Willard J. De Filipps, CPA, PC
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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. INDEX OF *DTW* ARTICLES THROUGH DEC. 31, 2005. We have expanded and updated our *Index* of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December, 2005.

This *Index of Articles* is available for your review on our web site, www.defilipps.com. You can print the *Index* out on your own or, if you prefer, contact us for a printed copy.

This *Index of Articles* is divided into ten sections which list all articles by key topic or subject. It also includes *Finding Lists* for all tax cases, Revenue Rulings and Procedures, Letter Rulings (including TAMs), IRS Coordinated Issue Papers, Field Service Advice Memos, Motor Vehicle Technical Advisor *Automotive Alerts*, and *Practice Guides.*

#2. EMERGING ISSUE - SEC. 263A COST CAP FOR DEALERSHIPS. It seems like the IRS is making a mountain out of a mole hill over the application of Section 263A to certain automobile dealerships. The IRS update at the AICPA Dealership Conference last October in Baltimore had hinted at this. But there weren't any details available at that time.

Talking with several people at the NADA Convention confirmed the fact that the IRS is, indeed, challenging the interpretation that most CPAs thought was generally accepted over how Sec. 263A should be applied to dealerships.

Perhaps you thought (as I do) that automobile dealers were retailers and that meant that they should be treated under the "reseller" rules of the Cost Capitalization regulations. If you did ... Surprise!

The IRS now apparently thinks auto dealers are "producers." As such, they should be under the rules for "producers" and use the Section 263A (simplified) production method. The result ... more dollars in revenue for the IRS.

WATCHING OUT FOR

We are told by CPAs whose dealerships are under audit on this issue that the deficiencies assessed by the IRS over this are quite large. For more about this, see pages 3 and 14.

#3. 2006 NADA DEALERSHIP CONVENTION. In this issue, you'll find a summary of the three days I spent at the NADA Convention in Orlando in February. See the article on "Walking Around at the Convention" on page 13 and a list of the top issues

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and dealer concerns from the various dealer make meetings on pages 24-25.

#4. "STATE OF THE INDUSTRY." At NADA, I was invited to attend a seminar presented by Myers & Fuller, P.A. This "State of the Industry" seminar was packed with excellent information and practical suggestions.

One of the subjects discussed at this seminar was what might happen to dealers if a manufacturer declares bankruptcy. Case in point, what if GM were to do so? The answers provided at the Myers & Fuller seminar are not very comforting for dealers.

You'll find a summary of this outstanding seminar beginning on page 19.

#5. AS GM GOES ... SO GOES THE INDUSTRY? It was ironic that the week before the NADA Convention, *Fortune* magazine (the February 20 issue) had GM splashed all over the cover. One of *Fortune's* most prestigious editors, Carol J. Loomis, authored a searing analysis entitled "The Tragedy of General Motors."

Right below the title, it was hard to miss the bold print ... ***"It's heading for a wreck."***

For a summary of this fine article and our related comments, see page 26.

#6. *THE WHEELS OF JUSTICE*." In addition to representing dealerships and dealer associations, Myers & Fuller, P.A. publishes a monthly legal newsletter that (I think) you ought to be reading on a regular basis. Like the seminar the Firm presented at NADA, each issue contains current developments, good information and suggestions that can save your dealers big dollars.

For a look at a typical issue of their newsletter, see pages 30-31.

#7. "*PREMIUM ADVANTEDGE.*" Another resource for you to be aware of is a new newsletter published by Tony Freeman. Tony specializes in providing objective analysis of dealer life insurance policies, costs and alternatives, and he has been a contributor to the *Dealer Tax Watch* in the past.

The current issue of his newsletter is reprinted, with permission, on page 32.

#8. DOES YOUR EXIT STRATEGY CAPITALIZE ON YOUR KNOWLEDGE & SPECIALIZATION IN AUTOMOBILE DEALERSHIPS? One notion that struck me after talking to the CPA firms and dealer-CPA associations at NADA was how remarkably different things are today for CPA firms that specialize in handling automobile dealerships than they were many years ago when I started publishing the *Dealer Tax Watch*.

I have personally been involved in the formation of three of these dealer-CPA associations (the *AutoCPA Group*, the *Driving Force* and the *National Association of Automobile Dealer Advisors*) over the last 18 years or so. These organizations do provide significant benefits for member firms.

If you are currently not a member of one of these organizations, you might think about the possibility of affiliating your firm. In many instances, this has become an excellent exit strategy for practitioners nearing retirement to get top dollar for their niche specialty practice.

In addition to further comments on this in *"Marketing Your Dealership Practice Specialty at the NADA Convention,"* you'll find a listing on page 17 of the firms specializing in auto dealerships who have allied themselves in various associations.

#9. IRS UPHELD IN DISALLOWING ACCOUNTABLE PLAN TREATMENT. We recently discussed the *Namyst* case in connection with Section 62(c) accountable plans. This case (a Tax Court Memo decision) was discussed on page 31 of the June, 2005 *Dealer Tax Watch*.

Namyst involved an individual and a very unusual set of facts. The IRS held that payments Mr. Namyst received from his employer were not excludable from his income under Section 62(c).

In November of 2004, the Tax Court agreed with the IRS that Mr. Namyst should have reported these payments as fully taxable wages. Mr. Namyst appealed, and recently, the decision of the Tax Court was affirmed. The fatal flaw? ... There was no evidence that Mr. Namyst was required to return to his employer any amounts he received that exceeded his expenses. No surprises here.

#10. IRS *AUTOMOTIVE ALERTS*. While visiting the IRS booth at NADA, I saw three *Automotive Alerts* recently issued by the Motor Vehicle Technical Advisor. These dealt with (1) technicians tool reimbursement plans, (2) alternative motor vehicle credits and (3) cash reporting and Form 8300 filing requirements.

I also saw an "older" *Alert* on the subject of PORCs that I hadn't seen before. It has a catchy title ... *Service Contract 'Overpayment' Programs May Improperly Divert Dealership Income* ... and was written in October, 2000, before the whole dealer-PORC issue blew over.

In case you haven't seen them, these *Alerts* are reprinted beginning on page 33. We've added our own *At A Glance* supplement to the one on new vehicle credits to show just how complicated it will be to properly claim these credits. Let the fun begin.

SHOULD AUTO DEALERSHIPS BE TREATED AS "*PRODUCERS*" OR AS "*RETAILERS*" UNDER SECTION 263A?

SECTION 263A

Background

In the last issue of the *DTW*, we summarized the IRS update presentation by Terri Harris, the IRS Motor Vehicle Technical Advisor, at the AICPA Dealership Conference. One of the subjects in her presentation in October was the application of the domestic production activities deduction (under Section 199) to automobile dealerships.

In indicating that it was unlikely auto dealers might obtain any significant benefits under Section 199, Ms. Harris said that the position of the IRS was that Sections 199 and 263A were, or could be, mutually exclusive and potentially inconsistent.

What this means, in plain English, is that according to the IRS an automobile dealership might not be a "*producer*" under Section 199 (that would make it a "*retailer*") but that same dealership might be considered a "*producer*" under Section 263A (and that would mean it could not be a "*retailer*" under that section).

At this point, we'll stop using italics and quotes around the terms producer and retailer. It should be understood that in the subsequent discussion, these terms are being used in their most technical sense and as they are defined in the Code and Regulations.

Section 263A ...
An Emerging Tax Issue for Dealers

In her presentation, Ms. Harris acknowledged, but did not go into any real detail, that the IRS was "looking at" how dealers were determining what costs should be capitalized under the Uniform Inventory Cost Capitalization rules (i.e., Section 263A).

In the packed auditorium where Ms. Harris spoke that morning, these words might have come as a rude awakening to anyone under the influence of a light nap. Because what Ms. Harris was really saying was that perhaps auto dealers should not be using the Simplified Resale Method (available to retailers), but instead, they should be using the Simplified Production Method (available to producers).

This "second look" at this issue by the IRS can only mean two things: (1) more "stress on the system," and (2) more revenue for the IRS. Some thought that maybe if you let a little time go by, this issue would go away on its own (meaning, "when the IRS came to its senses"). Unfortunately, this has not happened.

At the NADA Convention in Orlando in February, I asked Ms. Harris informally about this as a possible emerging issue for auto dealers. She confirmed that in fact there were currently several dealers under audit in which the proper application of Section 263A was an issue. In a separate conversation with Paul Metrey, Director, Regulatory Affairs for NADA, he also confirmed with me that he has been receiving calls from CPAs indicating they were under audit and they were in somewhat of a dilemma over this.

I have had the opportunity to talk with two different CPAs whose dealer clients are under audit where this 263A issue has been raised and I'll try to explain as best I can what I think the IRS position is and what the Service appears to be driving at.

Clearly, the Service is looking for a different calculation under Section 263A that ends up with dealers capitalizing more costs than they are presently capitalizing by using a Simplified Resale Method. It doesn't take a genius to figure that out.

How Big is the Problem?

Based on recent conversations, including those with CPAs with dealerships actually under audit on this issue, see "What's Going On" below for my understanding of the overall situation.

I did not ask Ms. Harris ... I'll wonder out loud in print here ... whether every current IRS audit of an auto dealership requires the examining agent to in-

WHAT'S GOING ON?

First, only a few dealers currently under IRS audit have had this Section 263A issue raised.

Second, these dealers are located principally in the Northeast part of the country ... Massachusetts, etc.

Third, their discussions with IRS examining agents have been long and somewhat contentious, beginning with the expression of complete surprise by the CPAs that the IRS might even think of such (a bizarre) application.

Fourth, the adjustments proposed by the IRS agents involve significant dollar amounts.

Fifth, all of this is being coordinated by a Section 263A IRS Specialist (an individual headquartered in a Midwest IRS office) who has been called in to participate (extensively?) in guiding the examining agent in developing the Section 263A issues.

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quire into Section 263A and report back to the IRS' Sec. 263A Specialist. In other words, is the Sec. 263A issue so important that the average examining agent cannot sign off on it without first clearing it through either (1) the IRS' Sec. 263A Specialist, or (2) Ms. Harris, the IRS Motor Vehicle Technical Advisor?

What Are the Issues?

The box below summarizes my understanding of the three issues it appears the IRS is raising.

First Issue

The first issue is ... Do the repair services that a typical auto dealership provides to its customers meet the Sec. 263A definition of a "production activity?"

The typical dealership in the ordinary course of its business provides normal and routine repair and warranty services to its customers. This activity is carried on in its service department. Some dealerships also carry on body shop and collision repair activities as part of their overall operations. Others basically do not do this type of work and send it outside the dealership.

In order for the IRS to get what it wants in dealing with this Section 263A emerging issue, it is necessary for the Service to overcome one major obstacle. This obstacle, or threshold issue, is that Section 263A does not apply to property that is provided to a client or customer incident to the provision of services by the taxpayer if the property provided is (1) *de minimis* in amount, and (2) not inventory in the hands of the service provider. The language of this two-part test is found in Reg. Sec. 1.263A-1(b)(11)(i).

In the emerging controversy, it would appear the Service's efforts to overcome this obstacle lie in its interpretation of the definition of "services" found in Reg. Sec. 1.263A-1(b)(11)(ii) and (iii).

"Services" is defined with reference to its ordinary and accepted meaning under Federal income tax principles. In determining whether a taxpayer is a bona-fide service provider for this purpose, the nature of the taxpayer's trade or business and the facts and circumstances surrounding the taxpayer's trade or business activities must be considered.

In interpreting the ***first*** portion or test of the Regulation that excludes the provision of services by a taxpayer from Section 263A if the property provided to the customer is ***de minimis in amount***, further guidance is found [in (iii)] which provides that in determining whether property provided to a customer/client by a service provider is *de minimis* in amount, "***all facts and circumstances***, such as the nature of the taxpayer's trade or business and the volume of its service activities in the trade or business, must be considered."

In this regard, the Regulation continues ... "A significant factor in making this determination is the relationship between (1) the acquisition or direct materials costs of the property that is provided to clients and (2) the price that the taxpayer charges its clients for its services and the property."

The Regulation goes on to say that "if the acquisition or direct materials cost of the property provided to a client incident to the services is ***less than or equal to five percent of the price*** charged to the client for the services and property, the property is *de* →

263A Issues — ***WHERE IS THE IRS COMING FROM? ... 3 POSSIBLE ISSUES***

In contending that automobile dealerships should be treated as producers, rather than as resellers, it appears that the IRS is raising three issues.

1. Whether the repair services provided by a typical dealership meet(s) the definition of "providing services" under Reg. Sec. 1.263A-1b(11). This would put the dealership either (1) directly under the producer rules of Section 263A, or (2) treat the dealership as a "reseller with production activities" under the reseller rules of Section 263A.
2. How should the tax principles relating to "separate trades or businesses" be applied in the dealership context? Is there some way to separate and distinguish certain activities of a dealership (namely, the Parts, Service and Body Shop activities) from the dealership's other activities which involve the purchase and sale of new and used vehicles?
3. If a dealership previously has been considering itself to be ***a reseller*** under Section 263A, how should the IRS correct the dealership's erroneous interpretation / method of accounting in that regard?

minimis. If the (acquisition or direct materials) cost of the property exceeds five percent of the price charged for the services and property, the property may be *de minimis* ***if additional facts and circumstances so indicate."***

What is important in connection with this ***de minimis*** part of the test is that although in most cases the cost-to-dealer vs. the price-charge-to-the-customer will exceed the five percent ratio, that is merely one factor (albeit a significant factor) to be considered in arriving at an overall conclusion as to the status of the service activity. The Regulation leaves ample room for the taxpayer to argue the existence of ***"additional facts and circumstances"*** which should be considered in arriving at any conclusion regarding the *de minimis* nature of the services provided.

It should also be noted that Reg. Sec. 1.263A-1(b)(12) provides a *de minimis* rule for certain producers with total indirect costs of $200,000 or less. This rule, not likely to be applicable to auto dealerships of average size, provides that if the producer has total indirect costs of $200,000 or less, it will be treated as having no additional Section 263A costs for purposes of the Simplified Production Method.

The ***second*** portion or test of the Regulation excludes the provision of services by a taxpayer from Section 263A if the property is not inventory in the hands of the taxpayer. The Regulation does not amplify this requirement. In this regard, the typical dealership does maintain a usually considerable parts inventory with related monitoring and accounting methods and controls. This requirement presents more difficulty to the dealership in trying to avoid the implications the Service would like to allege.

Although a typical dealership may fail the second part of this test, it should be noted that the analysis on which the Regulation focuses is an analysis of whether or not Section 263A applies to the property ... it does not focus on whether a taxpayer who fails to be eligible to exclude inventory costs from Section 263A should be treated as a producer or as a reseller. What the IRS would like to do is leap to the conclusion that a typical dealer is a "producer" for purposes of Section 263A because it fails either one or both of the tests in Reg. Sec. 1.263A-1(b)(11).

Taxpayers may argue against the IRS' interpretation on several other grounds. First, the dealership has not produced the part which it has installed on the customer's vehicle. Parts are purchased directly from the manufacturer and they are not altered or changed in any way. The dealership merely affixes them to the vehicle with no further modification nor customization. The parts can be, and frequently are, later removed and used on other vehicles.

Second, the IRS may be considering the customer's vehicle after the part has been installed on it as the "property produced." In this connection, the dealership cannot be considered to be the "producer" under Reg. Sec. 1.263A-2(a)(1)(ii) because the dealership is not the owner of the property. For Federal tax purposes, to the extent that the dealership might attach a mechanics lien to the vehicle as security for the customer's payment for services, such a security interest does not constitute ownership.

Reg. Sec. 1.263A-3 should apply to the dealership as a "purchaser for resale." The dealership's installation of parts by the service department and/or the body shop meets the exception provided for "mere assembly" activities.

Second Issue

The second issue relates to the "separateness" of the dealership's activities. Are the Parts Department, the Service Department, the Body Shop (if applicable), and the sale of new and used cars considered separate and distinct business activities related to Section 263A and the income tax Regulations?

Reg. Sec. 1.446-1(d) applies to taxpayers engaged in more than one business. The Regulation provides that where a taxpayer has two or more separate distinct trades or businesses, a different method of accounting may be used for each trade or business, provided that the method used for each trade or business clearly reflects the income of that particular trade or business.

In this regard, the method first used in accounting for business income and deductions in connection with each trade or business, as evidenced by the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

This Regulation contains two further provisions. First, no trade or business will be considered as distinct unless a complete and separate set of books and records is kept for such trade or business.

Second, the trades or businesses of the taxpayer will not be considered to be separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases or expenses) so that income of the taxpayer is not clearly reflected.

It appears that the IRS does not recognize the separate departmental accounting that every automobile dealership is required to maintain, in accor-

see **SECTION 263A**, page 8

Sec. 263A Overview	***SOME TECHNICAL BACKGROUND BASICS*** *Page 1 of 2*
Background	• Section 263A requires the capitalization and inclusion in inventory costs of certain expenses. • The regulations divide taxpayers into two general categories ... ◆ ***Producers*** ... i.e., rules relating to property ***produced*** by the taxpayer. ◆ ***Resellers*** ... i.e., rules relating to property ***acquired for resale*** by the taxpayer. This category includes retailers, wholesalers and distributors. ◆ The regulations for "resellers" include special provisions for ... ***resellers with production activities.*** Reg. Sec. 1.263A-3(a)(2) provides that a reseller that also produces property must capitalize the additional Section 263A costs associated with any property it produces. • These rules have been in effect since 1987. • The determination of costs to be capitalized under Sec. 263A is different depending on whether the inventory valuation method used by the taxpayer is First-In, First-Out (FIFO) or Last-In, First-Out (LIFO).
Producers ... The Simplified Production Method	• Producers/manufacturers are expected to undertake an extensive analysis of their activities to determine costs required to be capitalized. • Costs expected to be capitalized include direct and indirect material costs, direct and indirect labor costs and a broad range of other indirect costs. However, marketing, selling, advertising and distributing expenses are not required to be capitalized. • A special rule is provided for allocating "mixed service costs" (i.e., those costs which directly benefit production activities, but also benefit other non-production activities). • The ***Simplified Production Method*** computes costs to be capitalized by ◆ Determining an absorption ratio (the ratio of total additional Section 263A costs to total Section 471 inventory costs), and ◆ Multiplying that absorption ratio by the ending FIFO inventory amount.
Reseller Activities Requiring Capitalization of (Allocable) Costs	• Initial acquisition of the inventory and any costs involved in bringing the goods to the shelf or store point of final sale to the customer. All direct purchasing costs including transportation must be capitalized. • In addition, ***four separate*** account groups and personnel functions must be analyzed to see whether they contain additional indirect costs that are required to be capitalized. ◆ Off-site ***Storage*** or warehousing facilities. ◆ ***Purchasing*** activities. ◆ ***Handling*** activities (including limited processing, assembly, repackaging and transporting activities). ◆ ***G & A*** (general and administrative) expense allocable to each of the three expense categories above. • ***Small Resellers ... Gross Receipts Exception.*** Sec. 263A does not apply to a taxpayer if its average annual gross receipts for the three preceding years do not exceed $10 million. • The regulations contain examples of the application of the ***simplified resale method*** either ***with*** or ***without*** the historic absorption ratio election (Reg. Sec. 1.263A-3(d)).
Costs Allocable To P, H, & S Activities -3(c)(2)	• Direct and indirect labor costs (including retirement and other fringe benefits). • Occupancy costs such as rent, depreciation, insurance, security, taxes, utilities and maintenance. • Other costs including materials and supplies, other rentals, maintenance, insurance of vehicles and equipment, tools, telephone, travel. • General and administrative costs that directly benefit or are incurred by reason of these activities. • Resellers (like producers) are not required to capitalize marketing, selling, advertising and distributing expenses.
Purchasing Activities -3(c)(3)(ii)(A)	• The determination of whether an employee is engaged in purchasing activities is based upon the activities performed by the employee, and not upon his or her title or job classification. • ***1/3 - 2/3 Rule for Allocation Labor Costs.*** A taxpayer may elect to apply the following rule for allocating labor costs in connection with employees who perform both purchasing and non-purchasing activities. Under this rule, which is based on the person's ***activities*** relate to purchasing ◆ ***If less than 1/3 ... none*** of that person's labor cost is allocated to purchasing activities. ◆ ***If more than 2/3 ... 100% or all*** of that person's labor cost is allocated to purchasing activities. ◆ ***If 1/3 or more or less than 2/3 ... a reasonable allocation*** must be made between activities.
Handling Activities -3(c)(4)(i)	• Handling costs incurred at a retail sales facility with respect to property sold to retail customers at the facility are ***not*** required to be capitalized. ◆ Thus, handling costs incurred at a retail sales facility to unload, unpack, mark and tag goods sold to retail customers at the facility are ***not*** required to be capitalized. • Handling costs incurred at a dual-function storage facility with respect to property sold to customers from the facility are ***not*** required to be capitalized ***to the extent that the costs are incurred with respect to property sold in <u>on-site</u> sales. Handling costs allocable to <u>off-site</u> sales are required to be capitalized.*** • Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the sales ratio computation found in Reg. Sec. 1.263A-3(c)(5)(iii)(B).

SOME TECHNICAL BACKGROUND BASICS

Storage Costs, In General ***-3(c)(5)(i)***	• Generally, storage costs are required to be capitalized to the extent they are attributable to the operation of an ***off-site*** storage or warehousing facility. • Storage costs attributable to the operation of an ***on-site*** storage facility are not required to be capitalized ... i.e., they can be expensed. • Storage costs attributable to a ***dual-function facility*** must be capitalized to the extent that the facilities costs are allocable to off-site storage.
Definitions ***-3(c)(5)(ii)***	• An ***on-site storage facility*** is a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility. • A ***retail sales facility*** is a facility where the taxpayer sells merchandise exclusively to retail customers in ***on-site sales***. Special rules apply to various situations and portions of specific retail sites. ◆ Two lots of an automobile dealership physically separated by an alley or an access road would generally be considered to be one retail sales facility, provided that customers routinely shop on both of the lots in order to select the specific automobile(s) they wish to purchase. (Reg. Sec. 1.263A-3(c)(5)(ii)(B)(2)). • ***On-site sales*** are sales made to ***retail customers*** physically present at the facility. ◆ Mail order and catalog sales are made to customers not physically present at the facility, and thus, they are not considered to be on-site sales. (Note: Certain purchases over the internet would fall into this category.) • ***Retail customers*** are the final purchasers of the merchandise. ◆ A "retail customer" does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers. ◆ Special rules apply which may treat a non-retail customer as a retail customer under certain conditions. • ***Off-site storage facility*** is defined as "a storage facility that is not an on-site storage facility."
Dual Function Storage Facility & Sales Ratio ***-3(c)(5)(iii)(B)***	• Storage costs associated with a dual-function storage facility must be allocated between ◆ The **off-site** storage function (i.e., these costs must be capitalized), and ◆ The **on-site** storage function (i.e., these costs can be expensed - they do not have to be capitalized). • ***Allocation ratio (based on sales) for dual-function storage facilities.*** These costs must be allocated (between the off-site storage function and the on-site storage function) ***using the ratio of ...*** ◆ ***Gross on-site sales*** of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored there in) ***to*** ◆ ***Total gross sales*** of the facility. ▪ The total gross sales of the facility includes the value of items shipped to other facilities of the taxpayer. • Note: This sales ratio computation is also the ratio to be used for the allocation of handling costs.
90%-10% de minimis Rule ***-3(c)(5)(iii)(C)***	• For dual-function storage facilities, there is a special *de minimis* rule. • ***If 90% or more*** of the costs of the facility are attributable to the on-site storage function, then the entire storage facility is ***deemed to be an on-site*** storage facility ... and thus, no costs need to be capitalized. • ***If 10% or less*** of the costs of the storage facility are attributable to the on-site storage function, then the entire storage facility is ***deemed to be an off-site*** storage facility ... and thus, all costs are required to be capitalized.
Is What the IRS Should Be Looking For ... ***Handling Costs ?***	• Generally, the amount of additional Sec. 263A cost that a typical small or medium size dealership would end up capitalizing under the Simplified Resale Methods is usually very small or there are none at all. • From our discussion over the years with many CPAs specializing in auto dealerships, the application of Section 263 to a typical dealership generally boils down to three areas of investigation which are summarily reviewed by three simple questions. These three areas involve (1) storage costs and (2) purchasing activities, and (3) whether the dealership is basically a "retail facility" under the special rules of Sec. 263A and the sales ratio calculation above. ***Most CPAs do not address handling costs at all.*** • What may be upsetting the IRS now is the fact that in some dealerships, the IRS sees large Parts/Service/Body Shop activities; however, there are little or no costs allocated to these activities/departments under Sec. 263A. • It would appear (at the very least) that if the 10% sales test *de minimis* is not met (i.e., the wholesale and other non-retail sales of parts exceeds 10% of the parts department's total sales), then some amount should be capitalized as handling costs. An analysis of only these departments' activities (justified under a specific allocation/facts and circumstances approach) might yield a more "reasonable" result consistent with the principles of Section 263A. • For a sample format/calculation, see page 12.

(Continued from page 5)

dance with its Franchise agreement with its manufacturer and in accordance with the accounting principles specified by that manufacturer, as constituting the maintenance of "a complete and separable set of books and records" for each respective activity (see Reg. Sec. 1.446-1(d)(2)).

As a result of the IRS denial that the dealership has maintained separate and distinct books and records, the Service would maintain that there is no "separate accounting." And, from this it would follow, that the applicable ratio of costs to be capitalized must be applied to a frame of reference that encompasses the entire range of the dealership's activities. Besides, there is far more revenue to be derived when larger amounts of costs are allocated to year-end inventory under the IRS' approach.

Taxpayers might argue against the IRS on this issue by claiming that the dealership should be eligible to use a *facts and circumstances* allocation under which its taxable income would be more clearly reflected.

Under the general franchise agreement with the manufacturer, the dealership is required to maintain a separate accounting for each department. In this regard, the dealership uses a "specific allocation method" for allocating overhead costs to its various departments and functions. This is in accordance with the standardized accounting system the manufacturer requires the dealership to follow and this approach also corresponds to the requirements in Reg. Sec. 1.263A-1(f)(1).

Further, with IRS approval, dealerships are allowed to value the inventories related to different activities by using different inventory methods. LIFO may be elected for new vehicles, used vehicles and/or parts. Also, for parts inventories, replacement cost–rather than actual cost–is used as the method of inventory valuation by all dealerships.

In the current dispute, often the allocation of costs made by the IRS to the dealership service department and body shop includes an allocation based on ending inventories of new vehicles and/or of used vehicles. This is wrong because these activities are separate and distinct (and mutually exclusive from) the activities which the Service argues are production activities carried on by the service department and/or the body shop.

Finally, if the position of the Service is correct that the activities of the service department and the body shop are production-type activities, the dealership should be recognized as carrying on at least one other separate business activity, namely that of buying new and used vehicles for resale. See Section 441 and Reg. Sec. 1.263A-1(j)(3). Under this approach, the reseller activities carried on by the new and used vehicle departments of the dealership would be subject to the applicable simplified resale methods.

Third Issue

The third issue relates to how the IRS should correct the dealership's method for capitalizing costs if it is presently using an incorrect or erroneous method. The IRS has plenty of precedent to fall back on, including the general language in Section 446(b) and a list of favorable precedents a mile long (*Thor Power Tool* comes to mind immediately). It is a well-established principle that the Commissioner may compute a taxpayer's taxable income by using any method that (in the Commissioner's opinion) clearly reflects taxable income.

In this regard, the correction of choice by the IRS would seem to be the requirement that the dealer change to the Simplified Production Method as it is set forth in Section 263A. This involves a simple three-step process ... (1) identifying the additional Section 263A costs, (2) computing the Simplified Production Absorption (SPA) Ratio and (3) multiplying that SPA Ratio by the additional costs identified in step 1 in order to compute the "additional Section 263A costs to be capitalized."

What "costs" should be considered? Another major point of contention with the IRS in this regard may arise over what amounts the IRS considers to be "additional Section 263A costs," especially if these amounts are arbitrarily pulled off the dealer's financial statement without any modification or adjustment.

To what amount should the Simplified Production Absorption Ratio be applied? Another major point of contention could arise if there is agreement with the Service over the additional costs, but the IRS intends to apply that (Simplified Production Absorption) ratio to "current year Section 471 costs" which the IRS determines to be a far larger amount than the taxpayer believes it should be.

In this regard, the dealership might contend that it should be permitted to use a method other than the application of the Simplified Production Method. The argument could be made that under the facts and circumstances, a computation of costs to be capitalized by a dealership under Section 263A should be made on the basis of departmental cost allocation results. These are readily available from the financial statements which the dealership is required to submit regularly/monthly to the manufacturer. (See page 12.)

Are the Cost Cap Regs Too Complicated for the Average Agent or CPA?

It took the Treasury over eight years to get around to *finalizing* the cost capitalization Regulations. The →

final Regulations (effective January 1, 1994) introduced one more variation to the complex world of Cost Cap for auto dealers. That was in the form of the Simplified Historic Absorption Ratio Method. This complimented –some say further confused– the other methods available for dealers which included (1) the Simplified Resale Method, (2) the Alternative Simplified Resale Method and (3) the Modified Resale Method. As it turned out, the new Simplified Resale Method introduced by the final Regulations for 1994 is identical to the former Modified Resale Method (described in IRS Notice 89-67).

Because of taxpayer complaints about the costly, time-consuming computations they were required to make every year, the final Regulations permitted an election to use the Historic Absorption Ratio in connection with the Simplified Resale Method or in connection with one of the former Simplified Resale Methods. That election was to be made in the first, second or third taxable year beginning after Dec. 31, 1993.

Everything stated in the immediately preceding two paragraphs is so complicated that it defies understanding by the average (and even the above-average) CPA, IRS agent or almost anyone else. One wonders why the IRS is now ignoring all of these specific rules ... which presumably are there to guide calculations made by retailers ... and is now concentrating on trying to "convert" auto dealers from reseller status to producer status under Section 263A.

The chronology and details of these methods are discussed in more detail in the December 1994 *Dealer Tax Watch.* See (1) *"Last Chance Relief for Dealers to Adopt Cost Cap Without Penalty (Rev. Proc. 94-49),"* and (2) *"Cost Capitalization for Auto Dealers,"* which includes sample calculations.

Suggestions for Getting to the "Right" Result

Many years ago, I testified at the Treasury hearings on Section 263A. I said that, in my opinion, the Section 263A rules were basically unworkable. What has happened is that over the last 15 years the IRS has added more layers of complexity to a monstrously complicated cost accounting theoretical approach that was developed by IRS employees who never worked in a real corporate cost accounting environment (let alone an auto dealership) and who never had to work with the complexities of corporate income tax return preparation.

Having said that, I believe that many of the approaches I have seen employed over the years by CPAs handling auto dealerships in coping with the basic requirements of Section 263A (i.e., that certain costs associated with inventory should be capitalized) fall far short of what they ought to be.

As far as automobile dealerships are concerned, all of the concentration by CPAs and by the IRS on trying to meet the technical strictures of the multiple simplified resale methods has produced a confusion of unsatisfactory results.

I believe that what is really required in connection with applying Section 263A to an automobile dealership is an approach that recognizes the fact that there are three major departments...(1) new vehicles, (2) used vehicles and (3) parts & service... and that each of these should be separately analyzed in order to arrive at proper compliance with the intention underlying Section 263A.

I believe this approach is necessary in order to recognize the fact that each department in an automobile dealership has its own method for valuing inventories and the dealership often employs LIFO for at least one of them. Therefore, trying to "cope" with Section 263A by lumping everything together (as the IRS is doing) fails to recognize and take these very basic and important considerations into account.

In a future issue of the *Dealer Tax Watch,* I may present in detail what I believe constitutes a far more practical approach to measuring capitalizable costs for an automobile dealership. This comes down to a more specific analysis based on *facts and circumstances* and involves a department-by-department analysis. Under this approach, the total amount of costs capitalized under Section 263A is determined as the sum of the amounts to be capitalized by separate computations for each dealership department.

This approach recognizes that a dealership may have elected to value some of its inventory (for example, new vehicles) using the Last-In, First-Out (LIFO) method, while it is using other methods of valuation for its other inventories (for example, used vehicles and parts and accessories). The Section 263A regulations clearly require different treatment of the costs capitalized under Sec. 263A depending on whether or not the LIFO method is used for that inventory. As far as I can see, the IRS nowhere has taken this into consideration in its "one-size-fits-all" approach to the situation.

If this approach seems "too complicated" or "too much work," then the alternatives seem to be either (1) settling for the current ambiguous guidance that exists or (2) something approaching the suggestion I made almost 20 years ago that the IRS establish certain ratios of Section 263A costs to sales and let those be the amounts capitalized under a safe harbor compliance method.

letters to the editor

SMALL BUSINESS NEEDS PRACTICAL ASSISTANCE FOR COST CAPITALIZATION RULES

To the Editor:

In following your coverage of the recent Treasury hearings on section 263A cost capitalization regulations, I found interesting the continued emphasis on the "practical capacity repeal" issue. Thanks to the well-intentioned and well-publicized planning strategy noted by a number of seminar speakers concerning practical capacity as a clever way around the section 263A rules, practical capacity indeed seems doomed at this stage. . . until it gets to Court.

As one of the 22 individuals presenting views at the Treasury hearings in Washington, D.C. on December 7th, I was neither an industry representative nor a lobbyist. I took it upon myself to speak for the *vast majority* of closely held businesses that have never heard of practical capacity, never will, and couldn't care less. But they are still stuck with the cost capitalization regulations and getting little practical assistance in the meantime.

A 'Form 263A' would protect many smaller businesses by forcing their accountants to affirmatively deal with the choices of various elections, especially those related to simplified methods.

For the possible benefit of your readers who might have smaller, closely held business clients, you might wish to publish the views I made before the Treasury and IRS representatives. Essentially, these were as follows:

1. For a broad range of fairly homogeneous taxpayers, essentially retailers such as automobile dealers and other retail and wholesale businesses, "safe harbor" ranges should be developed for use in allocating section 263A costs.
2. I pointed out that I had seen no evidence of trade associations attempting to develop prototypes or ranges, based on input from members' CPAs which could be used for the benefit of their entire membership. Most trade associations are narrowly concentrating on specific definitions and other technical interpretations, ignoring the broader problem faced by their smaller members' CPAs in actually coming up with figures in the very near future.
3. The technicalities of the section 481(a) transitional rules are far beyond the comprehension of the average generalist CPA practitioner who has to deal with them for smaller closely held business clients. Such things as the "expedited procedure" by which one determines the eligibility for a four-year, 25 percent pro rata spread simply causes confused looks in the seminars I teach on this subject. How in the world will this actually be implemented eventually? And Form 3115 is required to be filed with 1987 returns!
4. In my comments at the hearing, I pointed out that the section 481(a) adjustment in many cases probably could be paid in full so as to eliminate the necessary corollary computations in subsequent years to see if an acceleration of the section 481(a) adjustment were required. For many taxpayers, the amount of tax would be relatively small and far outweigh the nuisance-value in the next couple of years regardless of the possibility that rates might be lower.
5. If the regulations were amended to reflect acceptance of the use of "safe harbor" ranges by certain taxpayers who essentially had standardized or similar accounting systems and reported on a regular or monthly basis to a manufacturer or supplier, etc., then the same percentage could or should likely be used prospectively for several years, as well as for opening inventory restatement purposes, in an effort to achieve real *uniformity* in the application of the new rules.
6. The final point I attempted to stress was the need that a form (much like the Form 970 for initial LIFO elections) should be developed by which all of the important decisions being made in the first year under section 263A would be captured. My experience as a consultant over the years is that the IRS is not the party raising questions or issues in connection with LIFO or cost capitalization issues. In fact, the parties raising such questions are new accountants for closely held businesses who question the inventory practices of former accountants or CPAs when they take over a new account. Yes, many closely held businesses do change accountants frequently and they are seriously disadvantaged in instances where the former practitioner did not understand or adhere to the inventory

technicalities surrounding LIFO. The new cost capitalization rules may introduce similar pitfalls.

For example, a number of elections need to be affirmatively made in connection with the use of simplified methods available under section 263A. Where desired, if these methods are not properly elected, it will be the taxpayer who ultimately will be placed at a disadvantage if these issues are raised in the future. A "Form 263A" would protect many smaller businesses by forcing their accountants to affirmatively deal with the choices of various elections, especially those related to simplified methods. Although many might resist the notion of one more mandatory form, such a form would highlight these technical areas which otherwise might be unnoticed.

I went so far as to give the Treasury-IRS panel a copy of a "Form 263A" that I had developed for their consideration in this regard. I would be pleased to send a copy of it to any of your readers who might care to write me requesting a copy.

My written submission dealt with automobile dealers as representative of a homogeneous group of taxpayers who might significantly benefit from a "safe harbor" approach.

As a member of the American Institute of CPAs (AICPA), I find it most troubling that out of the thousands (?) of hours it devoted to practical capacity and fiscal year retention, no time could be found for thinking about the need to provide practical assistance to the closely held businesses which every accounting firm, whether small or large, has found to be the root of their own growth. It almost seems like no one seems to care any more about the small taxpayers....

Sincerely,

Willard J. De Filipps, CPA
Mt. Prospect, Ill.

Reg. Sec. 263A-3(c)(5)(iii)(B)	***XYZ DEALERSHIP - SALES ANALYSIS - CURRENT YEAR***					
Separate Department Results ...	***Sales***	***New Vehicles Sales***	***Used Vehicles Sales***	***Parts Department***	***Service Department (Including Body Shop)***	***Total All Activities***
Sales Analysis	Retail Sales	$ 38,922,068	$ 5,762,965	$ 2,515,195	$ 2,919,277	$ 50,119,505
	Non-Retail Sales (wholesale, etc.)	250,000	2,304,509	442,154	None	2,996,663
(Per Financial Statement Sent to Manufacturer)	Total Sales	39,172,068	8,067,474	2,957,349	2,919,277	53,116,168
	Non-Retail Sales as a % of Total Sales	0.64%	28.57%	*14.95%*	0.00%	5.64%

	Sales	***New Vehicles Sales***	***Used Vehicles Sales***	***Parts & Service Combined***	***Total All Activities***
Alternative ...	Retail Sales	$ 38,922,068	$ 5,762,965	$ 5,434,472	$ 50,119,505
Combining Parts & Service Departments	Non-Retail Sales (wholesale, etc.)	250,000	2,304,509	442,154	2,996,663
	Total Sales	39,172,068	8,067,474	5,876,626	53,116,168
	Non-Retail Sales as a % of Total Sales	0.64%	28.57%	*7.52%*	5.64%

Comments

(See Page 12)

- Treating the parts department as a separate activity, the % of non-retail sales to total sales ***exceeds 10%***. That would require the application of this factor to costs associated with handling activities.
- Combining the parts and service departments as a single activity results in the % of non-retail sales to total sales to be ***less than 10%***. Without further qualification, this result ***might not*** require the application of this factor (since it is less than 10%) to costs associated with handling activities.
- A more reasonable approach would be to apply the 15% factor to an analysis of the activities of the costs associated with the parts department (as if that department were separate from the service department).

Sec. 263A

Suggested Format for the Calculation of Handling Costs for the Parts Department of a Typical Auto Dealership

Based on considering an automobile dealership to be a retailer/reseller, below is a sample computation ... based on a *facts and circumstances* specific allocation ... for determining the amount of handling costs to be capitalized under Section 263A for the Parts Department of a typical auto dealership.

The total wages estimated for employees of the Parts Department who are involved with, or associated with, the "receiving and stocking (i.e., unpacking) function" have been reduced by the corresponding retail percentage. As a result, only the net wages allocable to wholesale (i.e., non-retail) sales remain as the labor amounts subject to capitalization.

	2005	
Wage factor allocable to "Shipper Receivers": to receive and check in parts shipments and stock shelves ... equivalent to 2 People: 1 @ $12.00/hour - 2,000 hours	$ 24,000	
1 @ $13.00/hour - 2,000 hours	26,000	
Wages allocable to drivers involved in picking up parts not purchased from manufacturer (75% delivery of parts sold: 25% allocable to pickup of purchased parts)		
Full-Time Driver: $18,000 x 25% Allocable =	4,500	
Part-Time Driver: $11,000 x 25% Allocable =	2,750	
Total Wage Costs	$ 57,250	*L*
Add: Benefit costs (insurance, etc.) allocable to wages - ***estimated*** at 15%, rounded	8,600	
Subtotal ... Wages & Allocable Benefit Costs	***$ 65,850***	**
Less: Adjustment to exclude costs allocable to on-site (i.e., retail) sales, as rounded ... per Reg. Sec. 1.263A-3(c)(4)(i)	(56,000)	*
Wages and benefits allocable to non-retail sales	$ 9,850	
Vehicle use cost factor - $4,800 x 25% - Note (3)	1,200	
Other occupancy costs and other directly related costs	0	
Parts Department Handling Costs, as adjusted	$ 11,050	

Notes & Comments:

- Department Personnel: 11 employees (including one manager).
- Typically, the fact that any one employee of the parts department may not have to spend more than 1/3 of his or her time engaged in ***purchasing*** activities results in the exclusion of costs allocable to the ***purchasing*** activity. However, the 1/3 - 2/3 *de minimis* rule applies only to purchasing activities. It does not apply to handling activities.
- All Parts Department equipment, bins, etc. - fully depreciated.
- Parts Department vehicle is a light-duty truck demonstrator vehicle whose cost is charged to expense based on the anticipated reduction/loss in selling price due to miles and use put on the vehicle by Parts Department. ***Estimated*** at $400/per month = $4,800 per year x 25% use of vehicle allocable to acquisition/purchasing of parts (the other 75% of vehicle use is allocated to selling - delivery of parts sold).

(*) [100% - 15% non-retail sales ratio] or (85% x ***$65,850*****) = $55,972, rounded to $56,000 *
The .15 factor is the ratio of non-retail sales (i.e., wholesale sales) to the total of retail sales plus non-retail sales.

L *L* is the Labor element that would be carried to a Mixed Service Cost Computation: ($57,250 x .15) = $8,588.

WALKING AROUND ... AT THE 2006 NADA CONVENTION

NADA REPORT

The 2006 NADA Convention was held February 11-14 in Orlando. The weather outside was frightful ... windy and cool (with frost warnings) ... but when the Florida sun was out, it was great. As per my usual practice, I spent a few days walking around and talking to various exhibitors and CPAs to find out as much as I could about what's going on in the industry.

If you had called me personally to ask, "What did I do and what did I 'learn' at the NADA Convention this year?" ... Here's what I'd say ...

I do have a game plan. I'm pretty much a creature of habit. So, my "game plan" for attending NADA hasn't changed too much over the past few years. I arrive on Saturday, with the sole objectives of getting settled into my hotel and going to the Convention Center to complete registration and get the hand-out materials, specifically the *Program & Exposition Directory*. The *Directory* lists all the speakers, sessions and exhibitors.

Actually, before leaving the office I've pulled my file with "notes from last year's NADA Convention" and reviewed them on the plane. This is to sharpen my anticipation and to try to get a further sense of continuity for this event.

By the time I get to the Convention Center on Sunday, I have already gone through the convention *Directory* and made my lists of exhibitor booth numbers that I definitely wanted to stop by and visit. I don't attend any of the technical sessions ... I only buy the tapes/CDs and listen to them later.

So, for me, *Day 1* at NADA is really Sunday. I start at the far end of the Convention Center and make my way up and down each aisle. I'm never sure how far I'm going to get or how long it will take to make my way down any aisle.

At the end of *Day 1*, I'll take stock of how much more is on my list of stops to make (exhibitors to see) and update my notes. For me, this is critical, especially if new ideas or questions occur that make me want to go back and ask some more questions. Also, there are a few booths I will want to go back to just for further discussion or to see someone who was not there when I stopped by the first time.

Day 2 (Monday) picks up where I left off ... and by the end of the second day I've pretty much covered everything. But since *Day 2* is a "short day" as far as exposition hours are concerned, that leaves *Day 3* for any final visits and completion of items on my to do list.

1. Overall. Attendance at the 2006 Convention was considerably smaller ... someone said it was down almost 40% overall, or at least significantly down from last year's attendance at New Orleans. Speculation is that this decrease seems, in part, to be due to (1) lower overall industry (dealership) profitability in 2005, (2) concerns over the outlook for the industry in 2006,

see **NADA CONVENTION**, page 14

WALKING AROUND ... AT THE 2006 NADA CONVENTION

(Continued from page 13)

and (3) a less-than-fully-satisfied feeling about Orlando as the location for the NADA Convention. Personally, though, I have no complaints about the Orlando venue.

One really big question that nobody seemed to want to talk about publicly ... was the most obvious ... What will happen to all of the GM dealers if/when GM takes the Chapter? More about this, elsewhere.

2. The IRS at NADA. Last year (in New Orleans) was the first time that the IRS had an exhibitor booth at a NADA Convention. Again, this year, the IRS was present as part of NADA's Federal Regulatory Outreach (FRO) program. The IRS shared space at the FRO booth with representatives of other agencies, including OFAC, FTC, EPA, OSHA and NHTSA.

I visited with Terri Harris, the IRS Motor Vehicle Technical Advisor and with her assistant, Laurie Schutter. Last year, the IRS was distributing copies of its updated *Automobile Dealership Guide.* This year, the IRS' literature rack was literally bulging at the seams with, among other goodies, three new ***Automotive Alerts*** ...

- ***Alternative Motor Vehicle Credit: IRC Sec. 30B & Notice 2006-9*** (Jan. 2006).
- ***Service Technicians' Tool Reimbursement Plans*** (Jan. 2006).
- ***Cash Reporting & Your Dealership ... Questions & Answers on Form 8300*** (Feb. 2006).

Ms. Harris said that the cash reporting *Alert* actually is in "draft" form, subject to a few minor additions that could not be included before the publication deadline.

In addition to these recent releases, the IRS literature rack included one older *Alert* that somehow I had not previously seen. This one is entitled ***Service Contract "Overpayment" Programs May Improperly Divert Dealership Income*** (dated October, 2000).

Could it be that since the huge furor over dealer PORCs has faded into a distant memory that the IRS wants to be sure to keep dealers and practitioners "***alert***" to the fact that the IRS still has dealer PORCs on its radar screen?

These *Alerts* are included on pages 33 to 47.

3. Emerging IRS Hot Topic ... Some Sec. 263A Hearsay. You may recall that last year, I reported some scuttlebutt concerning IRS audits involving cash transaction reporting and Forms 8300 audits. Is it any coincidence that one of the recent *Automotive Alerts* (see above) is on that very subject?

This year, the juiciest tidbits that I heard related to several audits in which the IRS was taking the position that auto dealers should be treated as producers (manufacturers) ... rather than as retailers (i.e., resellers). In other words, dealers should be making Section 263A elections with respect to the Simplified ***Production*** Method ... rather than with respect to the various Simplified ***Resale*** Methods.

This topic came up in my conversations with Terri Harris (of the IRS), Paul Metrey (of NADA) and several CPAs, including one CPA whose dealer clients have been directly involved with these audits. I also personally became aware of another IRS audit raising the same issue in the same geographic area. (For a separate discussion of this issue, see the article beginning on page 3.)

In short, it appears that this issue is being pressed under the coordination of another IRS Specialist, and it involves dealerships audits in the Northeast, principally Massachusetts. Apparently, the "263A connection" started out with an audit of a very large, multi-location tire wholesaler who had quasi-production-like activities. Then one thing led to another and the next thing you know, all auto dealerships were being thrown into the soup together.

Just about everybody (outside the IRS) thinks the Service is being disingenuous in taking the position that dealers should have exposure to the producer portion of the Section 263A regulations as far as inventory costs go, but that they should not be entitled to any benefits as "producers" for purposes of the domestic production activities deduction available under Section 199. But, the IRS has its rationale for this dichotomy, too.

Makes me wonder ... Will there be an *Automotive Alert* on Section 263A next year?... Or a TAM?

4. NADA Booth. In one of my visits to the NADA booth, I had a chance to catch up with Paul Metrey, the Director, Regulatory Affairs for NADA. As usual, he is busier than a one-armed paper-hanger giving presentations all over the country and dealing with an endless stream of calls related to issues raised by all of the agencies at the FRO Booth in their interactions with dealerships.

Paul specifically mentioned the Sec. 263A issue as being one of the items on his own IRS "hot" list.

Over the past several years, I've made it a point to have lunch with Paul Metrey and Bill Newman when I visited the D.C./Baltimore area. Paul told me that Bill had just retired from NADA. That made me think about several other NADA execs I've had the pleasure of working with over the years ... going as far

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back as Jay Ferron and Peter Kitzmiller ... especially in the years when we had some really contentious IRS issues over dealer LIFO. Remember all that stuff about how dealers should do their LIFO calculations (resulting in the Rev. Proc. 92-79 safe harbor)? ... And then about dealer financial statement conformity (resulting in Rev. Proc. 97-44)?

One of my associates recalls hearing Peter Kitzmiller go ballistic over the phone with me ... "Will, can you believe they (i.e., the IRS) are doing this?" It seems like it took about a week before the receiver cooled down. Ahhh, those were the days! ... IRS Specialists "stressing the system" ... dealers breathing down P.K.'s neck for quick settlements with the IRS and/or the Treasury Dept. on impossible issues ... I remember them all, fondly.

5. Sec. 62(c) Accountable Plan Reimbursement Programs for Technicians ... Do You Remember Them? Last year, only one representative of the tool plan industry had a booth at NADA. That was Pro-Check National, Inc. We all know what happened to the "tool plan" industry last fall when the IRS issued Revenue Ruling 2005-52. The Service in this Revenue Ruling said nothing more than ... just read the rules and follow them, and don't expect to get away with taking any short-cuts. It seems like that really hit home for some folks.

For the time being, it seems that the industry is in a "retreat and regroup" mode. Steve Mopsick, where are you? Anyway, there were no tool plan industry exhibitors in Orlando at NADA this year. About the only evidence of the existence of tool plans was found in the IRS literature rack in the aforementioned *Automotive Alert.*

6. Big Emphasis on F & I Credit and Dealer Risks. Many exhibitors and speakers at the Convention zeroed in dealers vulnerability to class action lawsuits from customers where the F & I department was slacking off on following proper procedures. Many exhibitors were marketing systems, controls and procedures to help dealers minimize the high risks they are facing in selling F & I products to customers.

Continuous enforcement by regulatory agencies and by litigation-prone customers (and their attorneys) have garnered many sensational headlines in the past year alleging wrong-doing by some dealers' F & I departments.

This area is a minefield. As noted in one recent article, dealers should keep in mind that they can never use the word "best" when discussing APR finance charges.

The litany of misdoings includes ... the forging of customers' signatures on purchase and funding documents, overstating the customer's income in attempting to get them credit, packing payments, non-compliant disclosures (Regulation Z), and the list goes on.

7. "State of the Industry" Seminar Presented by Myers & Fuller, P.A. On Monday afternoon, Feb. 13, Myers & Fuller presented its "State of the Industry" seminar at the Peabody Hotel. I was fortunate to be invited to attend this very informative presentation. This firm has been very active in "*leveling the playing field between motor vehicle dealers and manufacturers for over 20 years.*"

The seminar was divided into three parts ... (1) franchise law developments, (2) market analysis and its importance in dealer litigation with the factory and (3) F & I issues. Firm attorneys Richard N. Sox and Shawn D. Mercer covered the first and third subjects. Joe Roesner from the Fontana Group addressed factory marketing studies.

Of equal significance and interest was the added stimulation from questions from the attendees and responses by the presenters, as well as by Dan Myers and Loula Fuller. Some of the questions came from dealers in the audience (already embroiled in various disputes with the manufacturers). Other questions came from some of the state association representatives, whose remarks often included requests that dealers make more extensive use of their dealer associations, especially in an "early warning" capacity.

For coverage of this excellent seminar, see page 19.

8. Did We Say... "Energy Audit"? In the December 2005 issue of the *Dealer Tax Watch* (Update Item #3), we suggested that one way to help your dealership clients save a lot of money was to make a ***detailed study*** of its ***energy costs*** ... in short, conduct an "energy audit."

On page 3 of that issue, we referred to an article which indicated that 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.

Wouldn't you know it? Walking the floor at NADA there were several organizations specializing in providing this very service for automobile dealers. This still remains to be something you might want to look into on your own for your dealers.

see **NADA CONVENTION**, page 16

9. Buy-Here, Pay-Here Dealers. Another highlight was the opportunity to catch up with Ken Shilson, the Buy-Here, Pay-Here guru and a frequent contributor to the *Dealer Tax Watch*.

Ken indicated that this is really a challenging time for BHPH dealers, but the ability to analyze portfolio risks and sharpen accounting practices is clearly what will be setting the more successful dealers apart from those who are merely hanging on by doing business as usual.

Ken's checklist for ten steps to successful BHPH operations is on page 48.

For the past several years, Ken has been the driving force behind the National Buy-Here, Pay-Here Conference. The 8th Annual National BHPH Conference is scheduled for May 8-10, 2006 in Las Vegas. This Conference always gets rave reviews from attendees and participants, and I strongly recommend it to you.

10. Other Familiar Names & Faces. I also had a chance to see a few other people who have become familiar to readers of the *Dealer Tax Watch* over the years. Stopping by ***One View, Inc.'s*** booth, I had a chance to visit with ***Dave DeHaven***, whose firm we have prominently identified in many articles on compliance with the IRS' electronic recordkeeping requirements (Rev. Proc. 98-25).

Another visit to the ***Paul Gillrie Institute*** booth gave me a chance to note the significant expansion of Paul's services and activities in the area of helping dealers reduce (significantly) their computer expenses.

Over the years, Paul has helped more than 4,000 dealers negotiate contracts with various computer vendors. Although I missed visiting with Paul in person, I did talk with his associates who brought me up-to-date on their expanded activities.

Paul assisted NADA by providing information for "A Dealer Guide to Negotiating with Your Computer Vendors," which is a part of the NADA Management Series. This is a totally updated primer on managing dealership computer expense from initial proposal through the end of lease cycle.

Paul also publishes the *Journal of Dealership Computing* and you can get more information on this publication by contacting the Paul Gillrie Institute at 800-576-6959 or info@paulgillrie.com.

Finally, I had a chance to briefly visit with Joe Connolly of ***Capital REIT***, whose activities were the subject of an article in the September, 2004 *DTW*.

11. Marketing Your Dealership Practice Specialty at the NADA Convention. I've always believed that one of the most significant things that a CPA could do to expand his or her dealership niche practice is to attend the NADA Convention each year.

In days/years gone by, I have been an exhibitor at NADA Conventions marketing my LIFO services and publications ... so I have considerable empathy for everyone who has to stand on their feet all day marketing their wares.

Over the years, I've often heard CPAs say ... "the NADA Convention comes at a bad time ... I'm just too busy to get away from my office for that." To me, that always seemed like a huge mistake.

Many CPA firms use the NADA Convention as a forum to market their services. The CPA "exhibitors" at NADA fall into two categories: (1) individual firm exhibitors and (2) dealer-CPA associations. I made it a point this year to talk with each of the individual firm exhibitors ... O'Connor & Drew, PC (Quincy, MA) ... Morrison, Brown, Argiz & Farra, LLP (Miami, FL) ... Terry & Stephenson, PC (Denver, CO).

I also made it a point to stop by the booths of each of the dealer CPA associations. Out of the five current CPA associations, only one (the National Association of Automobile Dealer Advisors) was not an exhibitor. The other four have all been exhibitors at NADA for many years.

If you're not aware of it, there's been a whole lot of change going on in terms of the membership composition of these associations. For example, I looked forward to visiting some old friends at the Dixon Hughes booth. When I stopped by, I did a double-take because Dixon Hughes is now part of a much larger association, to which Moss Adams, Plante Moran and two other firms with very large dealer specialties have been added ... All are now promoting their dealership specialties under the name of Moores Rowland International.

I go a long way back with some of these dealer CPA accounting groups. In fact, I was the founder of the first group (the AutoCPA Group) back in 1987. That group grew out of the extensive "seminaring" I was doing around the country teaching LIFO to CPAs handling automobile dealerships. Several years later, in 1995, I formed two other dealer CPA groups which I actively managed for five years. After that, these groups became the Driving Force and the National Association of Automobile Dealer Advisors.

Auto Team America came into existence shortly after the AutoCPA Group was formed. The Moores Rowland group, as indicated, is the newest ... and probably the largest ... of the bunch.

see **NADA CONVENTION**, page 18

THE CURRENT STATUS OF DEALER-CPA ASSOCIATIONS

Moores Rowland International ... (5)	*Auto Team America ... (12)*	*Driving Force ... (13)*	*Auto CPA Group ... (23)*	
• Dixon Hughes, PLLC AL, GA, NC, SC, TN, TX, WV	• Beers & Cutler, PLLC Serving MD, DC, VA, & DE	• Allan Jay Kovitz, CPA Ronkonkoma, NY	• Peterson Sullivan, PLLC Seattle, WA	• Henry & Horne, LLP Tempe, AZ
• Moss Adams, LLP WA, OR, CA, ID	• Blum Shapiro & Co., PC Serving CT, NY, RI, VT, NH, ME & MA	• Brimmer Burek & Keelan, LLP Tampa, FL	• Sartain Fischbein & Co., CPAs Tulsa, OK	• Daoro Zydel & Holland San Francisco, CA
• Plante & Moran IL, MI, OH	• Crowe Chizek & Co., LLC Serving WI, IL, MI, IN, OH, FL, GA & TX	• Foti Flynn Lowen & Co. Roanoke, VA	• Dwight Darby & Co. Tampa, FL	• Green & Miller, PC Corinth, TX
• BKD, LLP AR, CO, IL, IN, KS, KY, NE, OH, OK, MO, TX	• Davis, Keller & Wigging, LLC Serving MO, AR, IL, OK, KS, NE & IA	• Bowden & Wood, CPAs Louisville, KY	• Mountjoy & Bressler, LLP Louisville, KY	• Porter & Co. Greensboro, NC
• Weiser, LLP NJ, NY	• Eide Bailly, LLP Serving ND, SD, MT, IA, AZ & MN	• UHY Advisors, Inc. Southfield, MI	• Welch & Company, LLP Ottawa, ON	• Rosenfield & Co., PA Orlando, FL
	• Goldenberg Rosenthal, LLP Serving DE, PA & South Jersey	• Gearhart & Associates, PC Williamsport, PA	• Pomares & Co., LLP Sacramento, CA	• Boyer & Ritter Harrisburg, PA
National Association of Automobile Dealer Advisors ... (10)	• Henderson Hutcherson & McCullough, PLLC Serving TN, KY, North GA & North AL	• Delap White Caldwell & Croy, LLP Lake Oswego, OR	• Walpert & Wolpoff, LLP Baltimore, MD, Washington DC, Virginia area	• Lattimore Black Morgan & Cain, PC Weinhold & Associates Irvine, CA
• Councilor Buchanan & Mitchell, PC Bethesda, MD	• Larson Allen Weishair & Co., LLP Serving MN, WI, NC & SC	• Samuel Goldstein & Co., PC Great Neck, NY	• Simpson & Osborne Charleston, WV	• Woodward & Associates Bloomington, IL
• Vawter Gammon Norris & Co., CPAs Cordova, TN	• MacKay, LLP Serving Canada	• Pugh & Co. Knoxville, TN	• Thom-Dobson-Womack, Inc. Oklahoma City, OK	
• Hays Neltner & Schmidt, PSC, CPAs Fort Mitchell, KY	• Mironov Goldman Wortzel Sloan & Parziale, LLC Serving NJ, NY & PA	• McPhillips Roberts & Dean PLC Norfolk, VA	• Weisberg Molé Krantz & Goldfarb, LLP Hicksville, NY	
• Kruse Mennillo & Co Cerritos, CA	• Postlethwaite & Netterville, APAC Serving LA, MS & TX	• Serotta Maddocks Evans & Co., CPAs Augusta, GA	• Albin Randall & Bennett Portland, ME	
• Lane Gorman Trubitt, LLP Dallas, TX	• Tyler Simms & St. Sauveur Serving ME, NY & VT	• Rackers & Fernandez, LLC St. Peters, MO	• Hulsey Harwood & Co. Monroe, LA	
• Lewis & Knopf, CPAs, PC Flint, MI		• Brady Martz & Associates, PC Grand Forks, ND	• Hausser & Taylor Cleveland, OH	
• Masters Smith & Wisby, PA Jacksonville, FL			• Heider Tanner & Dirks Denver, CO	
• W. Keith Argabright, CPA Walnut Creek, CA			• Jensen & Keddington, PC Salt Lake City, UT	
• Weiser, LLP Tarrytown, NY				
• Wipfli Edina, MN	***Note:** These listings are believed to be accurate ... Some Firms may still be in the process of trying to work out which Association they will finally end up in.*			

 (Continued from page 16)

As a long-term strategy, CPA firms handling dealerships who are not currently associated with one of these groups, probably should consider learning about them and possibly trying to join one of them. From my own experience with these groups, I've seen that for smaller CPA firms specializing in auto dealerships, membership in a group may provide an eventual, viable exit strategy that maximizes the value of their dealership practices.

12. New Association of Attorneys Specializing in Representing Dealerships. Last year, I reported that an association has been formed whose membership consists of attorneys who represent automobile and other types of dealerships.

When I saw Ronald Coleman at the Convention this year, he indicated that the Association has moved forward rapidly over the past year. The National Association of Dealer Counsel (NADC) now has about 1,500 members and more information about it is available from its web site (www.dealercounsel.com). Associate memberships may be available for non-attorneys.

13. Down Memory Lane. Without realizing it until I thought about it later, one of the most satisfying aspects of walking around "the floor" at NADA ... was the realization that quite by chance I had also touched base with a few other people in a way that brought back some very pleasant memories.

In addition to all the foregoing conversations, I "ran into" two other special people. One was Harold DeValk. In late 1972 - early 1973, I began working for Harold's firm and it was there that I first became involved with automobile dealers and dealerships. So we go a long way back.

Part of what I remember about working for Harold years ago was his emphasis on organization and discipline whenever you set out to try to accomplish something. Back in 1973, it was Harold (as managing partner of his firm at that time) whom I first had to convince that LIFO was a good thing for the firm's 100 or so automobile dealer clients.

He was an easy "sell" because he saw the benefits instinctively. He encouraged me to develop my ideas. Even more significantly, he was supportive of my writing an article which basically shared some of the "trade secrets" in terms of how to apply LIFO to an automobile dealership at a time when there was absolutely nothing (useful) in print on the subject for car dealers.

When I saw Harold, I happened to have in my hand my list of booth numbers to visit. I told him that, too, was a habit I had picked up from working with him years ago. With a broad smile, he reached into his own pocket, and pulled out his own handwritten list. Some things just never change.

I had run into Harold on Monday. The day before, I had made it a point to stop by the booth for Art Neimann & Company. My reason for stopping by there was simple. From last year's convention, one of the seminar tapes I had bought was Art Neimann Sr.'s presentation and I had just listened to that tape within the past few days. (It got lost in the shuffle somewhere and I just happened to find it about a week earlier and I listened to it just before leaving for NADA.)

Some of Mr. Neimann's comments related to the remarkable effect his working for Clement Stone in the 60's had on his own life. Coincidentally, I had become familiar with Mr. Stone's works (as a result of working for Harold DeValk's firm). My life was similarly enriched by Clement Stone's remarkable philosophy, which I attempted to adapt as best I could for myself.

By a stroke of good luck, Mr. Neimann was at his company's booth. We shook hands and I told him how much I enjoyed listening to his presentation and of my own warm feelings towards Mr. Stone. As we chatted, it turned out that Mr. Neimann grew up on the Northwest side of Chicago, in the same neighborhood where I grew up.

We talked about the same "grammar schools" and "high schools." We talked about the neighborhood ... and how much it has changed over the years, and of playing ball (baseball, basketball, football) in the same school yards and public parks, and of going to various local theaters and retail stores (now all long gone).

As our conversation deepened, he asked me if I had ever played "pinners." I couldn't believe my ears. My first recollections of my parents allowing me to play outside alone or with a neighbor was of playing ... "pinners." This game was played by throwing or bouncing a rubber ball or a tennis ball against steps or against a wall with as little as one other player, who was the fielder. You could even play this game alone (with all sorts of imaginary heroics) if nobody could come out and play ...

I hadn't heard the name "pinners" anywhere in over 50 years! What great memories that brought back!

In many ways, as I reflect on my trip to NADA earlier this year ... I think it was about as good as it could get.

"STATE OF THE INDUSTRY" SEMINAR PRESENTED BY MYERS & FULLER, P.A.

SEMINAR REPORT

On February 13, Myers & Fuller, P.A. presented its "State of the Industry" seminar at the Peabody Hotel. The seminar was divided into three parts:

3 PARTS

- Franchise law developments,
- Market analysis and its importance in dealer litigation with the factory, and
- Finance & Insurance ... F&I ... issues.

Firm attorneys Richard Sox and Shawn Mercer covered the first and third subjects. Joe Roesner from the Fontana Group addressed factory marketing studies. Of equal significance were the questions from the attendees and responses by the presenters, as well as by Dan Myers and Loula Fuller.

Franchise Law Developments

This section of the seminar discussed three major areas ... (1) What the bankruptcy of a manufacturer could mean to dealers, (2) Various manufacturer incentive programs and (3) Nissan as being in a class by itself as the most aggressive (anti-dealer) manufacturer out there.

What happens if a manufacturer like GM goes bankrupt? It seemed there was little discussion at NADA ... in general ... about the magnitude of the bleak situation General Motors is in. The consequences should GM–or any other manufacturer, for that matter–face bankruptcy would be devastating.

Coincidentally, the February 20 issue of *Fortune Magazine* contained a detailed analysis of GM's situation, and this article is discussed elsewhere (on page 26). Many observers believe that over the next several months, GM's fate may be tied, in part, to Delphi's (Delphi Corp. is a former GM subsidiary and a major parts supplier). Their feeling is that "as Delphi goes ... so does GM." This, of course, relates to the fact that GM is inextricably bound up with the outcome of Delphi's union/labor settlements.

So ... what might happen to the dealer's franchise if the manufacturer (GM, Ford, whomever) filed for bankruptcy protection? Mr. Sox made clear that one of the first and most logical requests that the attorneys (for the manufacturer in bankruptcy) would probably ask the Bankruptcy Court Judge to approve would be to allow the company to reject all ... or some ... of the dealer franchise agreements.

And, that's probably exactly what would happen. As far as the Bankruptcy Court Judge is concerned, the key question is "does the proposed request make sense from a reorganization standpoint?" The matter of "fairness" to the other party–in this case the dealer who has the franchise agreement–is not relevant.

The Court would probably consider the franchise agreements that the manufacturer had with its dealers to be executory contracts. As such, these contracts could be voided if the manufacturer can show (i.e., convince the bankruptcy judge) that there would be significant cost savings as a result of eliminating some or many of the franchises ... or linemakes.

It would seem that the Bankruptcy Court could be selective in determining which dealer franchise agreements would or would not be terminated. As a practical matter, small rural dealers and/or poorly performing dealers in metropolitan areas might be the top candidates for franchise agreement termination under these circumstances.

Bankruptcy judges have an "incredible amount of power and their power trumps all state laws and statutes." So, in theory, if GM were to go into bankruptcy, it might be able to wipe out an entire linemake (i.e., Pontiac or Buick). Unfortunately, there would be no remedies available to terminated franchisees. Also, no changes in state laws could be pursued to avoid this consequence.

What can a GM dealer (or Ford dealer, for that matter) do? Setting aside speculation over what might happen, here's the advice offered for these dealers. ***First***, a dealer should think twice or at least think long and hard before investing any new money in the franchise. A dealer would want to have as little as possible invested in the dealership because ... it could all be lost.

Also, in doing any projections based on sales levels after a "restructuring," be sure to use realistically smaller numbers for projected sales. This sobering advice/observation is based on Daewoo's example which demonstrated the power of the public's perception, which did not give the benefit of doubt to the troubled manufacturer, where matters concerning future warranty protection for customers' vehicles, supply parts and reimbursements were involved.

Second, if the dealer is going to invest more money in the dealership (and the dealer can find no way to get around it), then the dealer should try to get a side agreement with the Factory to be reimbursed. The intention is that, even if the franchise cannot be protected, with a side agreement the dealer would become a creditor of the Factory for new construction

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costs (in the event of bankruptcy). But even in that case, any money paid out to the dealership under that creditor agreement would probably be paid out very slowly over a long period of time.

Incentive programs. Manufacturers are finding inventive ways to front load their incentive monies using programs that reward dealers for selling more cars, buying more cars and/or investing more money in their own dealerships.

Among the incentive programs discussed were the Kia and Hyundai multi-tiered incentives, the GMAC Platinum dealer incentive, BMW's Value-Added incentive and Chrysler's more recent incentive involving the deposit of $1,000 per car in a dealership's bank account ... if x number of cars are ordered by such-and-such date.

Mr. Sox emphasized that in connection with sales incentive programs, manufacturers are required to set their sales targets in relation to the market potential for the dealership. They can't arbitrarily select a number of units to be sold with no relevance to market potential because to do so might illegally penalize "smaller" dealers.

However, a distinction has to be made between incentive programs that may be "unfair to the dealer" vis-à-vis those that might be illegal under state law.

It appears that the common thread that runs through the different incentive programs is something referred to as "functional availability." The essence of what is objectionable is that the "smaller" dealer might be placed at a significant disadvantage relative to the "larger" dealer by the operation of the incentive program.

Myers & Fuller recently filed a Federal antitrust suit against Kia Motors in connection with its multi-tiered sales incentive program. The suit alleged that Kia's program was structured to insure that only the highest volume Kia dealerships would qualify for the largest dollar incentives payable under the program. To qualify, all Kia dealerships were required to meet the same minimum sales threshold, but above that level, the dealerships that sold more vehicles and more expensive vehicles received more money. After exceeding the minimum monthly sales level (24 vehicles), there were four levels of sales incentives ranging from $200 to $1,200 per vehicle based on the number and models of vehicles sold.

It was reported that Kia had subsequently altered its program (after the suit was filed) and that both Nissan and Chrysler have discontinued (similarly structured or intentioned) tiered incentive programs.

As for incentive programs aimed at stimulating dealers to purchase more vehicles (i.e., "buying" incentive programs), one Chrysler dealer in attendance related his dilemma under a recent program. Chrysler said that if the dealer ordered a certain number of cars by (say) February 15th, that dealer would receive $1,000 for each car ordered. Sounds great ... but ... what if a week after that closing date Chrysler comes out with *another incentive program* that ups the offer to $2,000 per car? The dealer may regret expending so much of his resources to qualify for the "first round" of incentives. A real *Catch-22.*

Still another issue for many dealers is the fact that the manufacturers are following their incentives through to their wholly-owned or captive finance subsidiaries. In other words, car buyers may only be able to obtain more favorable interest rates or other financing terms for vehicles sold by the dealer if those vehicles are financed through the manufacturer's captive insurance company (i.e., GMAC or FMCC, etc.).

In many cases, state law restrictions or regulations on lending practices do not apply to a manufacturer's wholly-owned finance company. Apparently, North Carolina is the only state that does have a law to regulate wholly-owned finance subsidiaries in this regard.

Nissan, Nissan, Nissan ... "So Many Issues, So Little Time". Nissan is by far the most aggressive manufacturer out there. As Mr. Sox said, "Nissan gets its own slot (in our discussion) and the dealers in the room know why."

Among the topics discussed were warning letters, notices of default, termination practices, NREDI and addendums to dealer agreements. It is important to clarify the difference between a statement that may be considered as expressing a goal vs. a statement that could be interpreted as the dealer's making a commitment to try to achieve that goal.

In connection with warning letters sent by Nissan to its dealers, the advice given was to "paper the file." This means dealers should respond in writing ... and without exception ... to every notice and/or communication the dealer receives from the Factory.

Instances were cited where, when the disputes were in the Courts, the judges' findings ... in fact the first point the judge made in holding against the dealer ... was that the dealer had failed to respond to the warnings and/or notices of default that Nissan had sent to them.

Nissan wants "only" three things from all of its dealers. ***First***, stand-alone facilities that look exactly like the Factory/Nissan wants them to. ***Second***, the

→

dealership must be 100% sales efficient. ***Third***, Nissan wants site control–indefinitely–forever.

In addition, there are sales standards, service standards, capital standards and training standards. Mr. Sox indicated that in many instances, Nissan has set unrealistic sales standards or expectations and that often a dealer can successfully contest those numbers because Nissan has improperly drawn the boundaries for its primary market area analysis.

A special point emphasized by Mr. Sox is that many dealers do not know that they do ***not*** have to enter into a facilities upgrade program in order to get their franchise with Nissan renewed. This holds true regardless of what the regional managers or other representatives may tell you.

As a practical matter, if you have any Nissan dealership clients, given the extensive and aggressive anti-dealer body behavior of this manufacturer, the likelihood that the dealer could lose his franchise agreement could be significant if the dealer is not already actively defending himself in some way against something. In other words, legal fee expenses shown on the books should be a fairly significant dollar amount. If the dealer does not have his attorneys actively involved in representing him vis-à-vis the Factory, sooner or later, that dealership could entail significant "going concern" risk.

Another excellent point came out in one of the questions and answers. This relates to all Factory situations, not just to Nissan. Dealers were advised to make it a practice to ***transcribe all voicemails*** they receive from regional managers and other Factory reps. This includes especially any voicemails that are either full of glowing praise (for how well the dealer has peformed in some areas) or "way off the wall" (which may be expressing excessive expectations or unduly threatening). Apparently, some dealers even take the precaution of rerecording these voicemails on another medium and they save both the rerecorded message, as well as the written transcription, as part of their "dealer defense file."

You just never know when something spoken (in haste, or in heat) by a manufacturer's rep could be critical in defending the dealer.

Market Analysis And Its Importance In Dealer Litigation With The Factory

Joe Roesner of the Fontana Group presented the second section of the seminar. His remarks were supplemented by extensive tables, graphs, maps and statistics. Below are just a few of the many informative points he made.

"Market based potential" calculations may involve either *retail* sales index or *registration* sales index databases. A dealer should be cautious or concerned about having additional areas assigned to

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Other Manufacturer Issues

Unfortunately, time did not permit coverage of several other areas that were included in the seminar outline. For more information on any of these, you can call the attorneys at Myers & Fuller directly ... (850) 878-6404.

- ***Image/Exclusive Facilities***
  General Motors - Channel Strategy, Kia & Hyundai, Suzuki, Hummer, Nissan, Mazda, Toyota, VW - Marketplace and Chrysler - Alpha Program.
- ***Audits ... Warranty & Incentive***
  GM, Chrysler, Ford, Mercedes Benz and Kia.
- ***Constructive Terminations***
  Pontiac, Buick & GMC; Saturn & Saab; Isuzu; and Chrysler, Ford & Nissan - small dealers.
- ***Add Points***
  GM, Ford, Chrysler, Mercedes Benz, Nissan, Toyota, Kia & Hyundai.
- ***Dealerships Transfers***
  Must be approved or rejected based upon State franchise law criteria and manufacturer cannot make transfer contingent upon new imaging or facility.
- ***Chinese Vehicles***
  Know What You Are Getting Into When Buying Rights to a Franchise.

him under the sales agreement because the larger the area assigned to the dealership, usually the worse will be the level of the dealership's overall performance.

Basic questions to ask include ... Is my (sales) area assigned correctly? ... Should I really be assigned this area?

It is important to differentiate between those factors which a dealer is able to control and those over which the dealer cannot exercise any control. Such factors include (1) drive times, (2) access to and from interstate or other major roadways and (3) the presence or absence of artificial geographic or municipal boundaries.

Other factors affecting a dealer's sales include (1) allocation of vehicles, (2) brand loyalty, (3) dealer loyalty, (4) the number of open points, (5) potential relocations and (6) a change in the ownership of a competing dealership in the area. The evaluation of these factors requires experienced professionals.

F & I Issues

At the NADA Convention, many exhibitors and speakers zeroed in on selling dealers systems and procedures to minimize the high risks they are facing in selling F & I products to customers.

The last part of Myers & Fuller's seminar was Shawn Mercer's discussion of F & I issues and problem areas. His presentation was based on asking a number of questions and then providing background information on the importance of each. These were framed as questions to ask the dealer directly.

In connection with OFAC checks, the following was related: In one dealership, a customer sitting at the F & I desk asked the F & I person ... "Are you going to perform an OFAC check on me?" The F & I person responded ... "What's that?" The customer reached in his pocket and pulled out a Federal badge and said ... "Let me tell you all about that." →

F & I

F & I Issues & Problem Areas ... Some Questions for the Dealer

1. Do you use a F & I menu? A menu should not be used as a tool to package your F & I deal.
2. Do you offer a service contract on a vehicle sold to a buyer with bad/poor credit?
3. Do you offer credit life on all deals?
4. Are you positive there is no payment packing or rate packing going on in your deals?
5. Are you certain that 100% of all potential customers who have been denied credit have received an adverse action notice from your dealership?
6. Are you properly handling bank acquisition fees?
   - Are you steering customers only to certain vehicles?
   - Are you adding the bank fee somewhere else in the deal ... possibly trying to hide it?
7. Are rebates and credit card down payments being truthfully disclosed to the customer and to the lender?
   - When a customer uses a credit card to make a down payment, that down payment is considered to be financed.
8. Are privacy notices being properly distributed to customers?
9. Have you updated your information security program within the last 180 days?
10. Are all facts identical on the buyer's order, credits applications and bank contracts?
11. Is negative equity being properly disclosed on the deal?
    - Negative equity (a.k.a. "being upside down") exists when/if a trade vehicle bears more debt than it is worth.
12. Are you using conditional delivery agreements on spot deliveries?
    - In some states, that vehicle is required to be on dealer plates and on dealer insurance.
13. Are you properly using an arbitration agreement that can help you avoid class action lawsuits?
14. Are you performing OFAC checks ... comparing customer names to the Office of Federal Assets Control (OFAC) list?
    - Dealerships are prohibited from entering into transactions with certain sanctioned countries and governments and with organizations or individuals whose names appear on an electronic list of Specially Designated Nationals (SDNs) that is maintained by OFAC.
    - Dealerships need to have written programs and must retain proof that they are making these comparisons/checks.
    - OFAC checks must be made for all vendors the dealership is doing business with, as well as for all (potential) customers.

Another source of information on the subject of negative equity is an article entitled "Filling Empty Heads About Negative Equity" by James S. Ganther, Esq. in the magazine *F & I Management and Technology*, February, 2006, pages 28 to 32. In this article, the author indicates that even if the statute of limitations on Regulation Z has expired, state courts still look to the FTC's interpretation to guide their application of state deceptive trade practices statutes and some states specifically incorporate Regulation Z into their own statutes by reference.

It has been reported that in 2004, Sonic Automotive Group's F & I operations represented 17% of its gross profit ... an amount in excess of $225 million. For a case study on Sonic's reengineering of its F & I department, see "Sonic Takes the High Road" also in *F & I Management and Technology*, February 2006, pages 21-26. If an organization as large as Sonic ... with 177 franchises ... can do it, most other dealerships should be able to adapt, as well.

Interestingly, the telling remark in the interview with Sonic's COO, Jeff Rachor, is the statement that Sonic's move toward better compliance was much like any "12-step program." In other words, the first thing the Company had to do was to admit that it did have a problem. It then set out to fix it, promoting a "zero tolerance" culture.

Firm Profile	***MYERS & FULLER, P.A. ... Specialists in Dealer Representation***
General	• Founded in 1987, Myers & Fuller, P.A. represents automobile, truck and motorcycle dealers in a wide range of complex commercial transactions, business disputes and litigation issues. • The Firm currently has two offices ... ***Tallahassee, Fla.*** (850/878-6404) ... ***Raleigh, N.C.*** (919/847-8632). • It has broad experience in all aspects of manufacturer/dealer relations, and it has represented clients in over 40 states, Puerto Rico and Canada. A summary of the Firm's activities in a few of its various specialty areas is below.
Franchise Disputes	• Myers & Fuller represents clients in all aspects of disputes that may arise related to dealership terminations, line-make market withdrawals, franchise turndowns, transfers, facilities, addition of dealership points, sale of automobile dealerships, franchise alignment and good faith and fair dealing claims.
Add Points	• Myers & Fuller has represented protesting dealers in additional dealership/relocation cases. ◆ The issue in add point cases is whether existing dealers are adequately representing the factory within the RMA. Myers & Fuller routinely deposes and cross examines factory experts and works with other expert witnesses on the issue of market share, retail sales indices, CSI and other purported measures of customer satisfaction. ◆ The Firm has written state franchise laws on relevant market areas (RMA) in over 10 different states and argued for, or acted as a consultant on, RMA issues in more than 20 states.
Litigation	• The Firm has litigated on behalf of auto dealers in Federal and in state courts, as well as in administrative forums. ◆ Issues covered include dealer terminations, audit charge backs, management and dealer succession turndowns, additional points of sale protests, violations of dealer agreements, exclusive use agreements, site control agreements, business plan agreements, facilities agreements and captive finance agreements.
Terminations	• Myers & Fuller has represented franchised dealers threatened with termination in both Federal and in state courts. • Termination issues that the Firm has represented dealers on range from failure to meet performance standards to warranty audit charge backs. Additionally, the Firm has represented dealers threatened with termination for dualing, not dualing, relocating, not relocating and refusing to provide factory image facilities or to follow proposed "channel strategies." ◆ When judicial remedies were not available or warranted, its attorneys have represented dealers before New Motor Vehicle Commissions, Departments of Motor Vehicles or Departments of Transportation, Divisions of Administrative Hearings, various factory Alternate Dispute Resolution Boards and third party arbitration/mediation panels.
Factory Audits	• The Firm represents dealers in all manner of manufacturers' dealership audits including audits relating to warranty service, new motor vehicle sales and the finance and insurance practices of a dealer. This representation covers the spectrum from pre-audit preparation to the challenge of post-audit findings, conclusions and penalties recommended by factory auditors. ◆ Manufacturers exercise their contractual audit rights on an ever-increasing basis. In particular, the extrapolation based warranty audit has become a powerful revenue tool and "charge backs" are collected from open accounts in many instances, without the opportunity for meaningful dealer input.
Ownership Transfers & Change of Management Turndowns	• Myers & Fuller has represented both buyers and sellers ... public and private corporations ... in turn downs of proposal transfers (both stock and asset transfers) and/or in matters involving proposed changes of executive management. This representation has been before Federal and state courts, administrative hearing agencies and mediation/arbitration panels. • The Firm has represented dealers seeking damages (lost profits or lost blue sky) as well as dealers seeking specific performance (requiring factories to accept the buyer). "Turn down" litigation generally consists of analyzing the qualifications of a buyer as well as interpreting what the state franchise laws in the home state of the seller require of a factory in reviewing a proposed transfer or ownership or change in executive management.
Franchise Law	• Myers & Fuller has assisted various state automobile dealer associations with drafting franchise laws. ◆ Members of the Firm have also testified before many state legislatures advocating dealer-favorable new legislation.

Dealer Concerns	***TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS*** ***At the NADA Convention ... Orlando, Fla. ... February, 2006***
ACURA	1. Develop a clear brand image. 2. Get more new products. 3. Keep the sales momentum going.
AUDI	1. Continue to increase dealer profitability with better trading margins and better leases. 2. Increase marketing to gain share. 3. Launch the *Q7* successfully.
BMW	1. Improve retail profitability. 2. Get the right models in the right numbers. 3. Hire the best salespeople, technicians and support employees.
BUICK	1. Get more new and distinctive products. 2. Ensure long-term viability of the brand. 3. Move more aggressively with implementation of the channel strategy with *Pontiac* and *GMC*.
CADILLAC	1. Reposition and market the *SRX* better. 2. Launch the V-series performance vehicle and *Escalade* SUV successfully. 3. Provide premium service, sales and branding of products.
CHEVROLET	1. Improve dealers' return on investment. 2. Gain market share and continue to beat *Ford*. 3. Get more vehicles to compete in the marketplace.
CHRYSLER-JEEP	1. Boost dealer profitability 2. Ensure a flow of hot products, competitively priced. 3. Craft marketing messages that attract import buyers.
DODGE	1. Improve dealer profits. 2. Create marketing that draws in customers who are new to Dodge. 3. Increase retail service business at dealerships.
FORD	1. Improve dealer profitability. 2. Get hot new product. 3. Push for quality gains.
HONDA	1. Have more space for service and parts facilities to serve customers better. 2. Continue to make sure *Honda* knows what dealers and customers need. 3. Improve dealer profitability.
HUMMER	1. Maintain a premium-brand image. 2. Continue the off-road Hummer Happenings consumer-event program. 3. Keep pushing until every *Hummer* dealership has a stand-alone *Hummer* showroom and service write-up area.
HYUNDAI	1. Dealer profitability. 2. Strong product launches. 3. Dealer incentive programs.
INFINITI	1. Improve profitability. 2. Reduce vehicle inventory. 3. Get more new product.
ISUZU	1. Get more products. 2. Get *Isuzu* dealers more engaged in the franchise. 3. Make diesel engines available.
JAGUAR	1. Dealer profitability. 2. Tell dealers which features will be on which vehicles in certain countries. 3. Prepare dealers for Jaguar's move upmarket.
KIA	1. Replace the *Circle of Excellence* program. 2. Get programs to help dealers put deals together for customers with poor credit. 3. Get word out that *Kia* quality is improving.
LAND ROVER	1. Make sure the allocation is balanced. 2. Keep quality. 3. Price vehicles competitively.

Dealer Concerns	TOP ISSUES & DEALER CONCERNS FROM DEALER MAKE MEETINGS At the NADA Convention ... Orlando, Fla. ... February, 2006
LEXUS	1. Use incentives when needed to keep *Lexus* competitive. 2. Manage growth so that as volume climbs, customer service doesn't suffer. 3. Add sports car and superluxury sedan.
LINCOLN MERCURY	1. Increase dealer profitability. 2. Improve flexibility and long-term outlook of sales and marketing programs. 3. Align local and factory advertising.
MAZDA	1. Focus marketing efforts on new products. 2. Develop a stronger dealer voice in product development. 3. Support U.S. management team.
MERCEDES-BENZ	1. Find ways to increase dealer profitability. 2. Keep improving quality. 3. Make parts available in 1 or 2 days.
MITSUBISHI	1. Spend more on advertising. 2. Be more consistent with ad spending. 3. Shrink the dealer body.
NISSAN	1. Successfully introduce new sedans this year. 2. Maintain service quality levels, despite rising sales. 3. Continue to improve dealer profitability.
PONTIAC - GMC	1. Launch products flawlessly. 2. Give the dealers more say in local marketing groups' creative work. 3. Hire a new public relations team at GM or outsource PR.
PORSCHE	1. Increase brand and model awareness. 2. Invest more money in marketing. 3. Update the *Cayenne* SUV.
SAAB	1. Get a 7-passenger vehicle. 2. Clarify what GM thinks of investor Kirk Kerkorian's idea of killing *Saab*. 3. Get the lowdown on the *9-5*'s replacement.
SATURN	1. Launch each *Saturn* vehicle on time and with high quality. 2. Create a marketing strategy for new vehicles that connects with the public. 3. Ensure that *Saturn* retailers have enough sales and service help to handle increased volume.
SUBARU	1. Maintain dealer new-car profitability. 2. Step up advertising and marketing. 3. Shorten product cycles.
SUZUKI	1. Raise *Suzuki's* auto image to the level of its motorcycle image 2. Have a captive finance company that can provide capital loans and floorplanning for dealers. 3. Double or triple sales per dealership.
TOYOTA	1. Long-term profitable growth. 2. Combine quality with design passion. 3. Keep pricing in the heart of the market.
VOLKSWAGEN	1. Improve dealer profitability. 2. Strengthen *VW's* marketing presence. 3. Improve quality and launch exciting new vehicles.
VOLVO	1. Improve customer satisfaction. 2. Improve product quality to industry's best. 3. Get more bang for ad bucks.

GENERAL MOTORS ... WILL IT SURVIVE OR NOT?

TO BE ... or, NOT TO BE?

GM ... to be or not to be? ... will it survive or not survive? Those are the questions.

Hanging over the entire automobile industry is the question of whether General Motors will be able to survive the financial difficulties it has gotten itself into. Is it really possible that GM will not be able to survive? ... or that its filing for bankruptcy is just a matter of time?

For many at the 2006 NADA Convention, these unspoken questions were weighing heavily on their minds. But you'd never know it by looking at GM's exhibit or by talking to most people connected with the industry.

The February 20, 2006 issue of *Fortune* magazine featured an article by one of *Fortune's* most prestigious editors, Ms. Carol J. Loomis. Her article, entitled "The Tragedy of General Motors," came right to the point in bold print on the first page ....
It's heading for a wreck."

Ms. Loomis gives an uncompromisingly hard look at the bleak financial picture that is General Motors. An earlier article in *Fortune* (September 19, 2005) describes her unparalleled credentials and experience as an analyst ... see "My 51 Years (and counting) at *Fortune*."

That article, in itself, is an education for any long-term reader of *Fortune* and I recommend it highly to you. You might want to read it if for no other reason than to assure yourself that Ms. Loomis' analysis of General Motors' current situation is the product of the highest level of analysis and observation.

I want to try to summarize Ms. Loomis' article here and add a few observations of my own. Several related developments have already occurred since the publication of her article in *Fortune*. These include the filing for bankruptcy by Dana Corp.–another major supplier of automotive parts, GM's reduction of retirement benefits for salaried employees, GM's attempt to sell a major block of its investment in Suzuki, GM's attempts to sell a portion of its investment in GMAC, GM's restatement of 2005 earnings to further increase its reported loss and its announcement that earnings for the period from 2000 forward will be restated (downward) as a result of recently discovered accounting errors. All of these fit somewhere into the big picture of what years from now will be seen as contributing to the "fate of General Motors."

The Realities Of The Current Situation

Some of Ms. Loomis' observations ... the grim realities ... are below. Some of these result from decades of decisions by former GM CEOs to trade off "a certain amount of wage restraint from the union–and labor peace for their own terms of office–by granting retiree health benefits that had neither large, immediate cash costs nor, under the accounting rules then applying, much effect on the bottom line."

Ms. Loomis points out that the annual effect on GM's bottom line is that these retiree health costs add about $1,300 to the cost of every car and truck GM makes in the U.S. (Talk about a competitive disadvantage, especially against the likes of Honda, Toyota and Nissan.) →

How Bad Is It?

G-RI-M REALITIES ... "It's Heading for a Wreck"

- *In losing $8.6 billion last year, GM was not very successful in offsetting North American losses with overseas profits. (Note, since this article was published in Fortune, GM has increased its reported loss for 2005 by $2 billion up to $10.6 billion, and announced that it intends to restate its earnings from 2000 through the first quarter of 2005 as a result of recently discovered accounting errors.)*
- *GM's product mix "is on the wrong side of gas prices," being heavily weighted towards trucks, pickups and SUVs.*
- *GM's finance subsidiary, General Motors Acceptance Corporation or GMAC, probably should be sold ... but finding a buyer will not be easy for GM.*
- *GM is "inextricably entangled in the bankruptcy of its biggest supplier, Delphi ... in that imbroglio, as in countless others, it is up against a formidable and sometimes militant union whose ability to accept the full reality of GM's problems is not assured."*
- *GM is burdened by health costs "which it supplies for a population bigger than Detroit's - for a total of 1.1 million employees, retirees and dependents." At the end of 2005, this retiree health burden, totaling $64 billion, was unfunded.*
- *$1,300 is added to the cost of every car and truck that GM makes in the U.S. as a result of these retiree health costs.*

"In character, today's GM is a weird and painfully scarred combination of businesses. It is a car company doing poorly, and it is an insurance company engulfed by obligations way beyond its ability to pay. Such an enterprise probably cannot escape bankruptcy. The securities markets flash their warnings with regularity ... "

In looking for something optimistic to report, Ms. Loomis says it's important to remember that giant auto companies have been turned around before (think Chrysler/Lee Iacocca and Nissan/Carlos Ghosn). She adds, however, those rescue jobs "surely pale in comparison to what it would take to turn around General Motors." Consider, for example, the fact that in the first 50 years *Fortune* magazine was compiling its "*Fortune's 500*" list, GM ranked number one on that list in 37 out of 50 years.

The JOBS Bank ... and the "Rubber Room"

In her article, Ms. Loomis describes GM's efforts to accelerate product introductions. But even she points out that she is merely quoting what Rick Wagoner has been saying all along to try and appease the public. Her analysis of GM's cost-cutting efforts is especially interesting in the part where she talks about GM's attempts "to free itself at least partially from the nearly un-American *JOBS* bank." Under this GM-UAW creature, laid off union members get paid for not working.

Her article quotes another source in estimating that there may be 5,200 employees in the *JOBS* bank at the end of 2005 and an estimated cost of each member in the *JOBS* bank as "at least $100,000" to GM annually.

A more recent article in *The Wall Street Journal* (March 1, 2006) provided an in-depth look at the *JOBS* bank. In my opinion, this explains, in part, why GM is in its current deplorable situation. The *JOBS* bank is a program almost 20 years old "under which nearly 15,000 auto workers continue to get paid after their companies stop needing them. To earn wages and benefits that often top $100,000 a year, the workers must perform some company-approved activity. Many do volunteer jobs or go back to school. The rest must clock time in the rubber room or something like it. It is called the rubber room ... because a few days in there makes you go crazy."

Further on this subject, NADA reported (on March 9, 2006) that GM's *JOBS* bank has grown to about 8,000 workers nationwide. And, it should be remembered that the number of employees in the *JOBS* bank is likely to increase in some proportion if GM introduces any further cuts in its production facilities employing union workers.

Franchise Law Restrictions

Getting back to Ms. Loomis' article, she comments that in the U.S., GM cannot easily reduce the number of dealer franchises because of various state laws. [This subject was prominently discussed at Myers & Fuller's seminar which brought out the point that by going into bankruptcy, GM could easily accomplish a significant reduction in its dealer body ... with the permission of the judge in bankruptcy. For more on that, see page 19 of this issue.]

One GM executive is quoted in her article as saying that the cutting up of each independent dealer is like a "*little soap opera*," ... "in which entrepreneurs, in some cases with kids they expect to inherit their business, give up their turf by inches."

Cost-Cutting Doesn't Change the Need for Revenue Growth

It remains to be seen just how effective the newly appointed GM executive responsible for cost-cutting, Frederick Henderson, a/k/a "Chainsaw Fritz," (think Sunbeam, et. al. here) will be. He certainly has got his work cut out for him. More significant is the observation that ... "no companies have ever turned around because of cost cutting alone. The essential partner is revenue growth–and as those losses in market share show ... in product design, it (GM) lost the magic long ago."

In recalling some of the poorly designed interiors of GM vehicles, one reporter said "some of GMs used to be grotesque" and said ... "I miss those bad fits, those gaps ... I used to store my quarters for tolls in those." Obviously, that was in the days before I-Passes were developed for toll ways.

Add another concern, namely the enormous "perception problem." This may be described as the belief held by many U.S. consumers that GM doesn't make cars as reliable as those of foreign producers. In elaborating on this, Ms. Loomis references *Consumer Reports*, J.D. Power rankings and comparisons with Toyota, whose Camry seems to be inferior in performance rating comparisons to GM's Chevy Malibu, and which costs $2,640 more than the Malibu. Despite the Malibu being less expensive (cheaper), ... "customers shrug their shoulders and keep on buying (Toyota's) Camrys–their memories are long, and their motivations for returning to GM small."

One cogent summary is that GM's sales problem is that even though its vehicles "don't break like they used to ... nobody will buy them." Despite successive incentive programs over the years ... Keep America Rolling, "employee discount" programs and "selling

see **GM SURVIVAL**, page 28

 (Continued from page 27)

the product, not the deal" ... GM's overall sales efforts still have been unsuccessful.

It is reported that as part of its new marketing program, GM is planning to cut back on its large-scale sales to rental companies. Rental companies usually buy at significant discounts. They also tend to "quickly flip their vehicles into the resale market and thereby hurt the residual values of GM cars."

GM Liquidity Issues ... is Selling GMAC a Solution?

Although GM's balance sheet at year-end 2005 showed \$20.5 billion in liquid assets, did you know that on any given day GM needs a minimum of at least \$5 billion just to operate? And some people estimate that minimum amount to be closer to \$10 billion.

In discussing GM's captive finance subsidiary, Ms. Loomis points out that GMAC is a well run company with good earnings and profits and an impressive balance sheet of its own. Nevertheless, GM may have to sell GMAC to save itself. But here's the rub ... "GMAC's credit ratings are linked to GM's and therefore, have been repeatedly lowered. This means GMAC is no longer welcome ... in the commercial-paper market which is in effect a deep-pocketed bank with good interest rates. So GMAC has been funding itself more expensively, by selling off its loans or borrowing against them."

Complicating the potential sale of less than 100% of GMAC is the likelihood that a prospective buyer would have to speculate on what might happen if it did purchase a less than 100% ownership position in GMAC and then its co-owner, General Motors, went bankrupt.

"Equality of Sacrifice" Issues

There is much discussion about the need for GM to reduce compensation costs for its non-union constituencies ... so-called "equality of sacrifice." GM directors annually earn \$200,000 each, but they are required to put 70% of that or \$140,000 into GM stock. The recent departure of one director, it was observed, could "possibly qualify as shrewdest move by a director in 2005." It was also interesting to learn from the article that Mr. Wagoner, the current CEO, is required to invest seven times the amount of his 2004 base salary (\$2.2 million) in GM stock (\$15.4 million).

The article talks about the ramifications of either reducing or totally eliminating GM's dividend payments to shareholders. As long as GM pays a dividend, shareholders are at least getting something in return for their investment; if GM declares bankruptcy, shareholders would get nothing. Not reducing its dividend rate would put GM in a even greater bind in attempting to discuss wage and/or benefit concessions or "*givebacks*" with its union constituencies.

To keep matters in perspective, it should be noted that totally eliminating GM's dividend would not even cover one-fifth of GM's annual spending for health care. In fact, recently GM reduced its annual dividend rate by 50% from \$2.00 to \$1.00 per share.

GM's "Indenture" to the UAW

Ms. Loomis also discusses GM's precarious relationship with the UAW in which "the union's leverage over GM affects everything that the company tries to do in cost-cutting."

She observes: "The truth is that GM is essentially indentured to the UAW because of the union's power to strike." In discussing GM's quandary in how far it can or might try to push the union for *givebacks*, another analyst is quoted as saying that if you push the union too far ... "you'll be building cars with three wheels. At the end of the day, these guys you're dealing with are the ones who build your products."

Who Really Owns GM? ... Hint ... It's Not the Shareholders!

Here, Ms. Loomis is really at her best.

"To that sign of bondage (i.e., GM's indenture to the UAW), add another ... GM's hourly and salaried employees, present and past, essentially own this company." Ms. Loomis' analysis indicates that as of the last date for which figures were available–year-end 2004–GM had banked \$119 billion for its employees. Compare that with GM shareholders who "recently owned their grubby \$13 billion in market value.

"This is a bizarre, Alice-in-Autoland result from 98 years in which capitalism supposedly reigned."

Entanglement with Delphi

Ms. Loomis also analyzes GM's entanglement in the bankruptcy of its biggest supplier, Delphi. This company was owned by GM until it was spun off in 1999. As part of that spin-off years ago, GM agreed to be contingently liable for Delphi's post-retirement benefits (mainly pension and health) owed to certain employees if Delphi ever failed to provide them.

Delphi's liability has been estimated (Ms. Loomis prefaces the amounts as "the latest oracular word on Delphi") at between \$3.6 billion and \$12 billion. It is possible that the more or most probable figure for this liability would be toward the low end of that range. However, if GM's liability should be at the higher end of the range, that–by itself–almost equals the \$13 billion amount of GM's market value for shareholders.

→

And note, that $13 billion shrunk by $2 billion when GM corrected its 2005 loss from $8.6 to $10.6 billion in mid-March.

In a still broader context of parts suppliers relating to GM, Delphi Corp. had been preceded in filing for bankruptcy protection by Tower Automotive and by Collins & Aikman Corp., two other large parts suppliers. More recently, Dana Corp. filed for Chapter 11 protection and one industry observer notes that at least two or three more global parts suppliers will likely file for bankruptcy protection in the coming months.

How all of these mini-dramas will play out and impact GM over the summer months remains to be seen. This almost rivals the now-playing Enron saga.

Should GM Just Bite the Bullet Now?

In bringing her article to conclusion, Ms. Loomis discusses the pros and cons of GM taking action now (sooner, rather than later) to file for bankruptcy protection. One advantage if it were to do so could be that it might reduce its liabilities to a more manageable size and thereby possibly enhance its likelihood of emerging from bankruptcy as a viable entity.

Organizations in bankruptcy usually find that the bankruptcy courts help them negotiate higher prices on contracts and/or give them somewhat greater leverage in potentially rejecting suppliers' pressures to get higher prices. Furthermore, the indirect threat of union strikes, as these companies in bankruptcy seek to shrink their labor costs, has significant ramifications on the assumption that if prices with suppliers can be negotiated satisfactorily, then an unbroken stream of product will automatically follow.

On the other hand, the downside (to GM declaring bankruptcy sooner, rather than later) includes the fact that a significantly large number of people have already bought GM vehicles, and their warranty protection periods are very important to them. Current and prospective buyers expect that uncomplicated warranty service will be available in connection with their vehicles. Ms. Loomis observes that "a buyer just might avoid any company in bankruptcy. And avoidance is hardly what GM needs; it's already had enough of that."

Will the Federal Government Bail Out GM?

Last but not least, Ms. Loomis raises the possibility of a bailout by the U.S. government. Will Uncle Sam try to save GM ... like it did Chrysler years ago? What might be the economic ramifications? What might be the political implications? All of this, too, remains to be seen, but more likely over a period much longer than the summer months.

The article concludes by quoting an anonymous GM dealer who says "I can't really believe that the people who got GM into this mess are going to be the people who can get GM out."

What Do You Make of All This?

Are you a gambler? Or possibly one of those financial planners/astute investors? After reading this article, would you invest a significant amount of your own money in GM's stock at today's prices? If not, why not do so anyway and sell short?

This is more of an observation, than a prediction. But I can't help being reminded of one of Johnny Cash's top hits ... *"One Piece at a Time."*

It tells, with a great rhythm and beat ... and a fabulous chorus ... of a guy who left Kentucky back in '49. He went to Dee-Troit to work on a GM assembly line, putting wheels on shiny Cadillacs.

He always wanted one of those beauties that was long and black. So he devised "himself" a plan. He'd sneak out all of the parts he needed in his lunch box. He figured "I'd have it all by the time I retired and GM wouldn't miss just one little piece ... especially if I strung it out over several years."

All went well. The first day he snuck out "a lunch box full of gears." Then, the fuel pump, engine, trunk and transmission ... and all the chrome. The little things he could get out in his big lunch box ... like nuts, and bolts, and all 4 shocks. The big stuff, he snuck out in his buddy's mobile home.

Some time later, our friend finally got around to putting all of the pieces together. He had three headlights, "two on the left and one on the right," but when he pulled the switch, all three of them came on. One rear tail fin, instead of two. (You get the picture here.)

When he drove his wife uptown to get the tags for the vehicle he put together "one piece at a time," envy was not the emotion he inspired from folks laughing for blocks around.

Well, maybe that vehicle resembles what GM looks like today ... something unrealistically put together "one piece at a time" and which now seems to have little semblance of form, functionality or future in today's brutally competitive global automotive marketplace.

Monthly Newsletter	***THE WHEELS OF JUSTICE*** ***Published by Myers & Fuller, P.A.*** ***Page 1 of 2***
Highlights From the Jan. 2006 Issue	• One of the objectives of *The Dealer Tax Watch* is to alert you to Dealer/CPA resources that will help you maintain a general awareness of what is going on in the industry. • *The Wheels of Justice*, a monthly newsletter, discusses current issues and how they impact dealers and dealer associations. • The January, 2006 issue is typical of the range and depth of coverage of dealer-related topics each month. • ***The five articles that appeared in the January, 2006 issue are summarized below.*** • For a sample issue, or to subscribe, contact Myers & Fuller directly at 2822 Remington Green Circle, P.O. Box 14497, Tallahassee, Fla., 32308 ... phone (850) 878-6404 ... fax (850) 942-4869.
"More Factory Horror Stories" ***#1***	• There are three underlying key trends or pitfalls that are creating horror stores for dealers in their dealings with factories. ◆ Trusting the word of a zone manager that a potential buy/sell deal will meet Factory approval is dangerous for dealers. ◆ Factories are changing the metrics they use to evaluate existing stores - part of an effort by financially and sales-troubled factories to either eliminate small dealers or consolidate metro-area stores. ◆ Up-and-coming factories are working to maintain high, average volume levels at stores and to eliminate smaller, rural dealerships. • The three-point ***Article Summary*** is below: ◆ Prevent your buy-sell from becoming a horror story by writing a confirmatory letter to memorialize any oral representations from zone managers or factory employees that you rely on concerning factory approval of the buy-sell. ◆ Know your state laws and the protections they afford. ◆ Pay close attention to any changes that the factories make in how your sales performance is evaluated. • This article contains several recommendations. One was to conclude responses that are sent to the Factory "by stating that if there is anything in the letter that the Factory employee does not agree with, then the Factory employee should respond in writing immediately."
Tips to Ensuring an Organized Buy-Sell Agreement ***#2***	• The four-point ***Article Summary*** is below: ◆ A seller and buyer must understand what they are agreeing to in a buy-sell contract. ◆ Each buy-sell agreement should begin by identifying the parties and describing the proposed transaction. ◆ Buyers should discuss with their legal counsel the need to include the seller's shareholder(s) in the buy-sell agreement. ◆ A well-constructed buy-sell agreement should contain a number of sections, each of which address an important component of the transaction. • The article includes "pointers" on how to craft a cogent buy-sell contract, paying particular attention to three areas ... the opening, addressing shareholders and allocating risks. • The article states that each buy-sell agreement should contain a minimum of the following parts: ◆ A definition section. ◆ A detailed description of the transaction (i.e., what specifically is being sold and purchased). ◆ The purchase price section. This section details the pricing of each of the items being sold, as well as any prorations and allocations to which the parties agree. ◆ A section describing any deposit being posted by the buyer and its disposition. ◆ A section setting forth the date and place of closing and providing for any post-closing agreements between parties. ◆ A section enumerating each parties' respective contingencies for performing. ◆ A clear description of the deliveries that are to be made at closing by each party. ◆ Sections setting forth the warranties and representations of the seller and buyer. ◆ An indemnification section. ◆ A section containing various sub-agreements between the parties that relate to the transaction. ◆ A section providing for the termination of the agreement and disposition of the deposit. ◆ A section containing miscellaneous terms (sometimes called "boilerplate").
OSHA - ADA Update ***#3***	• This article examines the subject of dealership Right to Know Training. • In addition, in discussing ADA (Americans with Disabilities Act) requirements, the article suggests how dealers can comply in a practical way with the requirement that dealers should have hand controls available for all test/demonstrator drives.

Monthly Newsletter

THE WHEELS OF JUSTICE

Published by Myers & Fuller, P.A.

Franchise Law Protections ... Restrictions on Additional Points of Sale #4

- This article is part of a series of articles dealing with critical provisions that should be contained in each state's franchise law protection for dealers. The article in the January, 2006 issue discusses protections from the addition by the manufacturer of a same linemake dealership within the dealer's market area.
- The ***Article Summary*** for this two-part article (the remainder comes in a subsequent issue) is as follows:
  - Protection from factories' adding a dealer to your market is more important now than ever.
  - An add point protection must include adequate definition of what qualifies as a protestable add point.
  - An add point protection must include an adequate definition of which existing dealers may protest the proposed new dealership.
  - A proper add point provision must include a notice provision which provides all dealers with more than sufficient time to protest the addition of a new dealership.
- Every "add point" protection must consist of the following:
  - The right for an existing dealer to protest any proposed add point,
  - Adequate notice of such an add point,
  - A "stay" of the add point while a protest is pending, and
  - Detailed criteria by which a decision-maker (administrative judge, for example) can balance the need for the new point with the harm it might cause to the existing dealer.

Your Role In Reducing Identity Theft Risks ... Complying with the FTC's Final Disposal Rule #5

- In connection with the FTC's requirements for disposition of consumer reports and records (derived from consumer reports), ***the Final Disposal Rule took effect on June 1, 2005.***
  - Dealers are now under several obligations to properly dispose of such information "by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal."
- The three-point ***Article Summary*** follows ...
  - Dealers must comply with the FTC's Disposal Rule (part of the Fair and Accurate Credit Transaction Act), which addresses how to dispose of documents and data containing consumer information.
  - The Rule requires following reasonable standards for educating employees about records disposal, and enduring vendors understand their obligations.
  - Disposal Rule compliance should not create significant additional compliance costs for dealers who already comply with the FACT act.
- Here are some examples of reasonable measures that a dealer should use to guide his/her compliance efforts:
  - Burning, pulverizing or shredding papers containing consumer information so they cannot practically be read or reconstructed.
  - Destroying or erasing electronic media containing consumer information so that it cannot be read or reconstructed.
  - After due diligence, entering into (and monitoring compliance with) a contract with a records disposal company that requires it to dispose of your consumer information in accordance with this Rule.
    - ***Note ...*** The owner of the consumer information ***and*** the disposal company are both responsible for its proper disposal.
  - Identifying consumer information (so it can be protected) when providing it to a records disposal company, another service provider or an affiliate.
  - Incorporating proper procedures for disposing of consumer information into your written information security program, which is required for business that must comply with the FTC's Safeguards Rule.

The Wheels of Justice

Volume 2, Issue 1 • January 2006

The Monthly Dealer Legal Newsletter compiled by "The Dealer's Law Firm," Myers & Fuller

Premium AdvantEdge

Vol. 1, No. 1 Your Objective Insurance Information Source www.pa-llc.com

The Source

Premium Advisors knows it's tough all over, and nowhere is it tougher than in the automobile industry–one of your key clients. The auto industry is experiencing serious financial problems, and the experts indicate these difficulties will continue for at least another year–and probably longer.

Auto dealers continue to see their margins dwindling while their expenses just keep growing. Finding ways to save real dollars is often your biggest job as an auditing and accounting firm serving these dealerships.

That's why we've created *Premium AdvantEdge*. Each quarter, we'll offer tips you can use to help your auto dealer clients make the most of their life insurance programs.

This first edition of *Premium AdvantEdge* focuses on two programs that can save your dealer clients a significant amount of money year after year. The first program can dramatically reduce the current annual premium on a "rated" life insurance policy (see "Exchange Programs") while the second is designed to maximize the legacy a dealer's family will receive from his profit sharing, 401(k) and IRA plans at his death (see "Passing On").

The strategies in *Premium AdvantEdge* are tried and tested and proven to work–and we're offering them to you in this complimentary newsletter.

If you have any questions or comments about any of the articles in *Premium AdvantEdge*–or if there's a topic you'd like to see *Premium AdvantEdge* tackle in the future–please contact Tony Freeman at 312-807-3700, tony@pa-llc.com, or visit the website at www.pa-llc.com.

Exchange Programs: Trade Up Your Insurance

It turns out automobiles aren't the only thing you can trade in–and, more importantly, trade up.

Many dealers have life insurance policies that were issued on a special class or "rated" basis.

This means the premium they pay includes an additional charge for a medical condition that existed at the time the policy was obtained.

Dealers that qualify can reduce their annual outlay for their coverage by as much as 50%

These extra charges can often be reduced or eliminated by taking advantage of an underwriting technique called "table shaving."

Several major players in the life insurance industry currently offer exchange programs that result in substantial premium reductions when a rated policy is exchanged for a new policy that provides the same benefit–and it doesn't require any major lifestyle changes, such as quitting smoking.

The new policy is issued on a standard basis even though the insured's medical condition has not improved.

Dealers that qualify can reduce their annual outlay for their coverage by as much as 50%.

And the dealer receives the commission and annual renewal fees on the new policy if he has an insurance agency in place at the time of the exchange.

Now that's what we call a real trade-in value.

Take A Pass On Taxes To Pass On Your Legacy

Many of your older clients soon will reach the age at which "minimum distributions" must be disbursed from their profit sharing, 401(k) and IRA accounts–and the same is true for certain life insurance policies, as well.

The impact of taxes can reduce the amount of an inheritance by 70%

In addition to the current income tax due each year, qualified plan assets are also subject to both income and estate taxes at the participant's death. The impact of these death taxes can reduce the amount the dealer's family inherits by as much as 70%. But there is a way to make sure your client's legacy reaches its heirs intact.

It is possible to substantially reduce or even eliminate the effect of these death taxes by restructuring the dealer's current retirement accounts.

A new program jointly developed by Premium Advisors in partnership with an actuary provides you and your client with a "before" and "after" comparison of the amounts received at different points in the future by the family.

Don't let taxes come between your client and his family.

For more information contact Tony Freeman at tony@pa-llc.com, 312-807-3700 or visit www.pa-llc.com.

ENERGY POLICY ACT OF 2005
IRC §30B and NOTICE 2006-9

IRS

Alternative Motor Vehicle Credit

Automotive Alert

Motor Vehicle Technical Advisor

January 2006

Introduction

The Energy Policy Act of 2005, signed by President Bush on August 8, 2005, contained several incentives intended to encourage taxpayers to make energy conscious purchases. The Act includes credits to improve the energy efficiency of existing homes such as credits for qualifying insulation systems, windows, doors, roofs, hot water heaters, furnaces, etc. The Act also provides a credit for taxpayers who purchase or lease energy efficient vehicles. Internal Revenue Code § 30B provides for the new Alternative Motor Vehicle Credit and is effective for vehicles placed in service after 12-31-2005. Expiration of the provision depends on the type of vehicle in question and varies from December 31, 2009 to December 31, 2014. The deduction allowable for certain hybrid vehicles under IRC §179A is no longer available for vehicle purchases after December 31, 2005.

Credits

IRC §30B potentially allows a credit for four separate categories of vehicles; (1) **Fuel Cell vehicles**, (2) **Advanced Lean Burn Technology vehicles**, (3) **Hybrid vehicles**, and (4) **Alternative Fuel vehicles.** The code section is complex and it is likely that the IRS and Treasury will at some point issue regulations. Currently, guidance on certain provisions has been issued in Notice 2006-9 (see below for additional information) and additional guidance is anticipated. Generally, the credits are comprised of two parts, a base amount and a second amount based on the vehicle's relative fuel economy rating or environmental rating. In all cases, credits are available for a vehicle, the original use of which commences with the taxpayers, made by a manufacturer, and that is acquired for use by the taxpayer and not for resale. The credit is an election but taxpayers that take advantage of the credit are required to reduce the basis of vehicles for which the credit is taken. In order to take advantage of the credit, taxpayers will be required to complete and attach to their income tax return a new form. At this time, the form has not been finalized.

Fuel Cell Vehicles

Qualified **Fuel Cell Vehicles** are defined as a motor vehicle that is "propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel ...stored on board the vehicle...." Qualified vehicles must also meet certain requirements of the Clean Air Act.

Credits for Qualified Fuel Cell Vehicles (IRC 30B(b)) depend on the gross vehicle weight of the vehicle and range from $8,000 for qualifying vehicles with a gross vehicle weight of less than or equal to 8,500 pounds to $40,000 for qualifying vehicles with a gross vehicle weight of more than 26,000 pounds. The initial credit may then be increased by up to $4,000 depending upon the vehicle's fuel economy as compared to a similar vehicle's fuel economy in 2002.

Advanced Lean Burn Vehicles

Advanced Lean Burn Vehicles are defined as a passenger automobile or light truck "...with an internal combustion engine which... is designed to operate primarily using more air than is necessary for complete combustion of the fuel...." The

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vehicle must also incorporate direct injection and must meet certain fuel economy standards and requirements of the Clean Air Act. The credit for an Advanced Lean Burn vehicle is based on relative fuel economy of the vehicle as compared to a 2002 model year vehicle. The base credit amount ranges from $400 for a vehicle that achieves a fuel economy of at least 125% but less than 150% of the 2002 model year city fuel economy to $2,400 for a vehicle that achieves at least 250% of the appropriate 2002 fuel economy amount. The base credit may be increased by $250-$1,000 based on the vehicle's lifetime fuel savings.

Hybrid Vehicles

The credit for qualified **Hybrid Vehicles** differs for passenger automobiles or light trucks and other hybrid vehicles. For passenger autos and light trucks (gross vehicle weight of not more than 8,500 pounds), the base credit and the increase to the base credit amount is determined in the same manner as if the credit were for an Advanced Lean Burn Vehicle, e.g. based on incremental fuel economy over 2002 standards and lifetime fuel savings.

For qualified hybrid vehicles that are not passenger vehicles or light trucks, the credit is a percentage based on the vehicle's incremental hybrid cost and relative fuel economy. The incremental cost is the difference between the cost of a particular hybrid vehicle and the cost of a similar vehicle if it were not a hybrid. The incremental cost is limited based on the vehicles gross vehicle weight.

A qualified hybrid vehicle is defined as a vehicle which "...draws propulsion energy from onboard sources of stored energy which are both...an internal combustion or heat engine using consumable fuel...and a rechargeable energy storage system." The vehicle must also have received a certificate of conformity under the Clean Air Act and meet other specific criteria. As in the Advanced Lean Burn vehicle, credits can vary from $400 to $3,400 depending upon the vehicle.

Alternative Fuel Vehicles

Finally, the **Alternative Fuel Motor Vehicle Credit** is determined by applying a percentage to the incremental cost of any new qualified alternative fuel motor vehicle. Applicable percentages start at 50% and can be increased by 30% if certain Clean Air Act and other requirements are met. The incremental cost is limited based on the vehicle's gross vehicle weight.

Alternative Fuel is defined as "...compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85 percent of the volume of which consists of methanol..." The credit also applies to certain other "mixed fuel" vehicles.

Phase Out Provisions

IRC §30B also contains **a phase out provision** for both Hybrid and Advanced Lean Burn Technology vehicles. During the phase out period, the credit amount is reduced by 50% or 25%, and eventually eliminated entirely. The phase out period begins with the second calendar quarter following the quarter in which the number of qualified vehicles sold by a manufacturer after December 31, 2005 is at least 60,000. For instance, the applicable percentage is reduced by 50% for vehicles sold during the first two quarters of the phase out period, 25% for vehicles sold in the third and fourth quarters of the phase out period and eliminated for each subsequent quarter.

Notice 2006-9

Although some environmental and industry organizations have published estimated credits, particularly for hybrid vehicles, at this time there is no official recognition of any vehicle as qualifying for a particular credit nor the amount of the credit. On January 13, 2006, the IRS and Treasury provided guidance, **Notice 2006-9**, on a

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process that manufacturers can use to certify that a vehicle qualifies for the hybrid (passenger vehicles or light trucks only) or lean burn vehicle credit and the amount of the credit that a purchaser can claim. Similar guidance on a certification process for fuel cell vehicles, alternative fuel vehicles, and hybrid heavy trucks is anticipated in the near future.

Notice 2006-9 includes a discussion of several items in addition to the certification procedures including the potential qualification of vehicles with a gross vehicle weight in excess of 8,500 pounds. Although IRC §30B requires the use of the 2002 model year city fuel economy for passenger automobiles and light trucks, as defined by the Environmental Protection Agency (EPA), and provides tables of those amounts for passenger automobiles and light trucks, it does not include similar statistics for vehicles that exceed 8500 pounds. Since the EPA has not issued regulations defining vehicles with a gross vehicle weight in excess of 8,500 pounds, the Notice advises that such vehicles will not be treated as a passenger auto or light truck for the purposes of the credit.

In order for a manufacturer to certify to purchasers that a make, model, and year of a particular vehicle qualifies for either the hybrid or advanced lean burn credit and the amount of the credit, the manufacturer must submit, under penalties of perjury, a certification containing specific, detailed information outlined in the notice. Once the manufacturer has received an acknowledgement of the certification from the Service, a purchaser of the vehicle may rely on the manufacturer's certification regarding the vehicle's qualifications for the credit. A manufacturer that has received an acknowledgement from the Service must submit, under penalties of perjury, a quarterly report listing of the number of qualified vehicles by make, model, and model year, sold by the manufacturer to retail dealers. The Service will review and issue an acknowledgement letter to the manufacturer which will state whether purchasers may continue to rely on the original certification.

Finally, the Notice also addresses erroneous certifications and quarterly reports and reminds manufacturers that they could be subject to penalties for improper certifications or reports. The Notice also notes that the acknowledgement issued by the Service is not a determination that a vehicle qualifies for the credit or the amount of the credit. The Service may upon examination determine that the vehicle does not qualify or that the credit amount should be different. Any determination that a particular certification or report was erroneous will cause the Service to withdraw the acknowledgement and purchasers who acquire the vehicles subsequent to that withdrawal may not rely on the certification. Purchasers may continue to rely on the certification for vehicles acquired on or before the date of any withdrawal and the Service will not attempt to collect any understatement of tax attributable to the purchasers reliance on the original acknowledgement.

Conclusion

The Alternative Motor Vehicle Credit provides a new benefit to energy conscious taxpayers. However, the provision is complex and requires a proactive approach from the manufacturers of the fuel efficient vehicles. Notice 2006-9 is the first step in providing clarification to taxpayers and manufacturers. The Service is expected to issue additional interim guidance on Fuel Cell vehicles and Alternative Fuel Vehicles and to issue regulations at a later date.

If you have any questions on this or would like to discuss the issue, please contact Motor Vehicle Technical Advisor, Terri Harris at 616-235-1655 or Terri.S.Harris@irs.gov .

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4 New Credits	***MOTOR VEHICLE CREDITS … SECTION 30B*** ***CONDITIONS & LIMITATIONS*** ***Credit Applies to Vehicles Placed in Service After Dec. 31, 2005*** *Page 1 of 2*
Fuel Cell	***The New Qualified Fuel Cell Motor Vehicle Credit … Sec. 30B(b)***
Base Amount of Credit	• A new credit is available for a qualifying fuel cell motor vehicle, based on the schedule below: • ***Gross Vehicle Weight (GVW)*** — Credit ◆ Not more than 8,500 lbs. — $ 8,000 … if placed in service after Dec. 31, 2009, the credit is $4,000 — - ◆ More than 8,500 lbs. but not more than 14,000 lbs. — 10,000 ◆ More than 14,000 lbs. but not more than 26,000 lbs. — 20,000 ◆ More than 26,000 lbs. — 40,000
Additional Credit Based on Improved Fuel Economy Performance	• Fuel cell vehicles that meet the definition of either a passenger automobile or light truck will be able to claim an additional credit amount based on the increase in fuel efficiency over the ***"2002 city fuel economy"*** standards, based on the schedule below: • ***Percent (%) of 2002 Fuel Economy Needed to Qualify for Additional Credit*** ◆ At least 150% but less than 175% — $ 1,000 ◆ At least 175% but less than 200% — 1,500 ◆ At least 200% but less than 225% — 2,000 ◆ At least 225% but less than 250% — 2,500 ◆ At least 250% but less than 275% — 3,000 ◆ At least 275% but less than 300% — 3,500 ◆ At least 300% — 4,000 • The fuel economy benchmarks for autos and light trucks by weight class are in Sec. 30B(b)(2)(B).
Lean Burn Tech	***The New Advanced Lean Burn Technology Motor Vehicle Credit … Sec. 30B(c)***
Base Amount of Credit	• The base amount of this credit depends upon the extent to which the vehicle achieves additional fuel economy (expressed as a % of the 2002 model year city fuel economy as determined by the EPA). • ***Percent (%) of 2002 Fuel Economy Needed to Qualify for Additional Credit*** ◆ At least 125% but less than 150% — $ 400 ◆ At least 150% but less than 175% — 800 ◆ At least 175% but less than 200% — 1,200 ◆ At least 200% but less than 225% — 1,600 ◆ At least 225% but less than 250% — 2,000 ◆ At least 250% — 2,400
Additional Credit Based on "Conservation"	• The basic credit can be increased by a "conservation credit" which is measured by determining "lifetime fuel savings expressed in (in terms of) gallons of gasoline." ◆ At least 1,200 but less than 1,800 (gallons of gas) — $ 250 ◆ At least 1,800 but less than 2,400 — 500 ◆ At least 2,400 but less than 3,000 — 750 ◆ At least 3,000 — 1,000
Other Definitions & Conditions	• ***Lifetime fuel savings*** is defined as the excess of (1) 120,000 divided by the 2002 model year city fuel economy for the vehicle inertia weight class, ***over*** (2) 120,000 divided by the city fuel economy for the vehicle. • ***Combined Limitation*** … Both this credit and the new qualified hybrid motor vehicle credit are limited by the sum total of the number of units sold. ◆ The credit amounts will be phased out when a manufacturer of these vehicles certifies that it has sold a combined total of 60,000 of these vehicles for use in the United States after Dec. 31, 2005. ◆ For vehicles purchased in the calendar quarter that includes the date of the sale of the 60,000th unit, and the next calendar quarter, taxpayers will be allowed to claim the full allowable credit amount. ◆ The credit amount will then be limited to 50% of the allowable credit amount for vehicles purchased in the next two calendar quarters and thereafter to 25% of the allowable credit amount for vehicles purchased in the next two calendar quarters. The credit is disallowed for all cal. quarters thereafter. ◆ Controlled groups of corporations and related foreign corps are considered to be a single entity. • Provision is effective for vehicles placed in service after Dec. 31, 2005 and it terminates as of Dec. 31, 2010.

4 New Credits	**MOTOR VEHICLE CREDITS ... SECTION 30B** **CONDITIONS & LIMITATIONS** ***Credit Applies to Vehicles Placed in Service After Dec. 31, 2005*** *Page 2 of 2*
Hybrid M. V.	*The New Qualified Hybrid Motor Vehicle Credit ... Sec. 30B(d)*
Overview ... ***This Credit Defies Summarization***	• If the vehicle has a GVW rating of less than 8,500 pounds, this credit is similar to the Advanced Lean Burn Technology MV credit ◆ It consists of two components ... (1) fuel economy credit and (2) conservation credit ◆ The amounts of this credit are referenced to the amounts for the Advanced Lean Burn Tech. Vehicles • Different requirements for different vehicles, depending on the gross vehicle weight (GVW) rating ◆ If GVW rating of 6,000 lbs. or less, the vehicle must meet or exceed the Bin 5, Tier II emission standard established in the regulations under the Clean Air Act for that make and model year. ◆ If GVW rating of more than 6,000 pounds but not more than 8,500 pounds, the vehicle must meet or exceed the Bin 8, Tier II emission standard. • If GVW rating of the vehicle exceeds 8,500 pounds, the special rules in Sec. 30B(d)(2)(B) apply. ◆ Limitations on applicable percentages of achieved fuel economy within certain ranges. ◆ Limitations on amount of "qualified incremental hybrid cost" that can be taken into account, which are also graduated by GVW ratings.
Rules & Conditions Vehicles Must Satisfy	• Qualified sources of "on-board sources of stored energy." • Certification of conformity with Clean Air Act and equivalent qualification with California low emission vehicle standards. • "Maximum available power" depending on GVW rating. "The term 'maximum available power' means the maximum power available from the rechargeable energy storage system, during a standard ten second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine." • Must use (i.e., run on) specifically defined "consumable fuels." • For more information on these, see Sec. 30B(d)(3).
Alternative Fuel	*The New Qualified Alternative Fuel Motor Vehicle Credit ... Sec. 30B(e)*
In Order to Qualify	• Original use of vehicle must commence with the taxpayer. • Vehicle must be acquired for use or lease, but not for resale. • Vehicle must be capable of operating on an alternative fuel (as specially defined). • Vehicle is made by a manufacturer.
"Incremental Cost" for Purposes of Credit	• The amount of the credit is determined by multiplying an "applicable percentage" by the ***incremental cost*** of any new qualified alternative fuel motor vehicle. • ***Incremental cost*** is defined as the ***excess of*** (1) the manufacturer's suggested retail price (MSRP) for the vehicle, ***over*** (2) the MSRP for a gasoline or diesel fuel motor vehicle of the same model. ◆ ***However***, the amount of the excess that can be considered for this credit is limited to (i.e., it cannot exceed) an amount based on the GVW rating of the vehicle. ***GVW Rating of Vehicle and Maximum Amount of Excess that can be Considered for the Credit*** ◆ Not more than 8,500 pounds. — $5,000 ◆ More than 8,500 pounds, but not more than 14,000 pounds. — $10,000 ◆ More than 14,000 pounds, but not more than 26,000 pounds. — $25,000 ◆ More than 26,000 pounds. — $40,000
Credit Consists of Two Parts	• ***50% of the incremental cost, plus*** • ***30% of the incremental cost, if*** the vehicle has received a certificate of conformity under the Clean Air Act and meets or exceeds the most stringent standard available for certification under the Clean Air Act for that make and model year vehicle (other than a zero emission standard), ***or*** if the vehicle has received an order certifying the vehicle as meeting the same requirements as vehicles which may be sold or leased in California and meets or exceeds the most stringent standard available for certification under California law(s) for that make or model year vehicle (other than a zero emission standard). ◆ ***Special standard if GVW rating of the vehicle exceeds 14,000 pounds*** ... if over 14,000 pounds, the most stringent standard available shall be such standard available for certification on the date of the enactment of the Energy Tax Incentives Act of 2005 (i.e., on August 8, 2005).

IRS

REVENUE RULING 2005-52

SERVICE TECHNICIANS' TOOL REIMBURSEMENT PLANS

Automotive Alert

Motor Vehicle Technical Advisor

January 2006

The proper tax treatment of Service Technicians' Tool Reimbursement Plans has been an area of considerable discussion for several years. The issue first came to the attention of the Motor Vehicle Technical Advisor Program in early 2000 and resulted in a Coordinated Issue Paper (CIP). The CIP concluded that generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements.

Tool programs have evolved since the issuance of the CIP and the industry approached Treasury and the IRS several times requesting additional guidance and clarification of how the accountable plan requirements apply to Service Technicians' Tool Reimbursement plans. On August 3, 2005, the Treasury Department and the IRS issued Revenue Ruling 2005-52 addressing the issue of employee-owned tools and the accountable plan rules.

The ruling discussed an employer that operates an automobile repair and maintenance business and requires its technicians to provide and maintain tools needed to perform repair and maintenance services. In addition to an hourly wage, the employer pays the technician a tool allowance intended to cover the employee's cost of acquiring and maintaining his tools. In this example, the tool allowance is determined annually using national survey data and employee specific information. The amounts determined using this formula are converted from an annual amount to an hourly amount.

At the end of each pay period, the hourly tool amount is applied to the employees' reported work hours to determine the tool amount payable to the technician. The employees are neither required to provide substantiation of expenses actually incurred nor to return any amounts received in excess of actual expenditures.

Any program purporting to comply with the accountable plan rules of IRC §62(c) must meet three requirements; (1) business connection, (2) substantiation, and (3) return of amount in excess of substantiated amounts. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan and are excluded from the employee's gross income, are not required to be reported on the employee's W-2, and are exempt from the withholding and payment of income and employment tax. If one or more of the requirements is not satisfied, all amounts paid under the arrangement are treated as paid under a non-accountable plan and must be included in the employee's gross income and the amounts are subject to withholding and payment of employment tax.

IRS

REVENUE RULING 2005-52

SERVICE TECHNICIANS' TOOL REIMBURSEMENT PLANS

Automotive Alert

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In general, amounts paid to an employee in the course of employment can be excluded from income *only* if a particular Code section provides for such an exclusion. As a result, unless all requirements of the accountable plan rules are complied with, the entire amount is includible in the employee's income. In the arrangement described in the revenue procedure, the program failed to meet the substantiation and the return of excess requirements.

A reasonable expectation for expenses can be used to establish that a program meets the business connection requirement. However, to satisfy the substantiation and return of excess requirement, actual expenditures must be used. The ruling clearly states that reporting hours worked while using tools does not satisfy the substantiation requirement. According to the ruling, "Employers may not substitute a reasonable estimate of expense to be incurred based on statistical data and hours worked for the substantiation of actual expenses...."

Some tool reimbursement programs attempt to comply with the return of excess requirement by including any excess amounts paid in the employee's W-2. The ruling specifically addresses this situation stating that even if amounts are required to be substantiated and the employer treats any amounts received in excess of substantiated amounts as wages, the program still would not qualify as an accountable plan.

There are many companies that offer tool reimbursement programs and each program has its own requirements and rules. In addition to auto dealerships, plan providers also offer their services to many other industries such as construction, aircraft maintenance, trucking companies, and independent car and truck repair facilities. Although the programs may seem similar, a thorough analysis of program documents and procedures is required to determine if the program meets the requirements of the accountable plan rules.

Further information on the tax treatment of accountable plans can be found in the Motor Vehicle Technical Advisor Coordinated Issue paper and in Revenue Ruling 2005-52.

If you have any questions or would like to discuss this issue further, please contact Motor Vehicle Technical Advisor, Terri Harris at 616-235-1655 or Terri.S.Harris@irs.gov .

IRS

Cash Reporting and Your Dealership

QUESTIONS AND ANSWERS ON FORM 8300

Automotive Alert

Motor Vehicle Technical Advisor

March 2006

Terri.S.Harris@irs.gov

Introduction

Generally, any person in a trade or business who receives more than $10,000 in cash in a single transaction or related transactions must complete a Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business. Form 8300 is a joint form issued by the IRS and the Financial Crimes Enforcement Network (FinCen) and is used by the government to track individuals that evade taxes and those who profit from criminal activities. Although the cash reporting requirements apply to many types of businesses, auto dealerships frequently receive cash in excess of $10,000 and are required to comply with the filing requirements.

With the increased emphasis on potentially criminal activity in the post 9/11 climate, auto dealerships find themselves facing some difficult situations as they attempt to comply with the filing requirements. The Motor Vehicle Technical Advisor Program in conjunction with IRS specialists on money laundering would like to assist dealers in their compliance activities.

In pursuit of that goal, we have compiled a list of dealership specific questions and answers. As we receive additional questions that need to be addressed, we will update this document as appropriate.

Some of the questions in this document are "the basics" and some are dealership specific. This document does not attempt to answer all of the possible questions on cash reporting and additional information can be found in the instructions for Form 8300 and in Publication 1544. The IRS also has specialists that can work directly with dealership personnel on compliance issue. For more information on IRS specialists; contact the Motor Vehicle Technical Advisor.

Now, let's start at the beginning...

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Form 8300 – Report of Cash Payments Over $10,000 **Auto Dealership Questions and Answers**		
The Basics		
1.	**What does "cash" mean for the purposes of Form 8300?**	▪ Cash is money; currency and coins of the United States and any other country. ▪ Cash is also *certain monetary instruments* - a cashier's check, bank draft, traveler's check, or money order - if it has a face amount of $10,000 or less and the business receives it in: o A designated reporting transaction (generally, a retail sale of a consumer durable, a collectible, a travel or entertainment activity) <u>or</u> o Any transaction in which the recipient knows the payer is trying to avoid the reporting of the transaction on Form 8300.
2.	**What is a related transaction?**	▪ Transactions between a buyer and a seller that occur within a 24-hour period are related transactions. ▪ Transactions more than 24 hours apart are related if the recipient of the cash knows, or has reason to know, that each transaction is one of a series of connected transactions
3.	**Does the 24-hour period mean one day such as all day Tuesday or does it mean literally 24 hours such as from 11:00 am on Tuesday to 11:00 am on Wednesday?**	▪ A 24-hour period is 24 hours, not necessarily a calendar day or banking day.
4.	**When is the Form 8300 due?**	▪ Form 8300 is due within 15 days after the date the cash was received. ▪ If there are subsequent payments that are made with respect to a single transaction (or two or more related transactions), the Form 8300 is due when the total exceeds $10,000. ▪ Each time the payments aggregate in excess of $10,000 the business must file another form 8300 within 15 days of the payment that causes the additional payments to total more than $10,000.
5.	**Must a business notify its customer that it has filed a Form 8300 regarding the cash transaction with the customer?**	▪ Yes, a business must notify its customer, in writing, by January 31 of the subsequent calendar year.
6.	**If a business filed a Form 8300 on an individual and checked the suspicious transaction box, and a Form 8300 was not otherwise required, does the business have to inform the individual that a Form 8300 was filed?**	• No. Reporting of the suspicious transaction in this instance is voluntary. A business is only required to provide a statement to individuals if the filing of the Form 8300 is required. A business is prohibited from informing the buyer that the suspicious transaction box was checked.

Form 8300 – Report of Cash Payments Over $10,000

Auto Dealership Questions and Answers

7.	**Instead of sending the customer a separate notification letter, can the dealership use the sales invoice as the notification requirement, if the sales invoice has language printed on it that the IRS will be furnished with information for cash sales over $10,000?**	▪ There is nothing in the code or regulations mandating a specific format for the customer statement. The regulations, however, establish certain minimum requirements. As long as these minimum requirements are met, there would be no problem if the seller chose to print the required language on an invoice. ▪ The statement must contain the following information: o The name and address of the person completing Form 8300 o The aggregate amount of reportable cash in all related cash transactions; o A legend stating that the information contained in the statement is being reported to the Internal Revenue Service.
8.	**Is a personal check considered cash for reporting on Form 8300?**	▪ No. Personal checks are not considered cash.
9.	**If the business is unable to obtain the Taxpayer Identification Number of a customer making a cash payment of over ten thousand dollars, should the business file Form 8300 anyway?**	▪ Yes, the business should file Form 8300 with a statement explaining why the Taxpayer Identification Number is not included.
10.	**Does a wholesaler (no retail) report transactions paid in US (or foreign) coins and currency only?**	▪ Yes, if the wholesaler receives payment in the form of coins or currency. A wholesaler, however, need not report transactions paid with cashier's checks, bank drafts, traveler's checks, or money orders unless the recipient knows the payer is trying to avoid the reporting of the transaction on Form 8300..
11.	**What if a retailer also does some wholesale transactions, must the business report all transactions, or just the retail ones?**	▪ If the trade or business of the seller principally consists of sales to ultimate consumers, then all sales, including wholesale transactions, are considered "retail sales" and are subject to the Form 8300 reporting requirements.
12.	**Does a dealer need to accumulate individual sales to a wholesaler throughout a 12 month period and report whenever they exceed a cumulative $10,000?**	▪ Each transaction stands on its own. But if the dealership knows that any of the individual purchases are related, a Form 8300 should be filed.
13.	**If a customer purchased an item, then eight weeks later the same customer purchased a different item, are these amounts aggregated and reported on the Form 8300?**	▪ No, if the two payments are for separate unrelated transactions.

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Auto Dealership Questions and Answers

Dealership Specific Questions

14.	**A customer purchased a vehicle for $9,000 cash. Within the next 12 months, the customer paid the dealership additional cash of $1,500 for a repair to the vehicle's transmission, accessories and a customized paint job, etc. Should a Form 8300 be filed?**	▪ No, unless the dealer knew or had reason to know the sale of the vehicle and the subsequent transactions were a series of connected transactions (for example, if the dealer and the customer agreed, as a condition of the sale of the vehicle, that the customer would be obligated to pay the additional $1,500). ▪ Transactions are related if they occur within a 24-hour period. Transactions are related even if they are more than 24 hours apart if you know, or have reason to know, that each is one of a series of connected transactions. o For example, items or services negotiated during the original purchase are related to the original purchase.
15.	**A customer wired $7,000 from his bank account to the dealership's bank account and also presented a $4,000 cashier check. Does the dealership complete Form 8300?**	▪ A wire transfer does not constitute cash for Form 8300 reporting. Since the remaining cash remitted was below $10,000, the dealer has no filing requirement.
16.	**A customer makes weekly payments in cash to a dealership as a lease payment or loan payment on a vehicle. During a twelve-month period, these payments total more than $10,000. Are these payments considered related transactions and is the dealership required to file a Form 8300?**	▪ Yes, the weekly lease or loan payments constitute payments on the same transaction (the leasing or purchase of the vehicle). ▪ Accordingly, the dealership is required to file Form 8300 when the total amount exceeds $10,000. ▪ Each time the payments aggregate in excess of $10,000 the dealership must file another Form 8300 within 15 days of the payment that causes the additional payments to total more than $10,000.
17.	**A husband and wife purchase two cars at one time from the same dealer and the total cash received $10,200. How many Form 8300s should the car dealer file?**	▪ The transaction can be viewed as either a single transaction or two related transactions. Either way, it warrants only <u>one</u> Form 8300.

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18.	**If a customer purchased a cashier's check at the bank for over $10,000, would the bank report the transaction? Does the seller of a vehicle need to report the transaction if the same cashier's check is subsequently used to purchase a vehicle?**	▪ The bank is required to file a Currency Transaction Report (not a Form 8300) in this scenario. ▪ Generally, the purchase of a vehicle with a cashier's check that is over $10,000 should not be reported on Form 8300. ▪ A cashier's check, bank draft, traveler's check, or money order with a face amount of ***more than $10,000*** is not treated as cash and a business does not have to file Form 8300 when it receives them. ▪ These items are not defined as cash because, if they were bought with currency, the bank or other financial institution that issued them will file the appropriate report.
19.	**Certain monetary instruments are considered cash – a cashier's check, bank draft, traveler's check, or money order. Are official bank checks considered cashier's checks or bank drafts which constitute reporting if $10,000.00 or less and received with other forms of cash resulting in payment in excess of $10.000.00.**	▪ Some banks may call their cashier's checks official checks. ▪ Checks that are not considered cash are those drawn on the account of the writer, and those that represent loan proceeds
20.	**How should a dealership handle a non resident alien with no SSN?**	▪ Use the IRS Individual taxpayer Identification Number (ITIN) if the nonresident has one. If there is no ITIN enter (NON) for SSN on Form 8300. ▪ The ADDRESS must be that of the foreign address. Item 14 of Form 8300 must be completed. ▪ The dealer may use a PASSPORT, ALIEN REGISTRATION CARD, or other official document to complete the form.
21.	**Do payments in excess of $10,000 in cash paid to a body shop need to be reported? Do requirements apply to services as well as goods?**	▪ Yes – cash received in excess of $10,000. However a service is not a consumer durable so the expanded definition of cash does not apply to payments for services. The body shop would file an 8300.
22.	**A dealership sold cars on 1/31 and 2/6 to one customer and received $20,000 in two payments of $10,000 each on the same date for the 2 cars. Is a Form 8300 required?**	▪ Yes. The dealership received over $10,000 in cash within 24 hours.

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Form 8300 – Report of Cash Payments Over $10,000

Auto Dealership Questions and Answers

23.	**Customer purchased 5 cars, each separately though the year totaling $15,000. Is Form 8300 required?**	▪ No. These are separate transactions and none are over $10,000 in cash.
24.	**Are wire transfers considered cash?**	▪ Wire transfers are not considered to be cash and no Form 8300 is required to be filed. ▪ The Money Services Business (MSB) that handles the wire transfer must document these types of transactions by filing a CTR on amounts over $10,000.
25.	**A dealership receives greater than $10,000 in cash on day one for the sale of a vehicle. On day three, the deal is cancelled due to an inability to finance the deal. The dealership returns the cash. Is a Form 8300 required?**	▪ Yes. Once the dealership receives the cash an 8300 must be filed. The deal not going through may in fact be an attempt to launder illegal funds. ▪ The law does not specify the form of the refund. If more than $10,000 in cash was received by the dealer and then the deal was cancelled, the dealer must file a Form 8300. ▪ If $10,000 or less was received by the dealer and the deal was cancelled, the dealer may voluntarily file a Form 8300 if the transaction appears suspicious.
26.	**If a dealership receives a bank check, not a personal checking account check drawn on a personal account of the customer but a bank check with the customer's personal account number and customer name on it, is this considered cash or a cash equivalent?**	▪ Bank checks (drawn on the bank's account, not the account of the customer) of $10,000 or less are cash under the expanded definition of cash, unless they are loan proceeds. ▪ The fact that there are notations on the check or even that the check is made payable to the dealership does not negate this.
27.	**A customer purchases a vehicle for $15,000 and pays for it with $9,000 in cash and puts the remaining $6,000 on a personal credit card. Should a Form 8300 be filed?**	▪ No Form 8300 is required. ▪ Less than $10,000 in cash was received. A credit/debit card is not cash.
28.	**For wholesalers, where more than one vehicle is purchased in a single day and cash is paid by the wholesaler, is that one transaction, a series of related transactions or a series of unrelated transactions given that there are multiple vehicles. What happens on separate purchases over the course of a week? What about a month?**	▪ Two or more transactions within a 24-hour period are related transactions. A trade or business that receives more than $10,000 in related transactions must file Form 8300. ▪ If purchases are more than 24 hours apart and not connected in any way then the purchases are not related and a Form 8300 is not required. ▪ Transactions may be connected if they are negotiated at the same time.

Form 8300 – Report of Cash Payments Over $10,000

Auto Dealership Questions and Answers

29.	**For individual retail customers there is little dispute that payment of cash for one car at multiple time periods is a series of related transactions. However, what about when the same purchaser buys a second car one week later and provides enough cash to trigger the reporting requirement? Since they are two separate vehicles are those related transactions? What is the time period break for considering them unrelated transactions?**	▪ The car purchases are separate transactions unless the purchase of the second car was negotiated at the same time of the first car. ▪ If the car purchases were negotiated at the same time the transactions are related because they are connected.
30.	**What exactly can be said to a customer who inquires about IRS 8300 reporting?** **Some dealers are advised not to refer to IRS 8300 reporting in the presence of the customer. In particular, dealers are concerned that advising customers that they need information for an IRS 8300 report could degenerate into a structuring conversation.** **What if the customer asks what the information is for? Can the dealer volunteer that it is for IRS 8300 reporting?**	▪ A customer can be told about the law requiring the reporting of cash payments over $10,000 to the IRS and FinCen. ▪ What a dealer cannot do is aid a customer in structuring a transaction to prevent a Form 8300 from being filed. ▪ A dealer who is filing Form 8300 voluntarily because of suspicious activity cannot inform the customer of the filing.
31.	**What are the penalties if a dealership doesn't file a Form 8300?**	▪ There are civil penalties for failure to file a correct Form 8300 by its due date and for failure to provide a statement as required. ▪ Additional penalties apply for intentional disregard of the filing requirements. ▪ Criminal penalties may apply in the case of willful filing of false or fraudulent Forms 8300.

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Motor Vehicle Technical Adviser
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Service Contract "Overpayment" Programs May Improperly Divert Dealership Income

Introduction

The sale of vehicle service contracts (VSC) continues to be a popular source of additional income for automobile dealerships. Vehicle service contracts are available in a variety of formats, with an assortment of options, and may name the dealership or another party as the obligor. Due to the varied programs available, the proper tax treatment can be complicated. This Alert is intended to address only **one** aspect of **some** service contract programs, i.e. the possible diversion of income using an "overpayment" agreement. It is **not** intended to clarify all issues related to VSC or to be inclusive of all areas of potential non-compliance.[1]

The VSC option described in this document (diversion of income from the dealership and non-reporting of the income by the recipient) presents an opportunity for confusion, inconsistent tax treatment, and possible widespread non-compliance. The Motor Vehicle Adviser (MVTA) is evaluating the issue to determine the scope of the non-compliance. This document is the first step in a program to provide guidance to IRS and industry personnel on the proper treatment of the issues and the possible effects of non-compliance.

Overview of the Issue

The MVTA has received information from examination teams regarding an arrangement that may be an area of abuse and significant non-compliance. The programs may vary slightly in operation, can be identified by various names such as "over submits," or "dealer override agreements," and are found in non-dealer obligor programs and dealer obligor programs for new and used vehicles.

[1] Proper tax treatment of the transaction will vary depending upon the specifics of the VSC program. Any potential tax issues related to other aspects of the transactions are not the subject of this Alert.

Example

Facts

In conjunction with the sale of a vehicle, the dealership also sells the customer a vehicle service contract. The price of the vehicle service contract is $800. The dealership is required to pay the obligor/administrator $400 under the contract.

No "over payment arrangement"

The dealership retains $400 as commission (retention amounts will vary by program) and submits the remaining $400 to the obligor/administrator. [2] Assuming that the program is a pure dealer agent program, the dealership reports $400 as income.[3] Generally, there is no unreported income issue.

"Over payment" arrangement in place

The dealer executes a voluntary supplemental agreement to pay to the obligor/administrator an amount in excess of the contractually required amount. For example, rather than retaining $400 and submitting $400 as in the example above, the dealer may submit $550 to the administrator and retain only $250.

The supplemental agreement between the dealership and the obligor/administrator allows the dealership to determine the amount of the overpayment and to designate a "beneficiary" to receive the overpayment amount. The designated "beneficiary" may be an individual, e.g. the dealership shareholder, spouse, child, etc., a corporation, e.g. the dealership, a related corporation, or another entity e.g. reinsurance company or a related S corporation.

[2] Depending upon the program, the amount submitted to the obligor/administrator may be used to purchase insurance, be placed into a trust or escrow account, or be used for other purposes

[3] The tax treatment will vary significantly if the program is a dealer obligor program or contains other features such as escrow or trust accounts.

The supplemental agreement may require the inclusion of the beneficiary's Federal Tax Identification number or Social Security number and the obligor/administrator may issue Forms 1099 if the beneficiary is an individual, partnership, or sole proprietor. If the beneficiary is a corporation, a Form 1099 is not required. On a periodic basis, generally monthly, the obligor/administrator aggregates the over submitted amounts and remits the total amount to the beneficiary.

By reducing the amount retained by the dealership from $400 to $250, the overpayment effectively reduces the income reported by the dealership by the $150 over submitted amount. The $150 over submitted amount might be reported as income by the "beneficiary," however if no Form 1099 is filed, there is no tracking of the beneficiary. Even if the beneficiary reports the income, the overpayment amount represents income to the dealership.

Discussion

There are many reasons, in addition to reducing reported income why a dealership might execute an over payment agreement. According to some industry sources, reducing the profit on the sale of a vehicle service contract reduces the base amount on which the Finance and Insurance Manager's sales commission is based. The over payment programs also allow an individual to redirect capital to another entity that enjoys a more favorable tax treatment. Regardless of why a dealership engages in the over payment program, it is vital that the program be treated properly for tax purposes.

Preliminary analysis indicates that the proper reporting of vehicle service contract overpayment amounts rests on the definition of gross income and the principle of assignment of income. By making an overpayment to the obligor/administrator and designating a "beneficiary' to received the over payment amount, the dealership assigns income to the beneficiary. Although, at this time, the MVTA has insufficient information to make a final determination regarding the proper tax treatment of this aspect of vehicle service contract programs, based on the facts known at this time, the following analysis applies.

IRC §61 defines gross income as income from whatever source including compensation for services such as fees and commissions. Dealerships earn income on the sale of vehicle service contracts. Ordinarily, the difference between the selling price of the vehicle service contracts and related expenses represents income to the dealership. When a dealership makes a payment to the obligor/administrator in excess of the amount ordinarily required, the dealership artificially reduces the income reported on the sale of the service contract.

The controlling principles regarding assignment of income issues are found in Lucas vs. Earl, 281 U. S. 111 (1930). Generally, the question is whether a taxpayer is responsible for the tax on an amount or whether some other person or entity that receives the amount at the direction of the taxpayer should pay the tax on the item. The Court ruled that the "...fruit must be hung on the tree from whence it came..." and that the taxpayer that directed the payment of the amount to another party is responsible for the appropriate income tax on that amount.

Overpayments made to the VSC obligor/administrator represent income earned by the dealership and assigned to the beneficiary. Lucas vs. Earl, supra, requires income to be allocated to the dealership that earned the income. Depending upon the relationship of the beneficiary to the dealership owner, the overpayment may be characterized as a non-deductible dividend to the dealership owner or in some other fashion.

Conclusion

The overpayment program is just one option in the variety of vehicle service contract programs that are available. The lack of uniformity in the overpayment programs makes it difficult to formulate a "one size fits all" approach to the proper tax treatment.

Based on the information provided to the MVTA, it is clear that the vehicle service contract overpayment programs present an opportunity to divert income and for widespread non-compliance with the tax laws. In an effort to provide further guidance in the proper treatment of the programs, we will continue to evaluate the programs and to look for cases suitable for a technical advice (TAM) request.

If you have information on similar programs, have a case you believe is suitable for a TAM request, or would like to discuss the issue please contact the Motor Vehicle Technical Adviser at 616-235-1655.

BHPH

Ten Steps to Successful BHPH Operations

By Ken Shilson, CPA

1. Understand the economics of your own business model.
   - The amount of "cash in each deal" determines the total amount of capital required to grow your portfolio to your desired size.
   - Successful operations find an optimum size which balances risk with return and they don't expand beyond it.
2. Carefully monitor your cash flow because cash is the "fuel" that drives your BHPH engine!
   - It is possible for a dealer to sell himself into financial trouble in the business.
3. Control costs and expenses and minimize your taxes with the proper organizational structure.
   - If you plan to grow your portfolio to more than $500,000, you need to set up a related finance company.
4. Measure success not by how big you grow; but rather, on how much you owe.
   - Maintain financial flexibility by controlling leverage. Relying on borrowed money is living on borrowed time!
5. Learn from your losses through portfolio analysis of your bad debts.
   - Learn from underwriting mistakes, don't repeat them!
6. Develop consistent underwriting policies and practices. Change in the BHPH business isn't often good.
   - "Inspect what you expect" to ascertain whether your underwriting policies are really being followed.
   - Changes in your underwriting make it difficult to predict portfolio performance and capital requirements.
7. Don't be afraid to sell some notes to maintain liquidity.
   - However, don't become dependent on sales of notes to fund your working capital needs.
8. Monitor legal and regulatory developments to avoid making fatal mistakes. Dealer education is a key to compliance.
9. Your most important assets are not recorded on your balance sheet!
   - Repeat customers and key employees are vital, so don't overlook either group.
10. Get your financial reporting aligned with the industry benchmarks.
    - Identify areas where improvement is needed by comparing your own results with others in the industry.

To discuss these BHPH suggestions further, call Ken Shilson at (713) 290-8171

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