C. • Oct. 31 - Nov. 1, 2005

Topics & Speakers

- *Legislative Update* ... Don Longano
- *Section 199 - Domestic Production Activities Deduction* ... David Helmer & Heather Maloy
- *Circular 230* ... Harvey Coustan & Stephen Whitlock
- *Current Developments at the Treasury Department* ... Eric Solomon
- *Schedule M-3 - What You Need to Know* ... Bob Adams, L. Michelle Carlone & Linda S. Gurene
- *Individual Update* ... Mike Mares
- *Tax Issues on Client's Real Estate* ... Dick Bartholomew
- *2005 Legislation - Digging Through the New Acts* ... Doug Stives
- *Information Security* ... Ido Dubrawsky
- *LIFO & Tax Accounting Issues* ... Bob Zarzar
- *Dealing With the Troubled Taxpayer* ... Mike Rusnak
- *Avoiding Malpractice Clailms in Tax Preparation and Advisory Engagements* ... John Eickemeyer
- *I.R.C. Section 41 - Research & Development Tax Credit* ... Ed Jankun & David Mayer
- *Divorce* ... Eleanor Breitel Alter
- *Family Limited Partnerships (FLP) Planning After the* Strangi *Case* ... Richard Petrofsky
- *Employment Taxes and the Limited Liability Company (LLC)* ... Debbie Pflieger
- *Psychology of Dealing with Clients* ... Brian Whitlock
- *Year in Review* ... Thomas Ochsenschlager
- *Individual AMT Planning Issues* ... Norm Solomon
- *Capture Your Share of the Trillion Dollar IRS Rollover Market* ... Ed Slott
- *What's Happening in Washington?* ... John Buckley
- *Pass Through Entity Update* ... Kevin Leifer
- *International Issues* ... Alan Alport & Neal Block
- *Statements on Standards for Tax Services (SSTSs)* ... Ed Karl
- *Sorting Out the Alternatives in Investing: Economic and Tax Highlights* ... Janice Johnson
- *The Impact of the New Business Valuation Standards in Your Tax Practice* ... Ed Dupke, Ed Karl & Bob Zarzar
- *Where to Spend the Golden Years: Your Exit Strategy* ... Brian Whitlock

IRS TAX UPDATE
AT THE AICPA DEALERSHIP CONFERENCE

Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, spoke again at the AICPA National Auto Dealership Conference in Baltimore. Her 2005 IRS Update session on October 25 covered five major areas, each of which is discussed below.

TECHNICIANS' ACCOUNTABLE PLANS FOR TOOL REIMBURSEMENT

Technically, these are accountable plans under Section 62(c) for the reimbursement of tool expenses incurred by an employee who is required to provide and maintain tools as a condition of his or her employment.

In this part of her presentation, Ms. Harris provided a general review of the accountable plan rules and of the generally negative Coordinated Issue Paper on this subject that the IRS had issued in 2000. She followed this with a discussion of Revenue Ruling 2005-52 and its implications.

Ms. Harris indicated that this Revenue Ruling was not based on any one specific taxpayer's plan. Instead, the fact pattern in the Ruling was a blend or combination facts taken from many plans that the IRS National Office had "seen" over the past several years.

In the Ruling, the employer's reimbursement plan involved a formula approach (i.e., it was a rate-based determination plan) with several very obvious defects. (Note: The subject of technician accountable plans has been dealt with extensively in previous issues of the *Dealer Tax Watch*.)

In discussing Revenue Ruling 2005-52, Ms. Harris emphasized the point that was added near the end of the Revenue Ruling regarding the so-called "recharacterization of income" issue. In this part, the IRS National Office indicated that even if the taxpayer had substantiated actual expenses, the plan described in the Revenue Ruling still would not have qualified under Section 62(c).

It would seem that what Ms. Harris was trying to do was to emphasize again the requirement in the Regulations that if there is an excess payment, that excess must be returned by the employee to the employer. The employer cannot just call the excess "wages" and include that amount on the employee's W-2. The IRS would consider that treatment to be a "wage recharacterization."

Some of Ms. Harris' slides from her discussion of tool plans are on the facing page.

Ms. Harris commented that she was aware that some of the vendors had come together to form a coalition to try to get additional guidance from the IRS on these reimbursement / accountable plans. She also emphasized that the Coordinated Issue Paper

see **IRS TAX UPDATE**, page 12

Ms. Harris on Treating Excess Payments as "Wages" ... Here's What She Said

"Even if the technicians in the fact pattern we just gave you had substantiated the actual amounts, and any excess that was paid was treated as wages, that plan still wouldn't qualify. So, I've heard a lot of discussion over the months and the years of ... 'What if we pay a little extra? ... And it turns out we paid some extra, and we'll call it wages?'

"That's allowable in certain situations - in some mileage situations, the IRS has allowed that to happen ... They've (i.e., the IRS has) said, 'If you pay excess in some mileage situations, you can call it wages.' There's a special provision in the Regulations that allows them to do that. ***That provision doesn't apply here.*** So, don't read too fast through the Revenue Ruling. And make sure you notice that paragraph towards the end that says, 'Look, even if they (i.e., the employees) have substantiated the expenses, and any excess we paid them, we called wages...' the plan still wouldn't qualify.

"So, that Revenue Ruling, while I don't think it addresses all of the facts, by any means, in all of the different programs that are out there... I do think it does give you a place to start."

Service Technicians' Tool Reimbursements

- Accountable Plan Rules - IRC §62(c)
  - Expense Must be Ordinary and Necessary
  - Employee Must Actually Pay or Incur an Expense
  - Employee Must provide Adequate Accounting to Employer of Expenses
    - Written Documentation & Receipts
  - Employee Must Account for All Amounts Received
  - Excess Amounts Must be Returned to Employer

Service Technicians Tool Reimbursements Programs – A Short Review

- What are the advantages of an Accountable Plan?
  - Amounts paid under a <u>qualifying</u> plan are not subject to income or employment tax
    - No income or employment tax for technicians
    - Reduced employment tax for employer

Service Technicians' Tool Reimbursements

- Key Questions for Dealers -
  - What Are the Requirements to Qualify as an Accountable Plan?
  - What is the IRS Position on Service Technicians' Tool Reimbursement Plans?
  - Is My Plan Compliant?

Service Technicians' Tool Reimbursements

Coordinated Issue Paper – July 2000

- Conclusion
  - Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements
  - Amounts paid under a non-accountable plan:
    - Included in the employee's gross income
      - Must be reported on employees' Form W-2
    - Are subject to the withholding and payment of federal employment taxes

Service Technicians' Tool Reimbursements IRS Position

- Revenue Ruling 2005-52 – August 3, 2005
  - Facts:
    - Employees required to provide and maintain various tools
    - Employees receive hourly wages and a tool allowance
      - Tool allowance is determined using national survey data and technician questionnaire
    - Employees not required to substantiate actual expenses
    - Employees not required to return any part of allowance that exceeds actual expenses

Service Technicians' Tool Reimbursements IRS Position

- Conclusion –
  - Arrangement fails to meet the accountable plan requirements
    - No substantiation required
    - No return of excess
  - Amounts paid under such a plan are:
    - Includible in technician's income
    - Subject to employment taxes
- Re-characterization Issue:
  - Even if employees substantiated actual amounts and any excess paid is treated as wages by employer -- Plan does not qualify

(Continued from page 10)

that the Service issued in 2000 does not rise to the level of a Revenue Ruling. Finally, she added that the IRS may make an effort in the future to update and reissue the Coordinated Issue Paper.

One of the questions during the Q & A session related to whether there was any type of tool plan reimbursement arrangement that might qualify under the accountable plan rules of Section 62(c). Ms. Harris repeated the same answer that she gave last year ... that she hasn't seen all of the possible types of plans, but she is not saying categorically that "it can't be done."

ENERGY POLICY ACT OF 2005

In discussing this legislation, Ms. Harris reviewed the Alternative Motor Vehicle Credit available under Section 308. This becomes effective for property placed in service after Dec. 31, 2005. This credit replaces the hybrid vehicle deduction, which was contained in Section 179A and expired as of Dec. 31, 2005.

The new credit under Section 308 consists of the sum of ***four*** other credits ... (1) the new qualified ***fuel cell*** motor vehicle credit, (2) the new ***advanced lean burn technology*** motor vehicle credit, (3) the new qualified ***hybrid*** motor vehicle credit and (4) the new qualified ***alternative fuel*** motor vehicle credit.

Although Ms. Harris did not say this, these credits are an administrative nightmare and will be driving tax return preparers crazy. These credits involve (1) detailed requirements that must be met before the credit can be claimed, (2) percentages and ranges which must be determined, (3) limitations relating to the number of automobiles or vehicle weight and on, and on, and on, and on ... I'm sure you get the point.

Many publications have included articles about the availability of these credits, but few mention the extensive limitations and the nightmare facing the return preparer confronted with "eligible" vehicles. In any event, this will be next year's problem ... We've got enough on our hands right now.

An article in the *Wall Street Journal* (December 31, 2005) listed the Toyota *Prius* as having the highest estimated credit ($3,150) followed by the Ford *Escape* (2-wd SUV) and the Toyota *Highlander* (2-wd SUV), both having estimated credits of $2,600 waiting for the "lucky" purchasers who qualify. At the bottom of the list were the Chevrolet *Silverado* (4-wd Pick-Up) and the Honda *Accord* at $650 worth of credit, and last, but not least, the Chevrolet *Silverado* (2-wd P/U) at $250.

Another source of information on this subject is the web site of the American Council for an Energy-Efficient Economy (ACEEE) ... www.aceee.org. Its listing is more complete, and you may want to check it out.

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION ... SECTION 199

Ms. Harris devoted more of her time to this subject than to any other topic. In addition to providing an overview of Section 199, including the proposed Regulations that had just been issued on October 20, 2005, Ms. Harris talked about the possible application of this Section to automobile dealerships, principally to their service departments and auto body shop operations.

In the December 2004 issue of the *Dealer Tax Watch*, we had mentioned the possibility that dealers might find some benefit in Sec. 199. Unfortunately, at the Conference in Baltimore, Ms. Harris expressed the opinion that it was more likely that there would not be much benefit, if any at all, for auto dealerships.

The principal reason for this is that the product must be manufactured in the United States ***and the taxpayer has to add at least 20% of the cost of goods sold of the product*** in order for the entire gross receipts from that product to qualify.

There may be situations where certain dealerships can benefit from this provision if its service department and body shop operations perform considerable installation activities. However, Reg. Sec. 1.199-3(d)(3) provides that the definition of "manufacturing" includes installation, ***but only if*** the taxpayer manufacturers the product that it installs. Most dealerships do not manufacture the products that they are installing.

However, the customization of some parts may qualify, and the special "shrink back" provisions, which apply to products that do not meet the 20% of cost rule, may result in a small benefit for some dealers. An activity that the "shrink back" rule might apply to could be the restoration of classic cars.

Ms. Harris provided several examples of potential dealership applications. Her slides on this are on the facing page.

Lack of consistency between Sections 199 and 263A. Ms. Harris said that the position of the IRS is that these two Sections are (1) independent, or mutually exclusive, and (2) "potentially inconsistent." The definition of "producer" for Section 199 purposes applies an "item-by-item" approach or basis. This means that a taxpayer may be considered to be a "producer" for purposes of the cost capitalization rules of Section 263A, even thought that taxpayer may not be considered a "producer" for purposes of the rules under Section 199.

see **IRS TAX UPDATE**, page 14

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

Example–Used Car Dealership-An unusual situation?

- Purchased a Used Vehicle For $1000
  - Substantial Rebuilding Performed for a Cost of $1000
- Vehicle is Sold for $3000
  - Because the dealership added costs of greater than 20%, the appropriate percentage may be applied to $3000 minus the dealership's costs of $2000 and allocated indirect costs to determine the deduction amount.

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- Shrink Back Rule
  - Applies to products that don't meet the 20% of cost rule
  - Company may "shrink back" the product to its components

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- Example:
  - A company performs restoration activities on a classic, collectible vehicle in the company's inventory
  - As part of the restoration, the company fabricates and installs a bumper
  - The restoration activities as a whole do not meet the 20% of cost test

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- Company may "shrink back" the activities to the fabrication of the bumper which qualifies
  - A portion of the selling price of the vehicle allocable to the bumper may qualify Qualified Domestic Production Income.

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- §263A and §199
  - The provisions of each code section are independent and potentially inconsistent
  - The definition of a "producer" for IRC §199 is determined on an item by item basis
    - Not on a per taxpayer basis
  - A taxpayer determined to be a producer for IRC §263A will not necessarily be a producer for IRC §199

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- Remanufacturing activity can meet the definition of manufacturing if:
  - Taxpayer owns the product they re-manufacture
  - They contribute over 20% of the costs of the remanufactured product
  - All other provisions of §199 are met
    - Income will qualify as Domestic Production Gross Receipts (DPGR)

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

- Remanufacturers' May Have Qualifying Income
  - Example:
    - A remanufacturer owns and remanufactures an engine core into a serviceable engine
    - The remanufacturer must meet the 20% of cost test
    - If so, the appropriate percentage is applied to the selling price of the remanufactured engine less direct cost and an allocation of indirect costs
      - Limited to 50% of W-2 wages paid

IRC §199 Deduction
Auto Dealership Service Departments
Body Shops, Remanufacturers

Example:

- Remanufactured engine sold for $5000 total
  - $3000 exchange price
  - $2000 core charge
- Core is returned by customer and purchased by remanufacturer for $2000
- Core is rebuilt into a serviceable engine and sold to another customer for $4000 exchange price and a $2000 core charge

 (Continued from page 12)

It is possible that some IRS examining agents are looking at auto dealerships' Section 263A calculations and concluding that the dealerships should be treated as "producers" under Section 263A. If this were the case, then these dealers would be ineligible to use the Simplified Resale Method, with its attendant beneficial short-cuts and *de minimis* rules. However, this conclusion as to the non-retailer status of the dealerships (under Sec. 263A) would not, per se, necessarily mean that the dealership would automatically be entitled to obtain the advantages of the Section 199 deduction for "producers."

ELECTRONIC RECORDS RETENTION & COMPLIANCE WITH REV. PROC. 98-25

This is an area that Ms. Harris has discussed at previous AICPA conferences, always pointing out that dealerships, as a group, are notoriously noncompliant. She indicated that many examining agents will typically request an IRS computer specialist to assist them in dealership examinations. Even with this assistance, examining agents often run into significant difficulties.

A few years back, the IRS attempted to bring most of the vendors of dealership software together. The IRS hoped to have an open discussion with them about the requirements of Rev. Proc. 98-25 and what could be done to improve the overall deplorable state of noncompliance. Unfortunately, this approach was not successful.

Since that attempt failed, the Service has adopted a new approach. It is now trying to work with vendors on an individual basis. At their own request, these vendors have approached the IRS expressing interest in considering and making necessary structural or other changes to their architectural designs.

The IRS cannot disclose which companies have approached the Service for this assistance, nor can it indicate which companies are considerably better, or worse, than others in this regard. The Service also cannot endorse any specific vendor or product.

Ms. Harris said that these are some questions that dealerships should be discussing with their current software providers. Probably the most obvious question is ... "Have you recently had a sit-down session with the IRS, and are your products in compliance with Rev. Proc. 98-25 requirements?" Other questions might include ... Is the data stored in an unalterable format? (The IRS requires that archived data must be in an unalterable format.) Will the IRS be able to use ASCII print reports versus the taxpayers' DBMS data files? (The IRS cannot convert .pdf files.) ... and other questions of a similar nature.

Possible penalties? Ms. Harris indicated that the IRS has about run out of patience with dealers and software vendors in this whole problem area. She said that the next step may be for the computer audit specialists to ***recommend penalties*** on audits involving dealerships that are noncompliant with the requirements of Rev. Proc. 98-25.

UPDATE ON RULINGS & CASES

PORC rulings. Ms. Harris gingerly tackled a discussion of the PORC Rulings released late last year, LTRs 200453012 and -013. She indicated that even though PORCs are no longer listed transactions, the IRS will still be looking closely at situations where dealers are using PORCs.

The Service will continue to review whether potentially abusive areas are being entered. Matters such as shareholder use of funds and non-performing loans and the appropriateness of the pricing of the insurance products (between the related entities) usually beg for IRS inquiry.

Ms. Harris also mentioned a recent Private Letter Ruling 200520035. Although this does not involve an auto dealership, it expresses several theories that could readily apply to dealership PORCs.

David Taylor Enterprises. This case involved the question of whether an auto dealer who had classic cars was holding them as "investments" or as "inventory." The dealer incurred losses on some sales and treated those losses as ordinary deductions. The IRS took the position that the losses should have been treated as long-term capital losses. The Tax Court did not agree with the IRS, and it allowed the taxpayer to have ordinary deduction treatment.

OTHER MATTERS

Ms. Harris' presentation materials also included information on truck and tractor excise tax developments (Rev. Rul. 2004-80), the *Freightliner of Grand Rapids* case, and the *Highway Funding Act* effective Sept. 30, 2005.

Finally, in a brief summary of other items on the IRS Chief Counsel Priority Guidance Plan, Ms. Harris mentioned (1) a pending Revenue Procedure regarding the use of replacement cost for the valuation of parts inventory by heavy equipment dealers, (2) a Revenue Ruling on the cancellation of lease of distributor agreements, (3) guidance on the treatment of vendor allowances and (4) donee reporting requirements in connection with the donation of vehicles to charities.

On another sensitive issue, see page 3 for Ms. Harris' answer to a question involving the cost capitalization rules for trade discounts and LIFO eligibility.

At A Glance	SEC. 199 ... DOMESTIC PRODUCTION ACTIVITIES DEDUCTION *Page 1 of 3*
Background	• When the *American Jobs Creation Act of 2004 (AJCA)* repealed the favorable tax rules for (1) foreign sales corporations and (2) the extra-territorial income exclusion provisions, it replaced these provisions with Section 199 which allows a deduction for certain domestic production activities. ◆ This deduction applies to all taxpayers who are involved in qualified domestic production activities, regardless of whether or not they are engaged in international operations or export operations. ◆ Section 199 is not limited only to taxpayers who are doing business outside the U.S. ◆ It is available to all taxpayers ... corporations, partnerships, other pass-through entities and individuals. • When fully phased-in, this deduction is intended to be the equivalent of a 3% income tax rate reduction for qualifying domestic activities for taxpayers in the maximum income tax bracket (33-35%). ◆ This deduction was not available for 2004. ◆ The deduction percentage is being phased in, starting in 2005. ◆ The deduction is allowable for both the regular and the Alternative Minimum Tax computations.
5-Year Phase-in	• The deduction under Section 199 is phased in over a 5-year period starting in 2005. • 3% for tax years beginning in 2005 and 2006. • 6% for tax years beginning in 2007, 2008 and 2009. • 9% for tax years beginning after 2009.
Limitation on the Deduction	• The Section 199 deduction is limited to the lowest of three amounts ... ◆ Applicable percentage (3%-6%-9%) of qualified production activities income, ◆ Applicable percentage (3%-6%-9%) of taxable income, or ◆ 50% of Wages. (See discussion *"The Wage W-2 Limitation"* below.)
NOL ...?	• First determine whether entity has a net operating loss for the current year. ◆ There is no benefit from Section 199 if the company has a Net Operating Loss for the current year. • If the taxpayer has a current-year Net Operating Loss ... forget about the Sec. 199 deduction for that year. • Taxpayers with flexibility in timing major deductions, may want to plan their deductions carefully, especially with respect to the years where the Sec. 199 deduction phases in to the next higher rate.
IRS Guidance	• IRS Notice 2005-14 • Instructions for Form 8903 are not anticipated to be released by the IRS before January 31, 2006. • Proposed Regulations issued October 2005 ... Very comprehensive ◆ 1.199-1 Income attributable to domestic production activities ◆ 1.199-2 Wage limitation ◆ 1.199-3 Domestic production gross receipts ◆ 1.199-4 Costs allocable to domestic production gross receipts ◆ 1.199-5 Application of Section 199 to pass-through entities ◆ 1.199-6 Agricultural and horticultural cooperatives ◆ 1.199-7 Expanded affiliated groups ◆ 1.199-8 Other rules • Final Regulations ... Proposed Regs. not anticipated to be finalized before April 2006. • Comment by an IRS representative at one conference: "Silence (on the treatment of an item) in the Notice or in the proposed Regs. is not a license to make up your own rules."
Tax Return Reporting	• The deduction for Section 199 will appear on the face of only two types of tax returns ◆ C Corporations ... Form 1120 or Form 1120-A ◆ Individual returns ... Form 1040 ... Line 35 as a deduction in arriving at Adjusted Gross Income • Other entities may be engaged in activities that qualify to some extent for the Section 199 deduction. In these instances, the information will "flow-through" or "pass-through" only in proportion to the ownership percentages on Schedules K-1 issued by ◆ S Corporations ... Form 1120-S ◆ Partnerships & Limited Liability Companies, electing to be taxed as partnerships ... Form 1065 ◆ Estates and Trusts ... Form 1041 • *Form 8903* - finalized ... However, instructions won't be released by the IRS until Jan. 31, 2006.

Form **8903**

Department of the Treasury
Internal Revenue Service

Domestic Production Activities Deduction

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

OMB No. 1545-xxxx

2005

Attachment Sequence No. **143**

Name(s) as shown on return | Identifying number

1	Domestic production gross receipts	1	
2	Allocable cost of goods sold — 2		
3	Directly allocable deductions, expenses, or losses — 3		
4	Indirectly allocable deductions, expenses, or losses — 4		
5	Add lines 2 through 4	5	
6	Subtract line 5 from line 1	6	
7	Qualified production activities income from pass-through entities: If you are a— a Shareholder: Then enter the total qualified production activities income from— Schedule K-1 (Form 1120S), box 12, code Q; b Partner: Schedule K-1 (Form 1065), box 13, code U; Schedule K-1 (Form 1065-B), box 9, code S2	7	
8	**Qualified production activities income.** Add lines 6 and 7. If zero or less, enter -0- here, skip lines 9 through 15, and enter -0- on line 16	8	
9	Income limitation (see instructions): • Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)	9	
10	Enter the smaller of line 8 or line 9. If zero or less, enter -0- here, skip lines 11 through 15, and enter -0- on line 16	10	
11	Enter 3% of line 10	11	
12	Form W-2 wages (see instructions)	12	
13	Form W-2 wages from pass-through entities: If you are a— a Shareholder: Then enter the total Form W-2 wages from— Schedule K-1 (Form 1120S), box 12, code R; b Partner: Schedule K-1 (Form 1065), box 13, code V; Schedule K-1 (Form 1065-B), box 9, code S3	13	
14	Add lines 12 and 13	14	
15	Form W-2 wage limitation. Enter 50% of line 14	15	
16	Enter the smaller of line 11 or line 15	16	
17	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6	17	
18	Expanded affiliated group allocation (see instructions)	18	
19	**Domestic production activities deduction.** Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return	19	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37712F Form **8903** (2005)

At A Glance	***SEC. 199 ... DOMESTIC PRODUCTION ACTIVITIES DEDUCTION***
Step-by-Step Approach	• Determine taxable income. ◆ Special rules aggregate/treat all members of an Expanded Affiliated Group (EAG) as a single corporation. • Determine W-2 wages. • Identify revenue sources. • Confirm that the property is MPGE'd (Manufactured, Produced, Grown or Extracted) by the taxpayer. • Confirm that the MPGE'd property was MPGE'd in whole or in significant part in the U.S. • Determine approach that will be applied to quantify ***Domestic Production Gross Receipts*** (DPGR) and related Cost of Goods Sold (CGS) ... i.e., determine how you will collect the data. • Compute DPGR. • Compute Cost of Good Sold allocable to DPGR. • Allocate and apportion expenses to qualifying gross income. (See *Allocation of Expenses*.) • Compute Section 199 deduction after applying taxable income limitation and wages W-2 limitation.

At A Glance	***SEC. 199 ... DOMESTIC PRODUCTION ACTIVITIES DEDUCTION*** ***Page 2 of 3***
A Few Basic Points	• In general, wholesalers and distributors will not qualify for Section 199 benefits because they are not manufacturing or otherwise adding to the product. • It is important to look at the activity that occurs with respect to the property, because within complicated chain processes, several activities may qualify for the Section 199 deduction. • In order to qualify for Sec. 199 benefits, the taxpayer must be applying the Sec. 263A cost capitalization rules. A taxpayer can qualify for Section 199 if it is using the simplified methods under Section 263A. • Aggregation occurs at the individual/owner level where pass-through entities are involved. • Corporate taxpayers who are members of an affiliated group are subject to special expanded affiliated group (EAG) rules which generally, in effect, treat all members of the group as a single corporation.
Item-by-Item Determination & The "Shrink Back" Rule	• The Regs. take an item-by-item approach, based on the taxpayer's normal business classification. ◆ This approach is based on the unit of Qualified Production Property offered to customers as a single unit. ◆ If the taxpayer sells by carloads, then carloads is that taxpayer's item. ◆ If the taxpayer sells by bushels, then bushels is that taxpayer's item. ◆ If the taxpayer sells goods in packages of three, then packages of three constitute that taxpayer's item. ◆ Qualified Production Activities Income (QPAI) is not determined on a division-by-division, product line-by-product line or transaction-by-transaction basis. • The concept of "shrink back" involves looking at the largest component that qualifies and then "shrinking it back" to determine what parts, if any, relate to property manufactured in the U.S. ◆ In other words, if the taxpayer is not otherwise considered as being the manufacturer of the product sold at retail, the taxpayer is permitted to treat a component part of the product as an "item." ◆ Prop. Reg. Sec. 1.199-1(c)(2) ... definition of an "item" ... See *Example 1.* ◆ If a part of a shoe is purchased from a foreign country and another part of the shoe is manufactured in the U.S., the taxpayer is entitled to a Section 199 deduction with respect to the portion of the property that is manufactured in the U.S.
MPGE & Qualifying Activities	• ***MPGE*** stands for ... ***Manufactured, Produced, Grown or Extracted*** property. • Manufacturing or production activity must... ◆ Involve Qualified Production Property (i.e., personal property), ◆ Occur in whole or significant part in the United States, and ◆ Either (1) be substantial in nature, or (2) involve the incurrence of conversion costs of more than 20%. (See special rule / safe harbor for conversion activities below.)
Special Rule for "Conversion Activities"	• An activity will be treated as qualified manufacturing or production activity if that activity involves the incurrence of conversion costs (direct labor and related factory burden) which are ◆ Account for 20% or more of the total Cost of Goods Sold of that Qualified Production Property ◆ Incurred within the U.S. • This safe harbor rule is found at Prop. Reg. Sec. 1.199-3(f)(3).
Installation Activities	• If a taxpayer installs an item of Qualified Production Property and engages in no other MPGE with respect to the QPP, the taxpayer's installing activity does not qualify as MPGE." (Prop. Reg. Sec. 1.199-3(d)(3)) • In other words, the taxpayer must manufacture the product that it installs in order to be eligible for Sec. 199 deduction benefits.
DPGR ***(Form 8903, Line 1)***	• ***Domestic Production Gross Receipts*** is derived from the following... ◆ Lease, rental, license, sale, exchange, or other disposition of ▪ ***Qualified Production Property*** (QPP) ... i.e., tangible ***personal*** property manufactured or produced by the taxpayer in whole or in significant part within the U.S. ◆ Construction performed in the U.S. ... Limited to real property ◆ Engineering and architectural services performed in the U.S. ... Limited to real property • Determination of DPGR must be made by allocating gross receipts between DPGR and non-DPGR activities. ◆ This should be done by making a "reasonable" allocation ◆ If the taxpayer already has a methodology in place for identifying receipts, that method must be used.

At A Glance	SEC. 199 ... DOMESTIC PRODUCTION ACTIVITIES DEDUCTION *Page 3 of 3*
QPAI ***(Form 8903, Line 8)***	• Calculation of ***Qualified Production Activities Income*** (QPAI) ◆ Domestic Production Gross Receipts .... Form 8903, Line 1 ◆ Less: Cost of Goods Sold allocable to such receipts .... Form 8903, Line 2 ◆ Less: Direct expenses allocable to such receipts .... Form 8903, Line 3 ◆ Less: Indirect expenses (ratably) apportioned to such receipts .... Form 8903, Line 4 ◆ Equals = Qualified Production Activities Income • Indirect expenses include selling, general administrative related to marketing and advertising. • Be sure to add in QPAI from K-1s provided by pass-through entities. .... Form 8903, Line 7
Allocation of Expenses ***Three Methods***	• ***Cost of Goods Sold*** (CGS) ◆ Determine CGS on item-by-item basis ◆ Allocate CGS between DPGR and non-DPGR • Expenses other than Cost of Goods Sold ◆ ***Method #1 ... Small business simplified overall method*** ▪ Allocate all expenses based on ratio of DPGR and non-DPGR gross receipts ▪ For taxpayers who have ***both*** (1) average annual gross receipts of less than $5 million ***and*** (2) total costs for the year of less than $5 million. ... Prop. Reg. Sec. 1.199-4(f)(2) ◆ ***Method #2 ... Simplified deduction method*** ▪ Allocate Cost of Goods Sold on basis of specific identification of elements of CGS. ▪ Allocate all expenses other than CGS in the ratio of DPGR gross receipts and non-DPGR gross receipts to total gross receipts. ▪ For taxpayers who have ***either*** (1) average annual gross receipts [3-year average] of less than $25 million ***or*** (2) total assets at the end of the taxable year of less than $10 million. ... Prop. Reg. Sec. 1.199-4(e)(1) ◆ ***Method #3 ... Section 861 method*** ▪ This is the very comprehensive method of allocating expenses required by Section 861. ▪ This is applicable only to the very small number of very large corporations ... less than 1% of all corps.
The W-2 Wage Limitation ***(Form 8903, Line 15)***	• The Section 199 deduction is limited to 50% of the W-2 wages for the year. • Caution: The term "W-2 Wages" is not limited to the amount shown in Box 1 on Form W-2. • Proposed Regulations include in the definition of "W-2 Wages"... ◆ Total amount of wages as defined by Sec. 3401(a) ◆ Total amount of elective deferrals (Section 402(g)(3)) ◆ Compensation deferred under Section 457 ◆ For years after 2005, the amount of designated Roth contributions (Sec. 402(a)) • Three methods for computing wages (Prop. Reg. Sec. 1.199-2(f)(2)) ... Form 8903, Line 12 ◆ Method #1 ... *Unmodified Box Method* ▪ Wages are calculated by taking, without modification, the lesser the wages reported on Form W-2 in Box 1 (wages subject to FIT withholding) or in Box 5 (Medicare wages). ▪ Although simple to calculate, this method doesn't include employee elective deferrals, which are reported other boxes on Form W-2. ◆ Method #2 ... *Modified Box 1 Method* ▪ Wages are calculated by making modifications to the amounts reported in Box 1 of the Form W-2. These modifications include adding various elective deferrals. ◆ Method #3 ... *Tracking Wages Method.* ▪ Under this method, the taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. • Be sure to add in Form W-2 Wages from K-1s provided by pass-through entities.
Selected References	• *"Do the Section 199 Prop. Regs. Clarify or Complicate the Domestic Production Deduction."* Conjura, Carol, Timothy A. Zuber and Katherine M. Breaks. *Journal of Taxation.* January 2006, pp. 9-20. • *"The Qualified Production Activities Deduction: Some Planning Tools."* Dilley, Steven C. and Fred Jacobs. *Tax Notes.* July 4, 2005, pp. 87-98. • *"The Domestic Manufacturing Deduction: Treasury and IRS Fill in Some Gaps."* Conjura, Carol, Timothy A. Zuber and Katherine M. Breaks. *Journal of Taxation.* April 2005, pp. 198-210. • *"AJCA Replaces Tax Incentive for Exports with a Domestic Production Tax Break and a One-Time DRD."* Alan S. Lederman and Bobbe Hirsh. *Journal of Taxation.* January 2005, pp. 6-20.

Conference Report	STRATEGIES TO MINIMIZE YOUR DEALERSHIP TAX BURDEN Page 1 of 3
Intro	*The session* Strategies to Minimize Your Tax Burden *was presented by Gregg Hamm and Tom Taricani from the firm of Boyer & Ritter. This session gave an overview of various strategies, all of which have been discussed more thoroughly in previous Conferences as well as in this publication. If you were expecting any new ideas, or detailed discussion to bring out the "finer points," you might have been disappointed.* *Although there were a few good comments and suggestions, in general, the presenters mostly read from their PowerPoint slides, adding nothing new. Summarized below are the topics and some of the presenters' comments, to which we've added a few comments of our own.*
Cost Segregation Studies	• Newly constructed, renovated or recently acquired facilities are good candidates for cost segregation studies. These studies typically result in allocating a portion of the facility costs to asset classes with lives far shorter than the 39 years prescribed for buildings. • Rule of thumb: The presenters said that the experience of their Firm has been that the net present value of the future tax benefits (from a cost segregation study) usually approximates 5% to 10% of the total cost of the facility, excluding land. • Typically, if the cost segregation study has been outsourced to an engineering firm, that should help resolve many questions that an IRS agent would raise if the study had been done by amateurs. • *Really good suggestion:* Where dealership facilities are held outside the corporation, consider a cost segregation study where the facility has been transferred/inherited as a result of death of the owner or co-owner. ◆ The step-up in basis to fair market value at date of death (or alternative valuation date) coupled with the Section 754 election made by a partnership on behalf of a partner, may result in significant benefits.
Section 263A Inventory Cost Cap.	• Described as an "often misunderstood issue," the presenters indicated that their Firm's experience with Section 263A has been that, when they look at how the former accountants for new dealership clients have treated Sec. 263A, ... it has been either ◆ Completely ignored, or ◆ Overcapitalized (i.e., the amount capitalized far exceeds the amount that should have been capitalized if the simplified methods and rules were properly applied.) • Amounts required to be capitalized for a typical dealership usually are less than $5,000 and often are only a few hundred dollars. • The moral of the story ... Whenever you acquire a dealership as a new client, be sure to carefully review how Section 263A has been applied. ◆ ***Our comment:*** *What wasn't discussed by the presenters (but probably should have been) was the change in method of accounting implications that arise when a change is made in the manner/method of capitalizing costs under Section 263A.*
Used Vehicle Writedowns	• It is clear that dealerships are allowed to write down their used vehicles at year-end, providing Rev. Rul. 67-107 is complied with. • The presenters emphasized that a dealer or used car manager cannot use their own judgment or experience in arriving at writedown amounts "to get different answers that suit your needs." • ***Our comments: For Used Vehicles Not on LIFO...*** *The Regulations permit inventory to be written down below cost to market at year-end in two situations.* ◆ *The first instance allows a writedown of purchased goods to replacement cost (Reg. Sec. 1.471-4(a)).* ◆ *The second instance provides, in part, that inventory may be valued at lower than replacement cost with correctness determined by actual sales for a reasonable period before and after the date of inventory. Prices which vary materially from the actual market prices during this period will <u>not</u> be accepted as reflecting market (Reg. Sec. 1.471-4(b)).* ◆ ***For used vehicles on LIFO...*** *The IRS permits the use of an official used car guide (such as the* Kelley Blue Book, Black Book, *etc.) in determining its LIFO cost of trade-in vehicles. However, the taxpayer must make the determination of value at the time of trade-in* ***and no future write-downs are permitted.*** *This latter limitation reflects the LIFO eligibility requirement that inventory on LIFO must be valued at "cost."*

STRATEGIES TO MINIMIZE YOUR DEALERSHIP TAX BURDEN

LIFO Inventory

- Many dealers have at least some of their inventory on LIFO, and there's nothing wrong with having only new vehicles on LIFO.
  - All day-to-day accounting procedures, inventory accounts and schedules are unaffected by the fact that the dealership has elected to use LIFO.
- A reasonable estimate of the year-end change in the LIFO reserve must be made on the December dealer financial statement (i.e., the statement sent to the Factory/manufacturer).
  - Failure to do so could result in loss of the LIFO election and recapture of all reserves.
  - ***Our comment:*** *Since the financial statement conformity requirement applies to **all** year end statements (and not only to statements sent to the manufacturer), extra caution must be exercised in situations where there is great pressure to issue year-end statements to lenders, shareholders, etc., to be sure that appropriate LIFO disclosures have been included.*
- For new vehicles, the presenters recommended using the Alternative LIFO Method (Rev. Proc. 97-36)
- Would/Will 2005 be a good year to elect LIFO? … That depends on the mix of vehicles at year-end.
- ***Our comments:*** *Our recommendation for dealers who are considering making a LIFO election, but aren't sure before the year is over, is as follows:*
  - *In order to keep their option open to make the LIFO election, they **must** include a LIFO estimate in their year-end statements.*
  - *This includes the statement hurriedly sent out the manufacturer in early January. The decision to elect LIFO can be made as late as 9 months after year-end at the time when an extended tax return is filed.*
  - *However, by that time, the year-end financial statements are long gone. And if the dealer did not include a LIFO adjustment on the year-end statements, then, failure to satisfy the conformity requirement in this regard will preclude the dealership from making the LIFO election for that year.*

Trade Discounts

- The discussion of this subject was particularly disappointing … It was far too general and, in some cases, incorrect.
- For example … The PowerPoint slide read (almost verbatim): … "Allowable tax treatment - reduce cost of inventory, provided you request IRS permission."
  - ***Our comments:*** *This is a glaring, inexcusable, erroneous statement. "...provided you request IRS permission." This is absolutely wrong. It is not a matter of permission at all. The Regulations and a Rev. Rul. (neither of which were mentioned by the presenters) state that the reduction of inventory cost by the amount of trade discounts is **mandatory, not elective**.*
    - *Reg. Sec. 1.471-3*
    - *Revenue Ruling 84-481 … 1984-1 C.B. 130*
    - *Could it be that the presenters were confused by the difference in treatment afforded to cash discounts (elective to capitalize or not) and trade discounts (reduction from inventory cost is mandatory)?*
  - *In fact, if a dealership changes its method of accounting from not reducing inventory costs for trade discounts to making that reduction in inventory costs, permission is granted automatically and the only requirement is that a Form 3115 be attached to the tax return (with a copy sent to the National Office).*
  - *No mention was made of the very significant planning opportunity and benefit for dealers using the LIFO method for new vehicles. This benefit is provided by the Section 481(a) adjustment which is locked in pro rata across all of the LIFO layers by years.*
  - *Another significant strategy to minimize taxes in connection with trade discounts that was overlooked (or not mentioned) was the comparable treatment that might be elected **(with IRS permission)** to reduce inventory costs by certain advertising fees and expenses for local/regional advertising … but not for national program advertising.*
- Another example … One of the presenters stated that the position of his Firm was that, if a dealership was not deducting trade discounts from inventory costs, that was not a "conformity" violation.
  - ***Our comments:*** *I believe the concern should be over whether the failure to eliminate trade discounts would be a violation of the "cost" (i.e., LIFO inventory must be valued at cost) requirement, rather than the "conformity" requirement which affects year-end financial reporting.*
  - *As discussed elsewhere, I believe the IRS' informal opinion on this question, as relayed by Ms. Terri Harris, is incorrect.*

STRATEGIES TO MINIMIZE YOUR DEALERSHIP TAX BURDEN

Related Finance Companies (RFCs)	• General discussion of whether dealership can obtain a tax deduction when it transfers vehicle finance contracts to an RFC. Vague, general discussion (i.e., "It is possible to do, providing it is done properly.") • ***Our comments:*** *Reference to the critical Regulation (Reg. Sec. 1.267(f)-1(f)) would have been helpful.* ◆ *This Regulation provides that ... If S has income or gain from a receivable acquired as a result of selling goods or services to a nonmember, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember.* ◆ *Our Rule of Thumb: Over the years and over many dealerships, discounts are roughly 33-1/3 %.* ◆ *There was no discussion of the substantial planning opportunities, which are not limited only to income tax savings.* ◆ *For a complete list of all articles in the* Dealer Tax Watch *on Buy-Here, Pay-Here and RFCs, see our web site at www.defilipps.com and follow the links to the Index of Articles for the* Dealer Tax Watch.
Tool Rental Programs	• This subject was not given a whole lot of emphasis, perhaps in part because Ms. Terri Harris discussed it at length in her IRS Tax Update presentation. • The presenters did not distinguish between "rental programs" and "accountable plans" intended to qualify under Section 62(c). From their general comments in this portion of their coverage, it appeared that they did not understand the significant technical differences distinguishing one from the other.
Other Topics Briefly Mentioned	• ***PORCs*** ... The discussion on PORCs was very brief and general. Basically, they're still out there. There was no discussion of the substantial planning opportunities, which are not limited only to income tax savings. • ***Extended service contracts*** ... Administrator obligor, dealer obligor, retrospective programs (which invite IRS scrutiny for potentially abusive arrangements), self-insurance, escrow and/or trust arrangements. • ***Sub-Prime financing*** ... Sales proceeds include not only cash, but also the fair market value of the right to receive "back-end" distributions. • ***Facilities assistance*** ... Payments received by dealers for facility assistance will be treated in one of three ways: (1) contribution to capital, (2) reduction of cost of facility, or (3) current income (the most conservative). By the way, is that ordinary income or capital gain? • ***Body shop incentives*** ... In exchange for agreeing to use a particular vendor's products, some dealers are able to negotiate the receipt of cash payments and/or equipment. • ***The importance of reviewing the tax basis for ownership in flow-though entities before year-end*** ... It is important to get cash or loans into the entity before year-end so that flow-through losses to investor owners can be fully deducted. • ***Entity types*** ... According to the presenters, "Most dealerships are S corps." However, limited liability company structure is attractive when the participants want to take disproportionate distributions. Note that LLCs may elect to be taxed as partnerships. • ***Alternative motor vehicle credits*** ... In discussing the 2005 tax legislation that spawned the four motor vehicle credits, a good point was made that may help in understanding them: there are two types of credits, fuel ***economy*** credits (which basically compare the fuel efficiency of a new vehicle to the fuel efficiency of a 2005 vehicle) and fuel ***conservation*** credits (which are based on the anticipated lifetime of the vehicle and how much fuel it is anticipated to save over the years).
IRS Audits - Dealership Issues	• Basically, we've gone about 2 years without any significant IRS audit activity. However, more recently, the Service has undertaken a number of audits of dealerships. • Issues typically raised (i.e., seen by the presenters) in IRS audits... ◆ LIFO, new vehicles ◆ Used vehicle writedowns ◆ Related party transactions ◆ Travel and entertainment substantiation

Conference Presentation Summary

Estate Planning: Securing Tomorrow's Success Today
Allison & Hills ... 2005 AICPA Dealership Tax Conference

Intro ... Get Out the Pom-poms

If you went to a 2-day conference and reflected on everything you heard there and then were asked the question, "If you could only have heard one presentation, which one would it have been?" ... My answer to this question with regard to the 2005 AICPA National Auto Dealership Conference would be the Estate Planning presentation by Anthony Allison and Marvin Hills, Partners in Crowe Chizek & Co., LLC, South Bend, Ind.

Out of the countless presentations I have heard on estate planning over the years (and especially, the more recent years) at a variety of conferences, including the AICPA, NADA, various state and local CPA meetings, etc., this presentation by Allison & Hills clearly stands out in my mind as one of the best.

Often, after an exquisite meal with my family, I'll start raving about how good everything was. One of my kids will say ... "Get out the letter sweater & pom-poms, Dad's gonna do a cheer." Well, get me the sweater and pom-poms ... Allison & Hills deserve some cheers.

I hope that this (my) strong recommendation stimulates you to get the tape on this and listen to it. *If it does, here's a further suggestion... Expect to be drawn in immediately by the very engaging and fresh way the material is presented. You'll probably want to listen to the tape just to "get the flow of the whole thing." Then, plan on listening again ... or a few more times ... to pick up the meat of the technical discussion and the recommendations so that you can fully benefit from the valuable information presented.*

Overview & Objectives

- *How often have you looked at the description of a presentation in a conference bulletin and been attracted by the promise of good coverage ... only to attend the presentation and find it leaves you flat? That did not happen here. All of the* ***objectives*** *of the presentation (see below) described in the AICPA Conference bulletin were met.*
  - The importance of early planning
  - The reasons planning is delayed
  - Why early planning is so important
  - Potential outcomes when planning is delayed
  - Benefits of early planning
- The materials in the Conference manual for this presentation include...
  - Excellent, detailed PowerPoint slides
  - An *Overview* and *Summary* of the presentation
  - Details of recommendations
  - Charts showing the relationship & flow of individuals, techniques suggested and benefits
- ***Suggestion*** *... You might want to contact the presenters to obtain a copy of their Conference materials. Hills (574-236-7605), Allison (574-236-8630) or www.crowechizek.com.*

Cast of Characters & Synopsis

- ***Fresh, engaging style.*** This presentation was delivered in the form of a "role play." This role play involved two "twin" brothers who are Dealers (played by Mr. Allison) who meet with their CPA, Marv (played by Marvin Hills), to discuss their estate planning situations over the years.
- ***Twin brothers are alike.***
  - They have similar asset ownership situations.
  - They have the same number (and approximate ages) of children and grandchildren.
  - They meet with Marv four times ... at 10 year intervals ... at ages 40 through 70.
  - At these "interviews" or meetings, they hear about planning concepts that are applicable to them at their particular ages and in view of their situations.
  - Each of the "interviews" is conducted with candor, humor and style.
- ***Twin brothers are still different in some ways.***
  - One of the two brother-Dealers, Walter, tends to have a "wait and see" attitude. He implements very few of Marv's recommendations.
  - The other brother-Dealer, Greg, has a "go ahead" attitude. He implements most of Marv's suggestions.
- Discussion of planning concepts at each meeting includes ...
  - Relevance and application, and
  - Why it makes sense to implement these suggestions at these life intervals.

Conference Presentation Summary	**Estate Planning: Securing Tomorrow's Success Today** **Allison & Hills ... 2005 AICPA Dealership Tax Conference** *Page 2 of 2*
Meetings at Age 40	• ***Facts & circumstances*** ◆ Dealership has one location and sells products of two manufacturers ◆ Real Estate is owned inside the C Corporation ◆ Net "Fair Market Value" of the C Corporation (including the real estate) is approx. $5 million ◆ Dealer is contemplating opening up a second location ◆ Married, with three grade-school children. No estate planning has previously been done. • ***Recommendations*** ◆ Basic estate planning, such as Family Trust and ***ILIT*** ... Irrevocable Life Insurance Trust ◆ Re-titling of assets between spouses and trusts to utilize all available exemptions. ◆ ***529*** ... Create Section 529 Plans for each of the children's college education. ◆ ***FLP*** ... New real estate (and debt) in a Partnership with children as Limited Partners. ◆ Purchase life insurance to cover estate taxes (while still young and healthy).
Meetings at Age 50	• ***Facts & circumstances*** ◆ Dealership has five locations, and net FMV of $15 million. ◆ Real estate net equity is $2 million ($10 million FMV less $8 million debt) ◆ One child in college, two in high school ◆ Federal Estate Tax lifetime exemption is $3.5 million, with 45% flat rate tax on the excess. • ***Recommendations*** ◆ Gift small blocks (up to 20%) of stock into trusts, which are possibly GST-exempt ◆ Gift minority positions (discounted) in real estate Family Limited Partnership. ◆ ***QPRT*** ... Create Qualified Personal Residence Trust to hold vacation home for children. ◆ Discuss importance of adequate disclosure in gift tax returns and need to obtain a valuation.
Meetings at Age 60	• ***Facts & circumstances*** ◆ Dealership has 15 locations, and net FMV of $40 million ◆ Real estate net equity is $8 million ($20 million FMV less $12 million debt) ◆ One child still in graduate school, two children are married, with two young grandchildren. ◆ Federal Estate Tax lifetime exemption is $5 million, with 40% flat rate tax on the excess. • ***Recommendations*** ◆ ***SERP*** ... Create a Supplemental Employee Retirement Plan inside dealership to reduce the value, and thereby "leverage" any gifting of stock. ◆ ***IDIT*** ... Sell stock to an Intentionally Defective Irrevocable Trust, so that father can pay the income tax on child's earnings without gift tax consequence. ◆ Once lifetime exemption has been fully utilized, consider a Walton-style ***GRAT***. ◆ ***529*** ... Establish Section 529 Plans for grandchildren's college education.
Meetings at Age 70	• ***Facts & circumstances*** ◆ Dealership has net FMV of $70 million. ◆ Real estate net equity is $15 million. ◆ Grandchildren are in high school. ◆ One client has had cancer, which is now in remission. • ***Recommendations*** ◆ ***CRT*** ... Utilize Charitable Remainder Trust for sale of remaining Partnership Interests. ◆ ***SCIN*** ... Consider a Self-Canceling Installment Note, if the health situation is appropriate.
General Techniques Discussed	• ***529*** ... Section 529 Plans for funding of child's (or grandchild's) future education • ***CRT*** ... Charitable Remainder Trusts • ***CST*** ... Utilization of Credit Shelter Trusts for the applicable exclusion amount • ***FLP*** ... Family Limited Partnerships (and related valuation issues) for both: (1) Real Estate leased to Dealership and (2) Marketable securities and other financial assets • ***GRAT*** ... Grantor Retained Annuity Trust (both "regular" or "Walton-style") • ***GST*** ...Generation Skipping Transfer tax (and how to use available exemptions) • ***IDIT*** ... Intentionally Defective Irrevocable Trust • ***ILIT*** ... Irrevocable Life Insurance Trust, with discussion of differences between: (1) Variable life, (2) Level premium term, (3) Universal life and (4) Second-to-die policies • ***QPRT*** ... Qualified Personal Residence Trust (for vacation home or primary home) • ***SCIN*** ... Self Canceling Installment Note • ***SERP*** ... Supplemental Employee Retirement Plan

YEAR-END 2005 DEALER TAX UPDATE
TAX STRATEGIES & IRS ACTIVITIES

Willard J. De Filipps, CPA ... Win-Win Concepts Teleconference - December 13, 2005

I. LIFO Issues

A. New vehicles

1. Are your dealers expecting large LIFO reserve recaptures at year-end?
   a. Will "employee discount" pricing result in deflation for LIFO indexes (under the Alternative LIFO Method)?
   b. Need to separate two factors: (1) lower inventory levels and (2) inflation or deflation
   c. Need to analyze LIFO layer history to see how much each layer is contributing to the LIFO reserve.
2. Form 970 to be revised for use in connection with 2005 LIFO elections ... Form is more complicated.
3. Inventory at cost requirement ...
   a. Changes in accounting method (CAMs) for trade discounts (floorplan assistance payments)
   b. General review and discussion.
4. Allocation of LIFO reserves by franchise ... Different methods employed for this purpose

B. Termination of LIFO elections by auto dealerships ... Use of Rev. Proc. 97-27 rather than 2002-9

C. Used vehicles & parts inventories ... Any questions on these?

D. Section 1363(d) partnership LIFO look-through recapture ("anti-*Coggin*") Regulations finalized

II. Forms & Schedules

A. Schedule M-3 ... Draft Form for 2005 available.

1. For 2005, all four (4) columns of Schedule M-3 will be required to be completed
   a. For 2004, the IRS permitted partial completion of Schedule M-3
2. Just a few line item changes
3. For 2006, IRS plans to extend Sch. M-3 to Forms 1120-S (S Corporations) & 1065 (Partnerships)

B. e-File requirement for large corporations ... $50 million in assets, etc. for 2005

III. Dealer Tax Issues

A. Electronic recordkeeping requirements ... Revenue Procedure 98-25 ... Still a big problem

B. Section 199 ... Domestic Production Activities Deduction (Form 8903) ...

1. Possible application to auto dealerships ... Sec. 263A interplay

C. Sec. 263A ... Avoidance of capitalizing unnecessary cost amounts under the UNICAP rules

1. ***Storage*** ... Are there any off-site storage facilities? ... How extensive?
2. ***Purchasing*** ... Do any dealership employees spend more than 1/3 of his or her time engaged in purely purchasing activities? ... To what extent? ... Special rules: Under 10% ... Over 90% ... Proration
3. ***"Retail Facility"*** ... Is the dealership basically a "retail facility"? ... Are +90% retail sales made on-site?

(Continued)

III. *Dealer Tax Issues* (*...Continued*)

D. Other opportunities available by changing to more favorable tax accounting methods

1. Reducing inventory costs at year-end by eliminating certain advertising fees and expenses (for ***Local/Regional*** advertising ... But not for ***National*** program advertising)

   a. This change in method is usually made in connection with a similar change for the treatment of trade discounts (floorplan assistance payments)

2. Accelerating deductions for prepaid expenses

   a. Rev. Proc. 2005-9 provides guidance for making changes for "12-month prepaids"

3. Accelerating Depreciation Deductions Based on ***Cost Segregation Studies***

   a. More depreciation, faster write-offs and 100% of negative Section 481(a) adjustment can be deducted in the year of change ... Thus, creating possibility for NOL carrybacks and tax refunds

   b. Automatic change ... advance approval from the IRS is not required (Rev. Proc. 2002-9)

   c. Increased special depreciation - 30% ... 50% under 9/11 Tax Relief and 2003 JGTRRA changes

   d. IRS *Cost Segregation Audit Techniques Guide* ... April 30, 2004 with subsequent revisions

4. Form 3115 filings and automatic vs. advance consent-required changes in method

   a. Form 3115 last revised - December 2004

E. *David Taylor Enterprises* ... Classic cars belonged in inventory and profit or loss on sales should be treated as ordinary income or loss rather than capital gain or loss.

IV. *Service Technician Tool Plans & Reimbursement / Accountable Plans Under Sec. 62(c)*

A. General background

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

   a. Business connection

   b. Substantiation, and

   c. Returning amounts (received) in excess of expenses (to the employer, so that only actual expenses have been reimbursed tax-free).

2. IRS Coordinated Issue Paper (June 2000) ... Negative or unfavorable toward technician reimbursement plans in general, especially rental plans and *Shotgun Delivery, Inc.*-type plans

B. Revenue Ruling 2005-52

1. The fact pattern for Revenue Ruling 2005-52 is relatively uncomplicated and is set forth in its entirety in the supplementary material. (See page 4 of 4 of this outline.) 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."*

2. 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 has 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.

(Continued)

IV. *Service Technician Tool Plans & Reimbursement / Accountable Plans Under Sec. 62(c)* *(...continued)*

B. Revenue Ruling 2005-52 *(...continued)*

3. 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, *"Employees are not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports are issued."* Second, *" 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."*

4. The Ruling states ... *"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."*

5. 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. Therefore, Rev. 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.

6. What about depreciating the cost of tool "inventories?" ... A question left unanswered by Rev. Rul. 2005-52

   a. 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.

   b. 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.

7. It is important to recognize the fact 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.

V. *Taking Advantage of the Lower (5%-15%) Tax Rates on Qualified Dividend Income & Capital Gains*

A. These lower, preferential rates were enacted as part of the *Job & Growth Tax Relief Reconciliation Act of 2003* (*JGTRRA*) tax rate reductions and other changes, expanding Sept. 11 tax relief changes

B. These lower rates are still in effect for calendar 2005. General discussion of applications & examples.

(Continued)

VI. *Supplementary Discussion Materials ... (Deleted, except for #6)...*

6. *Fact Pattern in Revenue Ruling 2005-52 re: Accountable Plans for Service Technicians*

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.***

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De Filipps' DEALER TAX WATCH
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

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