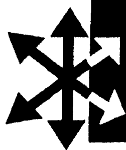

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www.defilipps.com

A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. IF YOU'RE GOING TO BE IN PHOENIX, PLEASE STOP BY AND SEE US. We will have an exhibitor booth at the AICPA National Auto Dealership Conference at Pointe South Mountain Resort in late October. We hope you'll stop by to say, "Hello," and find out more about some of the other activities that are keeping us busy these days.

#2. THE IRS IS NOW MUCH MORE ACTIVE IN AUDITING DEALERSHIPS THAN IT HAS BEEN FOR SEVERAL YEARS. Discussions with many practitioners support this observation. If you've not had auto dealer clients under examination by the LMSB division recently, you may be in for a surprise. On pages 3-9, we've given you a sample of what is going on and what you can expect.

The ***IRS treatment of auto dealers as "producers," rather than "resellers," under Section 263A*** is still an unresolved issue. We discussed this issue in the March 2006 *Dealer Tax Watch.* For an update on this, see page 9. Also, we've learned that the potential resolution of this issue now may be linked to a new creature of IRS design ... the ***GLAM***. For more on this ***GLAMorous*** development, see Update #6 below and also pages 15-17.

#3. TECHNICIAN TOOL REIMBURSEMENT ACCOUNTABLE PLANS ... STILL VERY MUCH ALIVE AND KICKING. Since late last year when the IRS issued Revenue Ruling 2005-52, things have been relatively quiet on the surface. In our last issue of the *DTW*, we did report that the Tax Court's decision in favor of the IRS in the *Namyst* case was upheld because the taxpayer did not return excess reimbursements to his employer.

After the IRS scared everyone out of the water in 2000 with its Coordinated Issue Paper, it took a few years for some folks to venture back onto the beach. (Think: *Jaws,* here.) After a while, the beach was swarming again, and in 2005, it was time for the IRS to yell "Shark!" again and drive more timid souls even further back from the shoreline. (Think: Revenue Ruling 2005-52, here.)

Both within, and outside, the industry, many have cynically referred to some tool reimbursement plans as ***"Buzz Lightyear" plans*** (think: *Toy Story*, here) in the sense that these plans would seem to (if unchecked by the IRS) *reimburse* technicians ... *"to infinity and beyond."* Under these plans, what about the technician repaying any excess disbursement back to the employer? *Fuggetaboutit.*

Maybe (even despite its tunnel-vision) the IRS didn't have it all wrong. But, the Service still has backed away from providing any positive guidance. (Think: "What you *can* do" vs. "What you *can't* do.") So much for the IRS line ... "we're here to help you."

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LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients—and, in the process, to help yourself.

see **DEALER TAX WATCH OUT**, page 2

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(Continued from page 1)

Last year, when the IRS again emphasized that "Overpayments ***must*** be repaid by the employees," most conservative CPAs we know of backed away from accountable plans into the next county. To them, because of Rev. Rul. 2005-52, the issue was regarded as well-settled and laid to rest.

The more conservative CPA-type may be unwilling to even think about reimbursement plans until the IRS kisses them on both cheeks and the forehead. Other CPAs may be comfortable with the notion that technician tool reimbursement plans are not abusive tax shelters.

In recent months, a few developments have come to our attention to suggest that, despite all appearances to the contrary, there are still many dealerships that already have tool reimbursement "accountable plans" in place. And, more are being added to the fold each month. For more on these developments, see page 10.

By the way, keep in mind that if the dealership is reimbursing the dealer's expenses for business meals, 20 Group and/or NADA meetings, etc., the dealership already is involved with the requirements for accountable plans in Section 62(c).

#4. <u>IRS UPDATES FORM 3115 INSTRUCTIONS</u>. In May of 2006, the IRS updated the Instructions to Form 3115 to incorporate several recent developments since the last revision of that Form in December of 2003. Form 3115 is the magic–and mandatory –form that taxpayers must file when they are changing most accounting methods.

The last revision of Form 3115 and the Instructions were analyzed in the March 2004 *Dealer Tax Watch*. At that time, we also included a list of the 76 Automatic Changes that do not require advance permission from the IRS.

The current revision to the Form 3115 Instructions (dated May 2006) is discussed on pages 12 and 13, and on page 14 you'll see the 27 automatic method changes (#77-103) added since the last revision. At this time, the IRS ***did not*** make any changes to Form 3115, so the current Form still bears the December 2003 revision date.

The taxpayer has a duty to reveal all material factors pertinent to its request for an accounting method change. It is not the responsibility of the IRS National Office to try to pry all of the pertinent information out of the taxpayer who wants to make the change. This applies regardless of whether the taxpayer is filing a Form 3115 that requests advance permission from the Commissioner to change the method, or whether the Form 3115 simply supports an "automatic" change in method, to which the Commissioner is deemed to consent.

One other note of caution. The IRS disclaims responsibility for the accuracy or reliability of its own forms. In Letter Ruling 200328001, the Service said, "Generally, forms and instructions do not bind the Service and are not intended to replace the law or change its meaning. The sources of authoritative law in the tax field are the statutes and regulations and not the informal publications and tax forms that are published by the Service.... ***Therefore, taxpayers who rely solely on IRS forms and instructions are at risk.***" Not very comforting, is it?

#5. FINAL PROCEDURES FOR AUTOMATIC <u>CAMs INVOLVING INTANGIBLES</u>. In Revenue Procedure, 2006-12, the IRS recently consolidated all of its rules and requirements relating to changes in accounting methods (CAMs) involving various intangibles.

Dealerships are involved with many Section 263(a) expenditures which are treated as "intangibles" and are covered by these procedures. Intangibles are often involved when new franchises are acquired or when dealerships are bought or sold. Another possible accounting method change that could be beneficial for dealerships might be made under the "12-month rule" for expensing certain short-lived expenditures like annual business insurance premiums.

These CAM procedures for intangibles are relatively complicated. Rev. Proc. 2006-12 introduces the notion of a "retroactive year of change" in order to deal with situations where previous changes under the final Regulations were made in a year for which the statute of limitations has expired when the taxpayer later decides to make the automatic change.

Fortunately, the revision of the Instructions to Form 3115 mentioned above incorporates a useful summary of these technicalities. For more on these changes in methods for intangibles, see the discussion on Automatic Change #78 on page 13.

#6. *TAMs* DON'T SEEM TO BE GOOD ENOUGH ... SO, NOW WE'LL HAVE *GLAMs* ... AND <u>THERE'S EVEN *CLAMs* ON THE MENU</u>. One recent development came to our attention in the course of following up on the status of the Section 263A "producers" versus "retailers" issue.

In May 2006, the IRS Office of Chief Counsel issued Notice CC-2006-013. Interestingly, this provides an "insider's view" of the process by which Technical Advice passes between Chief Counsel's Office and revenue agents (and others) in the field.

By "insider's view," we mean that much of the information in this Notice comes from interviews of a cross-section of managers from the IRS and the Office of Chief Counsel who are involved in the case- →

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AN UPDATE ON CURRENT IRS AUDIT ACTIVITY

Is the IRS actually auditing more dealerships this year than last? Only the IRS can answer this question. However, we are aware of many more auto dealership audits going on this year compared to last year. From these, we offer the following generalizations.

At the onset of each audit, the IRS usually emphasizes three major points. ***First,*** the Service is not interested in chasing after adjustments involving minor dollar amounts. ***Second,*** it will be looking extensively at most, if not all, aspects of inventory valuations (LIFO issues for new vehicles, the lower-of-cost-or-market write-downs for used vehicles, etc.).

Finally, if the taxpayer has participated in any listed/reportable transactions, investigation into that involvement automatically will become a priority matter for the IRS. In the June issue of the *Dealer Tax Watch*, we included the Information Document Request that the IRS regularly issues in connection with all tax shelter activities.

On the following pages, you'll find some of the material that you can expect to see right at the start of an audit if your dealership reported total assets of more than $10 million on its tax return, and therefore, is under the jurisdiction of the IRS Large and Mid-Size Business (LMSB) Division.

The IRS Agenda for its Opening Conference with the taxpayer and its representative(s) is on pages 4-5. Of particular interest is the following statement in connection with computer records under Section VII. ... ***"We will request the general ledger and detail be provided on a disk in a readable form such as an Excel spreadsheet to be utilized during the examination."*** Also, note the particulars listed under Section IX involving space and accommodations for the IRS Audit Team. Would you have all of these readily available?

To stress the importance of timely cooperation during the audit, the IRS will encourage the taxpayer and/or the taxpayer's representative to sign (1) an *Agreement* and (2) a *Memorandum of Understanding.* These are on page 6. To make sure the taxpayer is aware of all of its options, the IRS usually gives the taxpayer a summary of the available Case Resolution Initiatives and Tools. This handout is summarized (with some editing on our part) on page 7. And, last but not least, on page 8, is a summary of a few current audit scenarios involving auto dealerships.

Dealer Tax Watch Out (Continued)

specific advice process. So, this is what many IRS employees had to say about the Service's own current process for issuing TAMs (Technical Advice Memoranda). And, in short, this process does seem to be adequate in light of current taxpayer, practitioner and industry needs for guidance.

Perhaps more general guidance will become available on industry-wide issues under a new form of IRS Technical Advice. Are you ready for this? It's a ***GLAM*** ... Generic Legal Advice Memoranda. Without much difficulty, anyone can come up with a "short list" of good candidates for GLAM topics. In addition to the Section 263A issues, our list would include technician tool reimbursement plans, how non-compliance with the Regulations for the treatment of trade discounts affects LIFO users, and several others.

As for CLAMs, and for more on GLAMs, see pages 15-17.

#7. NADA UPDATES ITS DEALER TAX GUIDE. NADA recently updated its *Guide to Dealer Federal Tax Issues.* This revision, dated April 2006, replaces the previous 1994 edition. With the passage of a dozen years or so, it's worth your while to get a copy of this *Guide* and see what's been added (and note what's been dropped).

Our comments and observations on the 2006 Edition begin on page 18. We've also expressed some concerns about a few areas of coverage where, perhaps, dealers should have been given more cautionary information about relying on undocumented and apparently informal IRS acceptance of taxpayer short-cuts, notwithstanding their wide popularity. On these issues, we remain doggedly straight-laced.

#8. COST SEGREGATION STUDIES. Much has been said about the benefits available to dealers that result from making sure that they are depreciating their facilities over the shortest possible lives. The key to maximizing these benefits lies in the taxpayer's reliance upon trained specialists who have prepared the underlying detailed cost segregation studies.

Our guest author, Scott Zarret of KBKG, Inc. discusses these benefits in his article beginning on page 22. He has also included a schedule summarizing the benefits that several dealerships recently received as a result of his Firm's studies.

One IRS manual gives taxpayers a very good idea of what the IRS is looking for in the way of a thorough cost segregation study. For what the IRS considers to be the principal elements of a "quality report," see pages 26-27.

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Opening Conference Agenda for Meeting of Taxpayer & IRS Representatives

I. *Introduction of Participants*

For the Company

- Mr./Mrs. ABC, President, Shareholder
- Mr./Mrs. GHI, Controller
- Mr./Mrs. MNO, Taxpayer's Representative under POA

For the IRS

- Mr./Mrs. DEF, Supervisor
- Mr./Mrs. JKL, Revenue Agent

II. *Years under examination*

- Years and returns filed by entity (or entities) under examination ... "other entities may be examined if necessary"

III. *Current Cycle Team Members*

A. Mr./Mrs. P, Territory Manager Phone Number
B. Mr./Mrs. Q, Team Manager Phone Number
C. Mr./Mrs. R, Senior Team Member Phone Number
D. Mr./Mrs. S, Team Member Phone Number
E. Mr./Mrs. T, Audit Aide Phone Number

IV. *Monitoring the Examination Process*

A. ***Information Document Requests (IDRs) - Form 4564***

1. To whom should they be issued?
   - Is there a primary and secondary person to whom such should be issued?
   - All requests for information will be submitted in writing.
2. Periodic status meetings (to be held every 15 days) between corporate tax personnel and the IRS audit team to discuss open IDR status, information responses and the general progress of the audit.
3. Discuss IDR with TP before issuance: TP's Input - Is there a better way to ascertain the facts and/or information?
4. Turn around or response time mutually determined to 15 days.
   - Would more or less than 15 days be a reasonable response time on your part?
   - Please let us know within 7 days of issuance of an IDR if you can meet the 15 days or not.
   - If not, please keep us posted as to the reasons you are unable to completely fill an IDR.
5. We will indicate if any IDRs are to be given priority over others.
6. Do you have periods of down-time in your business when you can more quickly respond to IDR's?
   - If so, we will endeavor to issue them to you during down-time periods.
7. Dates of closures, vacations for POA or Controller planned?
8. Conferences and follow-ups with TP on IDRs will be conducted on the 15th, 30th, and 45th calendar day of delinquency.
9. IDRs delinquent after the 90th calendar day to include Team Manager and/or Territory Manager Involvement
10. Listed Transactions - due at meeting

B. ***Audit Plan - copy will be provided***

C. ***Form 5701 Notice of Proposed Adjustment***

1. To whom should they be issued? Again, is there a primary and secondary person?
2. Issues will be proposed in writing, as the audit progresses and efforts will be made to resolve them as they are developed. The taxpayer will respond to these issues as they occur.
3. ***Try to resolve issues at the lowest level.***
   - Supervisor and Manager will be involved in any unagreed issues.
   - Explain appeal rights.
4. Protest is due 30 days after issuance of Form 5701 to include additional Facts, Position, and Protest.
5. ***The Taxpayer will prepare, to the extent possible, its protest during the course of the examination.***

D. ***Periodic Meetings Confirmation***

1. Addressing mutual concerns
2. Communications
3. Resolving issues, problems, facts and law as appropriate
4. Progress of examination including review of claims

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IRS Audits

Opening Conference Agenda
for Meeting of Taxpayer & IRS Representatives

V. Span of Examination

A. Dates are estimates prior to presentation of the Audit Plan
1. Anticipated Report Date (RAR): _______ (Date approx. 6½ months after initial Conference)
2. Last 5701 (Notice of Proposed Adjustment) Issue date: _______ (Date approx. 5 months after initial Conference)
3. Last IDR Issue date: _______ (Date approx. 3½ months after initial Conference)

** Dates are contingent upon full cooperation in IDR and Form 5701 responses. It is critical that IDRs and Form 5701s be addressed timely. Dates are subject to change at Scope of Audit meetings, plan presentation and mid-cycle review.

- ***Priority*** is IDRs - request TP come forward at the initial date that they realize the response date cannot be met. A new response date will then be negotiated.

VI. Technical Advice Request, Formal Claims, Informal Claims

A. Errors found in the return and issues that the Taxpayer desires to have consideration given to during the audit will be provided by the taxpayer as they are discovered / developed.
B. Formal & Informal Claims: Must be submitted by _______ (date approximately 3 months after initial Conference) to ensure consideration in this examination.
C. Technical Advice - Both the Service and the taxpayer agree that requests for technical advice and changes of accounting will be submitted as early in the examination as possible.

VII. Computer Records

A. Conducting the examination through the computer as much as possible will provide the most efficient means of reviewing the records.
B. ***We will request the general ledger and detail be provided on a disk in a readable form such as an Excel spreadsheet to be utilized during the examination.***

VIII. Industry Specialization Program (ISP)

A. Motor Vehicle Technical Advisor
B. 3 Coordinated Issues for Auto Dealers
1. Dollar Value LIFO - definition of an item
2. Excess Parts Inventory - transfer to a warehouse
3. Service Technician's' Tool Reimbursements accountable plan

IX. Space and Accommodations for Audit Team

A. Location of office where exam will be conducted
B. Hours of access ... Normal working hours ... Number of people in office
C. Space for up to 3 team members at a time
D. Cabinet for storage with lock to secure records
E. Telephone
F. Photocopier and fax available
G. High speed printer

X. Preliminary issues (Prior to analysis & subject to change)

A. Inventory
B. Cost of Goods Sold
C. Advertising
D. Gross Income ... Sales ... Other Income

XI. Miscellaneous and other items

A. Pub 3498, The Examination Process
B. Team Manager and Supervisor are available to taxpayer for any concerns.
C. Open Forum

XII. Interview

XIII. Tour of business

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LARGE AND MID-SIZE
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON. D.C. 20224

Notice of Proposed Adjustment (NOPA) Audit Plan Agreement

The IRS Large and Mid-Size Business, Heavy Manufacturing & Transportation Industry Team Manager ("Team Manager") and ________ (Taxpayer), ________ (Taxpayer's Representative under Power of Attorney) make the following agreement:

Whereas, Team Manager intends to use the ***NOPA*** process set out in this ***NOPA*** Audit Plan Agreement during the IRS examination of Taxpayer's corporate tax returns for calendar year ended December 31, 200___.

Whereas, the Taxpayer's Tax Department functions as an agent in obtaining the information requested by the IRS from the various subsidiaries and divisions of Taxpayer and

Whereas, Team Manager and Taxpayer's Representative under Power of Attorney desire to enter into an agreement setting out the procedures for the issuance and processing of responses of Notices of Proposed Adjustments;

Now therefore, it is agreed as follows:

1. The IRS Audit Agent/Team will use best efforts to issue ***NOPAs*** as soon as the Agent/Team develops reasonable grounds establishing that a proposed adjustment is in order. Taxpayer will use best efforts to respond to all ***NOPAs*** issued within 30 days by either agreeing with the proposed adjustment or disagreeing with the proposed adjustment and stating the reasons therefor including factual and legal errors.
2. Parties agree to work in good faith to implement the ***NOPA*** process outlined in this agreement.
3. Nothing contained herein shall be construed to limit or reduce rights granted to either party by law.

By signing, the parties certify that they have read and agree to the terms of this document.

____________________________ (date)   ____________________________ (date)
/s/ IRS Team Manager   /s/ Taxpayer's Representative under Power of Attorney

INTERNAL REVENUE SERVICE
Large & Mid-Size Business Division
(LMSB Address)

MEMORANDUM

Date: ____________, 2006

To: XYZ Dealership, Inc. (Taxpayer)

From: Examination Team

Subject: ***Memorandum of Understanding for IDR Management Process Between Taxpayer and Examination Team***

1. ***We agree to a Response Date of 15 days from the date of IDR issuance.***
2. For IDRs that are delinquent 15, 30, and 45 days from the original response date, a series of conferences will be conducted and appropriate follow-ups will occur. The examination team will discuss the issue with the taxpayer and seek taxpayer's assessment of what records are available and identify problems and difficulties in retrieving documentation.
3. For IDRs over 90 days delinquent from the original response date, a Joint IDR Status Meeting will be held with Territory Manager, IRS Counsel, Team Manager, IDR requester and Senior Corporate Officers of the taxpayer. In this meeting, the circumstances will be evaluated and a determination will be made as to how the examinations should proceed.

____________________________ (date)   ____________________________ (date)
/s/ XYZ Dealership, Inc. (Taxpayer)   /s/ IRS Revenue Agent

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IRS Audits	LMSB CASE RESOLUTION INITIATIVES & TOOLS	
Existing Initiatives	*Description*	*How Effected*
Pre-Filing Agreements ***Rev. Proc. 2005-12***	• Applies to all LMSB taxpayers. • Taxpayers must request consideration prior to filing their return. • A user fee of $50,000 will be charged. • Issues submitted must be well settled legal principles involving domestic tax issues. Limited consideration of international issues is available under this program.	• Upon completion of the review of the taxpayer's records, a closing agreement reflecting agreed treatment of the item on the future tax return will be prepared. • The Director of Field Operations must sign the closing agreement. • The agreement is binding.
Fast Track - Appeals Settlement ***Rev. Proc. 2003-40***	• Applies to all taxpayers where the case is not docketed before the Tax Court. • Taxpayers may not use this process if the case involves service center penalty assessment, EP/EO cases, constitutional issues, coordinated issues, competent authority determinations, issues with no legal precedent, or issues where courts in different jurisdictions have arrived at different decisions.	• The taxpayer requests Fast Track after issuance of Form 5701 (Notice of Proposed Adjustment) and taxpayer's written response to unagreed issue. • Both taxpayer and exam must agree. • Generally, 5 or fewer issues. • The Appeals Officer assigned to a Fast Track Settlement request will have settlement authority to consider hazards of litigation.
Industry Issue Resolution ***Notice 2000-65***	• Applies to all taxpayers. • Taxpayers or trade associations with frequently disputed tax issues affecting numerous taxpayers within an industry may submit those issues to the Office of Pre-Filing and Technical Guidance for issuance of consistent technical guidance on their proper tax treatment. • Issues submitted for consideration should present the following characteristics: ◆ There is uncertainty about the tax treatment of the issue. ◆ The uncertainty has resulted in frequent, repetitive examinations of the same issue. ◆ The issue impacts a significant number of taxpayers within an industry group, especially larger businesses. ◆ Factual determination is a major component of the issue.	• An Industry Issue Resolution (IIR) team consisting of appropriate Service personnel (field, Appeals, Chief Counsel, and Technical Advisors) will review the issue and make recommendations for its proper tax treatment. • The process will normally result in issuing a Revenue Procedure prescribing the appropriate tax treatment.
Case Manager Settlement Authority - Appeals ***Delegation Order 4-24***	• Applies only to LMSB cases. • May be initiated by the taxpayer or the audit team. • The Team Manager may settle recurring issues where Appeals has settled a substantially similar issue in a prior examination cycle. • The Team Manager may settle an issue with a taxpayer where the other party to the transaction has had the issue settled by Appeals (i.e., "whipsaw" cases). • Citation: IRM 4.46.5.5.3	• Partially agreed cases should use Form 906, *Closing Agreement*, for the issue. • Fully agreed cases may use Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment.* • Team Manager approves Form 870-AD or Form 906 on behalf of the Commissioner.
Case Manager Settlement Authority - Coordinated Issues ***Delegation Order 4-25***	• Applies only to taxpayers with issues coordinated by Technical Advisors (TA), Appeals ISP, or ACI. • May be initiated by the taxpayer or the audit team. • With the documented concurrence of the TA, ISP or ACI, the Team Manager may offer settlements of coordinated issues to taxpayers based on published Appeals settlement guidelines. • Citation: IRM 4.46.5.6	• TA approves Form 5701S. • Partially agreed cases should use Form 906 for the issue. • Fully agreed cases may use Form 870-AD. • Team Manager approves Form 870-AD or Form 906 on behalf of the Commissioner.
Others Initiatives Referred to ...	• ***Accelerated Issue Resolution (AIR) ... Rev. Proc. 94-67*** • ***Advanced Pricing Agreements (APA) ... Rev. Proc. 2006-9*** • ***Early Referral to Appeals ... Rev. Proc. 99-28***	

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A FEW CURRENT IRS AUDIT SCENARIOS

Warranty Issues Involving Reinsurance ... Agent Requests a "Grid" Summary

In one dealership audit situation, the IRS is looking extensively at dealership warranty transactions with insurance companies and related reinsurance companies. The Agent is investigating this area because these entities, although not necessarily abusive PORCs, appear to involve foreign entities, to some extent. In this case, there are three insurance entities involved, in addition to the many franchised dealerships comprising the group under audit.

To assist the Agent in evaluating this activity and the specific services or programs involved, the Agent has requested that the taxpayer summarize these activities in a table or grid format.

The table or grid format requested by the Agent is as follows. The reinsurance companies/entities should be listed across the top of the grid. A common description of the service provided is to be listed down the left-hand margin. Under each reinsurance company, the taxpayer should identify the exact name or title of the service that is provided by that company that corresponds to the common description listed at the left side or margin of the table. For example, one of the generic descriptions (in the left-hand margin) might be "vehicle warranty" ... and corresponding to this one of the reinsurance companies might be involved with "repair" and another might be involved with "service contract" aspects. Initially, the Agent is not asking for dollar amounts, but rather just the general descriptions of the services provided and the specific name of the program through the specific reinsurance company.

The Agent requests the addition of the name of the manufacturer that is involved with each of the programs identified in each of the grid squares or cells. For example, if repair warranty services are offered for both Ford and Honda vehicles, then each of these manufacturers should be identified in the appropriate/corresponding grid squares or cells. This information should enable the Agent to determine whether a specific reinsurance company deals exclusively, or almost exclusively, with any one manufacturer.

In addition, the Agent has requested copies of all agreements between the dealerships and the other parties involved in the reinsurance arrangements. In connection with the "master grid" described above, the Agent is also asking for some further information. In each appropriate grid square or cell, the taxpayer should provide the specific section(s) or paragraph(s) number(s) in each contract that describes the responsibilities of the parties and the amount of compensation that is being paid therefor.

Our comment: Shouldn't a diagram of similar design already be part of the tax preparer's workpapers? If it isn't, how can he or she know what is actually going on? All that the Agent wants to be able to do is to see the big picture "at a glance" in order to more intelligently review compensation, commission payments, loan arrangements and loan performance.

Used Vehicles - Unsupportable "Lower-of-Cost-or-Market" Writedowns

In another audit situation, the IRS seems to be concentrating more heavily on inventory issues. The Agent has carefully reviewed the taxpayer's lower-of-cost-or-market valuations for its used vehicles and disallowed a significant portion of the writedowns. The Agent's item-by-item or vehicle-by-vehicle worksheet compares the taxpayer's net amount after writedowns with the subsequent sales price the dealer received for each vehicle. From this comparison, the Agent determined the portion of the writedown which the Agent claimed was excessive and should be disallowed in the year under audit. (Of course, this is simply a timing difference with a one-year turnaround.)

Dealership Restructuring Involving S Entity & Recapture of LIFO Reserves

In another situation, in one of the years under audit, the dealership had spun off one of its franchises into a separate entity, and that entity elected S treatment. The Agent has (properly) pointed out that the LIFO reserve attributable to that make should be recaptured under Section 1363(d). For many years prior to the year(s) under audit, the dealership had been using LIFO to value its new vehicles, and in 1992, it had elected to use the IRS safe-harbor Alternative LIFO Method for New Vehicles.

The complications here relate to the fact that under the Alternative LIFO Method, the new automobiles of all manufacturers are combined into a single pool. All of the new light-duty trucks of all manufacturers are combined into a separate, single pool. The audit issues here relate to how to quantify the amount of LIFO reserve attributable to the franchise/make that was spun off into the new entity that elected S treatment (i.e., the amount of the LIFO reserve to be allocated to the division that was spun off and recaptured).

In this regard, a comprehensive article appeared in the *LIFO Lookout* (June 2005 issue) on the different results obtained under different assumptions in allocating the LIFO reserve for each pool to the different manufacturers vehicles that have been included in that pool over several years. Needless to say, there are several different ways to go about addressing the Agent's development of this issue.

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A FEW CURRENT IRS AUDIT SCENARIOS ... INVOLVING SECTION 263A

Should Auto Dealerships Be Treated as "Producers" or as "Retailers" under Sec. 263A?

While in the update "mode," recall that the March, 2006 issue of the *Dealer Tax Watch* devoted significant space to the Section 263A issue of whether automobile dealerships should be treated as "producers" or as "retailers." The audits described in that article (pages 3-9) still have not been resolved.

It is our understanding that, in this regard, the IRS (1) had expanded this audit issue to cases outside of the Northeast area, (2) currently is not raising this as a major issue in any new audits that it is starting and (3) is awaiting "guidance" that may be available some time (early) next year in the form of a *"GLAM."*

GLAM stands for Generic Legal Advice Memorandum ... a new star in the IRS constellation of acronyms. In a nutshell, NADA has been significantly involved in discussions with the IRS trying to resolve this cost capitalization issue, which affects most of the larger dealerships.

One problem is that a TAM (i.e., Technical Advice Memorandum) is limited in its application to the sole taxpayer and its specific fact pattern. Nevertheless, the IRS and practitioners alike seem to be using guidance in TAMs more and more to settle issues involving other taxpayers with similar (not necessarily identical) fact patterns. Despite the existence of other "initiatives" such as the IRS' IIR program, it appears that the Service is willing to deal with this cost capitalization issue under its new GLAM procedures, which are supposed to generally not exceed 180 days from start to finish.

So, right now, there is nothing new to report on this, but hopefully, next year there will be "something." For more about this "*GLAM*orous" development, first publicized on May 5, 2006 in Chief Counsel Notice CC 2006-013, see pages ____.

Other Observations on the "Current State" of Section 263A as an IRS Audit Focus

A recent article entitled *"UNICAP Controversy"* (in *The Tax Adviser*, April 2006, pages 201-202), includes the following ...

> "Based on recent IRS audit activity, it appears the IRS had developed a focused approach to examining taxpayers' UNICAP (Sec. 263A) calculations. It no longer appears to follow the 'reasonable' approach analysis (i.e., it is not passing on adjustments just because a taxpayer is capitalizing a reasonable amount, if the taxpayer is not on a permissible method).
>
> "Historically, taxpayers and tax advisors may not have focused as much on the actual methods being used, but rather on the ***reasonableness*** [emphasis added] of the amount of additional cost being capitalized to ending inventory.
>
> "...It appears the IRS is now enforcing the Regulations more strictly. ... Recent audit activity indicates the IRS will require taxpayers to use one of the simplified methods (simplified production method or simplified resale method) when it determines that a taxpayer is using a facts-and-circumstances method that does not allocate costs to specific inventory items.
>
> "...Unfortunately, many businesses use a 'simple' method, which is not necessarily one of the 'simplified methods.'"

The article then discusses three Letter Rulings (TAMs) that upon which the Service seems to be relying ... LTRs 9717002, 9821001 and 200144003. The article points out that where taxpayers proactively (i.e., voluntarily) correct their accounting methods, they may obtain a 4-year spread of the Section 481(a) adjustment, if it is a positive adjustment. If the IRS changes the Section 263A method on audit, the taxpayer is likely to lose the 4-year spread for a positive adjustment and the taxpayer would be required to take the amount of the Sec. 481(a) adjustment into income 100% in the earliest year under audit.

Our comment: Interestingly, all of this seems to conflict with what we have recently heard from many practitioners working with dealerships.

- ***First,*** often the review of Section 263A calculations for auto dealerships that were made by a previous accounting firm indicates (to the new accounting firm) that significantly larger amounts have been capitalized in previous years than would be required. Therefore, the Section 481(a) adjustment resulting from a change in method of accounting for Sec. 263A costs would be a negative adjustment, all of which would be/is taken into income - as a deduction - in the current year (i.e., the first year to which the change applies).
- ***Second,*** in looking at Section 263A calculations in all of the dealership situations that we've heard about, the Agents have simply reviewed the worksheets offered by the CPA in support of the (relatively small) amounts capitalized under Section 263A and made no adjustments.

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ACCOUNTABLE PLANS FOR TECHNICIANS' TOOLS UNDER SEC. 62(c)

Big needs. Service departments are more vital than ever to the ongoing profitability of dealerships, and there seems to be a significant shortage in the need for skilled technicians. Apparently, over 250,000 technicians were employed in new vehicle dealerships last year and another 35,000 are expected to be needed over the next several years.

One aspect of the job entails fixing and overhauling various parts in need of repair. Another aspect involves replacing components after "scoping out" what could be the cause of this or that problem, and this requires mastery of the use of increasingly complex and expensive diagnostic equipment, some of which is owned by the dealership and some of which may be owned by the employee-technician.

Big dollars. Recent estimates indicate that the average technician spends over $20,000 in acquiring an inventory of tools. In addition, he or she spends an average of at least another 15% of that amount (or a little over $3,000) annually to maintain that equipment.

"ALL IS CALM, ALL IS..."

Since late last year when the IRS issued Revenue Ruling 2005-52, things have been relatively quiet on the Sec. 62(c) tool reimbursement plan front. In our last issue of the *DTW*, we did report that the Tax Court's decision in favor of the IRS in the *Namyst* case was upheld because the taxpayer did not return excess reimbursements to his employer.

Last year, when the IRS said that overpayments ***must*** be repaid by the employees, some plan providers found this requirement to be very difficult to overcome. Nevertheless, despite the appearance that this issue is well-settled, we've become aware of a few developments over the past few months which are reported below.

GM's BLESSING

It is our understanding that General Motors has recently (mid-year) given approval to one accountable plan provider to offer its services to General Motors dealers anywhere in the United States with the backing of General Motors Dealer Equipment.

If GM has given them its blessing, they must have built a better mousetrap ...or at least one that they believe can withstand Rev. Rul. 2005-52. Hmmmmmmm...

MORE PROTESTS / APPEALS ABOUT IRS' LACK OF GUIDANCE & TACTICS

In this category there are two developments to report. In an article in *Tax Notes* (August 7, 2006), Steven J. Mopsick indicated that ... "Tool plan administrators all across the country are receiving Section 6700 tax shelter investigation letters." Frankly, we were unaware of this development or the wide-spread use of Section 6700 by the Service (i.e., ... "all across the country"), so this came as news to us.

Mr. Mopsick's article is entitled *"IRS Abuse of Anti-Tax-Shelter Tools."* It begins by stating, "The IRS is using one of its biggest anti-tax-shelter weapons ... IRC Section 6700 ... to 'shoot first and aim later' by accusing legitimate businesses of fraud before their first meeting with a revenue agent."

In making his argument that the use of Section 6700 should not be a substitute for normal audit procedures, the author presents a discussion of the recent activity from the 2000 Coordinated Issue Paper through Rev. Rul. 2005-52.

A few weeks prior to the publication of this article in *Tax Notes*, another law firm (Morgan, Lewis & Bockius, LLP) sent a letter dated June 1, 2006, to the IRS Commissioner, and to others, urging them to consider the issuance of published guidance that will clarify the circumstances under which tool reimbursement plans may qualify as Section 62(c) accountable plans.

This Firm's letter points out that the IRS has consistently denied repeated requests by taxpayers and third-party administrators to have their issues addressed in the Industry Issue Resolution (IIR) program as well as through Private Letter Rulings.

The authors note that the guidance from the IRS so far "addresses only illegitimate situations of when the accountable plan requirements obviously are not met." They add ... "Unfortunately, these items of guidance have encouraged IRS agents to believe that all tool reimbursement plans are of the same variety, and that all of them necessarily fail to qualify as accountable plans."

Attached to the Morgan Lewis letter is an extensive briefing paper on three issues which the authors suggest require immediate published guidance by the IRS. Each issue is discussed thoroughly and is recommended reading for anyone seriously following this controversy.

→

First *... "Is depreciation for pre-owned tools a reimbursable expense under an accountable plan?"*

The authors include discussion of the fact that the Regulations authorize the reimbursement of depreciation, and that IRS Rulings acknowledge that depreciation is a reimbursable expense.

Second *... "Is an employer prohibited from adopting an accountable plan if the reimbursement is not in addition to what was formerly paid as salary or wages?"*

Here, the authors address the "recharacterization" of wages issue. They conclude that (1) recharacterization theory is not applicable where the employee must incur expenses as a condition of employment, and (2) recharacterization theory is applicable only where the business connection requirement is otherwise not met.

Third *... "Could the Service establish that a tool reimbursement plan does not meet the substantiation requirement because it is not tied to actual depreciation on an annual basis?"*

In discussing this question, the authors point out that (1) published guidance focuses only on when substantiation is insufficient, (2) case law in the accountable plan area does not provide helpful guidance on how to meet substantiation requirements, and (3) many tool reimbursement plans are distinguishable from the plan involved in Revenue Ruling 2005-52 and could qualify as accountable plans, but (these plans) need either definitive guidance or relief through the IIR program with respect to the substantiation requirement.

The authors conclude with several suggestions for consideration by the IRS.

SOFTWARE COULD RENDER TPAs OBSOLETE

Another development of interest follows from the availability of software–through a tool reimbursement software company–that would allow dealers to entirely bypass the need for third-party administrators (TPAs). In many instances, this could significantly reduce the cost of maintaining a Section 62(c) plan.

The Service has said publicly that there is no requirement that a taxpayer must use an outside third-party administrator in connection with its Section 62(c) accountable plan. Apparently, the company's software makes that possible.

Information is available on this software product (www.secondcheckonline.com). We note from the company's on-line materials that it has received a tax opinion letter from a major law firm. Although this tax opinion letter is referred to on the web site, there is no direct link to it ... customers must request a copy of it directly from the company.

As a disclaimer, our reference to this software provider should not be interpreted as an endorsement of its product or any comment regarding its opinion letter from counsel (which we have read), but rather as information on a Section 62(c)-related software product that is available for dealers who may be interested in pursuing these benefits based upon further professional advice from their own counsel and/or CPAs.

CONCLUSION

It appears to us that there is still much more to come in connection with the much-debated technician tool accountable plan requirements. We would suggest that perhaps this might be another area in which the new GLAM procedure (discussed on pages 15-17 of this issue of the *DTW*) might produce something constructive.

It would seem that ***unless*** an employer can show the IRS that during the period of the Sec. 62(c) plan's existence there have been at least a few instances where there was an overpayment and the employees actually returned the excess amounts to the employer, the IRS' reaction would probably be (1) to disbelieve the employer's claim that its reimbursement rates are set with such precision that they preclude the possibility of there ever being an overpayment situation, and (2) to raise its previous "wage recharacterization" arguments.

We are aware that a few of the large law firms stand quite ready to defend various reimbursement plans if they are challenged by the IRS and resolution requires litigation. The problem, of course, is that the IRS always singles out the weak sheep (ala *Shotgun Delivery*, or the facts in the plan in Rev. Rul. 2005-52, etc.) and these improperly structured and/or monitored plans become the poster children for the IRS' overgeneralized resistance and claims of taxpayer abuse.

Until these issues come before the courts and involve "better" fact patterns, the only conservative way for employers to obtain Section 62(c) benefits for technicians is to use dollar-for-dollar reimbursement programs based on after-the-fact documented actual expenditures and receipts. All dealerships probably should be getting these benefits, at a minimum, until the depreciation and "rate" issues have been more fully addressed. ✱

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Instructions for Form 3115

(Rev. May 2006)

(Use with the December 2003 revision of Form 3115)

Application for Change in Accounting Method

Overview	• Form 3115 must be filed in connection with almost every change in accounting method or item treatment. • Currently, two procedures exist under which a taxpayer may request these changes. ◆ One procedure involves so-called ***automatic change*** requests, … advance permission or consent from the IRS to make the change in method is not required. Payment of a user fee is ***not*** required. ◆ The second procedure involves ***advance consent*** requests. This involves all changes other than those specifically treated as automatic change requests. ***Payment of a user fee is required.*** • Current revision of Form 3115 is dated December, 2003. (The previous revision was dated May, 1999.) ◆ For summary, see the March, 2004 *Dealer Tax Watch* (pages 12-16). • Current revision of Instructions (dated May 2006) should be used with the December, 2003 version of Form 3115 for all changes in accounting method. ◆ The full text of these instructions (16 pages) and Form 3115 (8 pages) is available at www.irs.gov. • ***The current changes in the Instructions should not cause taxpayers any significant technical problems.*** ◆ Major changes are summarized below. ◆ Some "revisions" are wording changes so minor as to be inconsequential (such as those describing certain automatic accounting method changes involving depreciation and amortization [Automatic Changes #7-8-9]).
Updated List of Automatic CAMs	• Addition of 27 ***automatic*** changes in accounting method resulting from recent legislation and/or IRS developments. ◆ For a summary listing of changes that have been added (i.e., #77-103), see page 14. ◆ For a similar listing of Changes #1-76, see the March, 2004 *Dealer Tax Watch* (pages 17-18). • ***Includes procedures in Rev. Proc. 2006-12 for CAMs involving intangibles*** and certain transactions involving the acquisition of intangibles. These are covered in the newly-added Automatic Change #78. ◆ This could affect certain auto dealerships active in acquiring other franchises. (See page 2 of 2.)
More Emphasis on "Separate Trades or Businesses"	• In the section *"Who Must File,"* it is clear that a Form 3115 generally must be filed by, or on behalf of, each applicant seeking consent to change an accounting method. • The instructions now add the following… "An 'applicant' is a taxpayer ***or a separate and distinct trade or business*** of a taxpayer … ***including a qualified subchapter S subsidiary (QSUB) or a single-member limited liability company (single-member LLC),*** whose accounting method is being changed." • Special provisions apply where an identical accounting method change is being requested for applicants that are part of related group or corporations or where the application involves a separate and distinct trade or business of a taxpayer. • For guidance regarding the phrase, "separate and distinct trade or business," see Reg. Sec. 1.446-1(d).
Payment of User Fees	• Taxpayers filing under an automatic change request procedure ***do not*** pay a user fee. • A separate user fee must be paid for each member of an affiliated group and for each separate and distinct trade or business of a taxpayer (including a QSUB or a single-member LLC) to which the requested advance consent accounting method change applies. • Reduced user fees may be awarded in accordance with Section (A)(5)(b) of Appendix A of Rev. Proc. 2006-1. The Instructions detail some of the situations where a reduction in user fees may apply.
Reporting Advance Payments	• In general, advance payments must be included in gross income in the tax year of receipt. • ***Rev. Proc. 2004-34*** allows applicants on the accrual method, in certain circumstances, to defer to the next year amounts received (or amounts due and payable) that are attributable to a subsequent tax year. • The previous revision of Form 3115 Instructions was released before Rev. Proc. 2004-34. The current revision of the Instructions states that applicants requesting the deferral method under Rev. Proc. 2004-34 must provide the information and documentation required by that Revenue Procedure.
Valuation of Parts Inventories	• ***Use of the replacement cost method for valuing parts inventories by heavy equipment dealers.*** A change to this method is now listed as Automatic Change #96. The use of this method is allowed by Rev. Proc. 2006-14. (For further discussion, see the *Dealer Tax Watch*, Dec. 2005, Update #10, page 4.) • This change is made on a cut-off basis and no Section 481(a) adjustment is required.

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Instructions for Form 3115

Department of the Treasury
Internal Revenue Service

(Rev. May 2006)

(Use with the December 2003 revision of Form 3115)
Application for Change in Accounting Method

Rev. Proc. 2006-12 and Automatic Change #78
Method Changes for Intangibles,
Including Certain Transactions Involving the Acquisition of Intangibles

CAMs Involving Write-Offs of Intangibles

Rev. Proc. 2006-12

Automatic Change #78

- Some changes in accounting methods involving the write-offs of intangibles may be of particular interest to automobile dealerships ...
  - Expensing short-lived expenditures (i.e., prepaid expense-type expenditures where the benefit does not exceed one year).
  - Faster write-offs in connection with certain other intangibles, such as acquired franchise costs.
- In December of 2003, the IRS finalized the Regulations under Section 263(a) ... for a summary, see the March, 2004 *Dealer Tax Watch*, pages 2-3, Update #7 and page 7.
- Revenue Procedure 2006-12 brings together all of the IRS rules and requirements relating to changes in accounting methods involving various intangibles.
  - The IRS procedures discussed in R.P. 2006-12 involving these changes are relatively complicated. This is because taxpayers may have made changes (1) before the first set of Regulations was issued, (2) before the final Regulations were issued or (3) after the final Regulations were issued, but before Rev. Proc. 2006-12 was issued.
  - There are many possible different timing scenarios. Therefore, Rev. Proc. 2006-12 introduces the concept of a "retroactive year of change" in order to deal with situations where previous changes (under the final Regulations) were made in a year for which the statute of limitations has expired when the taxpayer later decides to make another automatic change.
- For more detailed analyses, see these recommended technical articles ...
  - *"Accounting for Intangibles: IRS Provides Automatic Changes of Method to Conform with Regs."* by Gaffney, Weber, Davis and Smith-Gaffney (*Journal of Taxation*, June 2005, pages 327-337).
  - *"Intangibles: New Automatic Consent Procedures for Method Changes to Conform to the Regs."* by Gaffney, Weber, Davis and Smith-Gaffney (*Journal of Taxation*, June 2006, pages 362-368).
- These various scenarios are addressed in the revised Instructions as part of Automatic Change #78.

  "***Costs of intangibles and certain transactions (Section 263(a)) - <u>for</u>*** amounts paid or incurred to acquire or create intangibles, or to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions, ***<u>to</u>*** a method of accounting provided in Regulations sections 1.263(a)-4, 1.263(a)-5, and 1.167(a)-3(b).

  "For a tax year ending on or after December 31, 2005, or for an earlier tax year that is after the applicant's second tax year ending on or after December 31, 2003, see Rev. Proc. 2006-12, 2006-3 I.R.B. 310.

  "For an applicant's second tax year ending on or after December 31, 2003, see Rev. Proc. 2005-9, 2005-2 I.R.B. 303, as modified by Rev. Proc. 2005-17, 2005-13 I.R.B. 797, which also provides, if the applicant desires, a change to utilize the 3½ month rule authorized by Regulations section 1.461-4(d)(6)(ii) or the recurring item exception authorized by Regulations section 1.461-5.

  "For information regarding the scope limitations and how to complete Form 3115, see Rev. Proc. 2006-12 or Rev. Proc. 2005-9, as modified by Rev. Proc. 2005-17."
- Note the following limitation ... ***"The Section 481(a) adjustment [is computed by] taking into account only amounts paid or incurred in tax years ending on or after January 24, 2002.*** See Rev. Proc. 2006-12 or Rev. Proc. 2005-9, as modified by Rev. Proc. 2005-17."

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"Automatic" CAMs #77-103		*AUTOMATIC ACCOUNTING METHOD CHANGES PER FORM 3115 INSTRUCTIONS (Rev. May 2006)*		
Code Section	***Assigned Reference # for CAM***		***Auto Dealer- and/or LIFO-Related***	***Other Applications***
263A	77	Environmental remediation costs	✓	
263(a)	78	Costs of intangibles and certain transactions	✓	
446	79	REMIC inducement fees		✓
	80	"All events test" method for credit card annual fees		✓
	81	Ratable inclusion method for credit card annual fees		✓
1272	82	Credit card late fees		✓
451	83	Full inclusion method for certain advance payments		✓
	84	Deferral method for certain advance payments		✓
446	85	Film producer's treatment of certain creative property costs		✓
162	86	Timber fertilization		✓
168	87	Change in general asset account treatment due to a change in the use of MACRS property		✓
	88	Change in method of accounting for depreciation due to a change in the use of MACRS property		✓
280F	89	Depreciation for qualified non-personal use vans and light-duty trucks		✓
832	90	Insurance companies' incentive payments to healthcare providers		✓
451	91	Up-front network upgrade payments made to utilities		✓
263A	92	Allocation of environmental remediation costs to production		✓
168/1400L	93	Election to not treat qualified New York Liberty Zone lease hold improvement property as 5-year property		✓
1272	94	Credit card cash advance fees		✓
263A	95	Self-constructed tangible personal property produced on a routine and repetitive basis		✓
472	96	Replacement cost method for heavy equipment dealers' parts inventory	✓	
1400I	97	Depreciation of qualified revitalization building in the expanded area of a renewal community		✓
197	98	Insurance contracts acquired in an assumption reinsurance transaction		✓
167(g)	99	Elections to treat participations and residuals under the income forecast method		✓
181	100	Election to treat the cost of any qualified film or television production as an expense		✓
194	101	Election to treat reforestation expenditures as expenses		✓
179B	102	Election to treat certain desulfurization costs as expenses		✓
451	103	Qualifying electric transmission transactions		✓

Note: For the listing of "Automatic" CAMs #1-76, see *Dealer Tax Watch*, March 2004, pages 17-18.

The identification of the CAMs in the right-hand columns is for general purposes only. It is not intended to be all inclusive. Some of the CAMs identified as "Other Applications" may be relevant or pertinent to very small or very large dealerships or in cases where special activities (such as buy-here, pay-here operations) are conducted.

GLAMs, TAMs & CLAMs

An Inside Look at What's Wrong with the TAM Process & How a New Form of IRS Technical Advice ... Generic Legal Advice Memorandum (GLAM) ... May Be More Effective

The primary function of the attorneys in the Office of Chief Counsel is to serve as the legal advisor to the Commissioner of Internal Revenue on all matters pertaining to the interpretation, administration and enforcement of the Internal Revenue laws. Written technical advice may also originate from within the various other branches of the Treasury/Internal Revenue Service. This variety of technical advice has resulted in a multitude of acronyms (such as TAMs for Technical Advice Memos, LTRs for Letter Rulings, FSAs for Field Service Advice, CIPs for Coordinated Issue Papers, GCMs for General Counsel Memos, etc.).

The IRS recently announced several new types of nonprecedential legal advice that it anticipates will be provided to its field examiners in the future. One form has been given the name ***Generic Legal Advice Memorandum*** or ***GLAM*** for short.

As discussed on page 9, it is our understanding that a GLAM will be used as a tool by the IRS to attempt to resolve the current significant audit issue that it has raised in connection with many auto dealerships under Section 263A. This issue involves whether automobile dealerships should be treated as "producers" or as "retailers." In that discussion, reference was made to this new technical advice tool intended to supplement at least one other TAM (currently under consideration by the IRS).

The following material summarizes Chief Counsel Notice CC-2006-013 dated May 5, 2006. This Notice, in turn, includes the full report of a Task Force set up in 2005 that considered whether improvements could be made in the process by which IRS field examiners (and their supervisors) interact with the National Office counsel in obtaining precedential and/or nonprecedential oral and/or written legal advice.

It is interesting to read the comments in this Notice explaining why the new GLAM procedure seems to promise better results in the future than might be expected by the continued use of TAMs.

Chief Counsel Notice CC-2006-013

The "Case Specific Advice" Task Force interviewed a cross-section of managers from the IRS and the Office of Chief Counsel who are involved in the case specific advice process and reviewed procedures for providing this advice. In April 2006, this Task Force submitted its report in which it analyzed the problems with the current case specific advice process and made suggestions for improvement.

The entire report of the "Case Specific Advice" Task Force is included in CC-2006-013. The Task Force report contained five recommendations to improve the timeliness and quality of formal and informal advice provided to the Service. The most relevant recommendations are those that suggest that existing TAM procedures be revised to remove impediments to timeliness and calling for the new GLAM procedure (discussed in more detail below).

Problems Concerning Formal Written Advice ... The Inadequacy of TAMs

The issues that come to National Office counsel for resolution through the Technical Advice process are not matters of well settled law. Rather, they involve gray areas of the law for which there may be no published guidance on point. A Technical Advice Memorandum (TAM) is a legal determination that is binding on the IRS with respect to one particular taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent. Thus, the TAM process is intended to resolve a difficult question of law in a particular taxpayer's factual situation. ***TAMs are not, and never were, intended as a means of providing industry-wide guidance.***

Today, most issues identified by examiners, particularly issues within the jurisdiction of LMSB, affect more than one taxpayer. Especially for LMSB, which has been organized by industry since the restructuring of the IRS in 2000, issues that are identified during an audit of one taxpayer are oftentimes raised in audits of others in that same industry. ***Consequently, in recent years, IRS personnel have used TAMs as more than merely a vehicle for resolving issues in specific cases.***

Interviews conducted by the Task Force led it to conclude that TAMs apparently are now being used regularly as a means of obtaining advice that can be applied across an industry. That is, ***IRS personnel request a TAM for one case with the intention that they will use its analysis of the issues to resolve other cases.***

For example, Technical Advisors in Large and Mid-Size Business (LMSB) division often post TAMs on their websites to alert revenue agents to industry-wide issues and advise them of arguments that may be made on those issues. Taxpayers likewise cite TAMs issued in other situations to advance their positions in support of their own cases. ***Because TAMs are so used by both examiners and taxpayers, the process of issuing a TAM has become cumbersome and time consuming.*** In some cases, examination teams may appeal to higher management if they anticipate that National Office counsel will not agree with their views on the issue.

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An Inside Look at What's Wrong with the TAM Process & How a New Form of IRS Technical Advice ... Generic Legal Advice Memorandum (GLAM) ... May Be More Effective

Not only do examination teams use taxpayer-specific TAMs on an industry-wide basis, they occasionally use them to obtain generic legal advice or strategic advice during the development of a case. The Task Force provided three reasons why the TAM process is not appropriate in these types of situations.

- ***First,*** the TAM process is a determination, and it should be used for specific issues that are ripe for a determination.
- ***Second,*** the TAM process contemplates participation by the taxpayer.
- ***Third,*** the TAM process is inappropriate as a means of obtaining case development advice since at this stage of an examination there are no issues with respect to which a substantive determination is needed.

The Task Force observed that a process exists currently for obtaining strategic or general legal advice outside of the TAM process in the form of non-TAM legal advice in a memorandum tailored to the needs of the recipient. This non-TAM legal advice may be sought at different stages of case development and may be issued to help decide what lines of factual development may be worth pursuing. However, interviews by the Task Force indicated that this process is underutilized because of several technical and procedural reasons.

Task Force Suggested Solutions

To address ... or more accurately, to rectify ... these problems, the Task Force identified three objectives ...

- To provide a vehicle for resolving audit issues that affect multiple taxpayers in an industry,
- To give IRS personnel an alternative to the TAM as a vehicle for obtaining timely advice to aid them in case development, and
- To streamline existing procedures to encourage the more timely issuance of TAMs with taxpayer involvement.

To accomplish these objectives, the Task Force made the three major recommendations discussed below.

#1. Where Appropriate, Replace TAMs with GLAMs ... Generic Legal Advice Memoranda

The creation of a Generic Legal Advice Memorandum (GLAM) should enable the various Associate Chief Counsel to provide generic advice on issues under their respective jurisdictions. In this regard, it is expected that a GLAM would be issued and signed by the Associate, Deputy Associate, or Assistant Chief Counsel. This GLAM could originate from a request by an Industry Director or by a National Program Manager or it could originate unilaterally from an Associate or Assistant Chief Counsel. It would assist IRS personnel in administering their examination program by providing them with an authoritative opinion on industry-wide issues.

Two primary benefits. First, GLAMs will give the Associate or Assistant Chief Counsel a means of providing advice on issues pending in audits of multiple taxpayers within a particular industry. ***Second,*** GLAMs will reduce the need for an Associate *or* Assistant Chief Counsel to delay the issuance of a TAM in order to explore how the issue might be decided on factual patterns that differ from that presented in the TAM. The pending TAM could be issued, and if so inclined, the Associate or Assistant Chief Counsel could use a GLAM to clarify how the issue might be decided or developed in other factual situations.

Nothing would prohibit IRS personnel from requesting both a TAM and a GLAM on an issue. As indicated above, it is likely that an Associate/Assistant Chief Counsel would be comfortable issuing a timely TAM at the branch level (regardless of the holding in that TAM) where an alternative vehicle exists for addressing the issue on an industry-wide basis.

When an Industry Director or other executive requests a GLAM, the Associate or Assistant Chief Counsel and the requestor should agree to a mutually acceptable time frame for completion of the advice. This would encourage good communication between National Office counsel and the requesting office.

Timeliness ... Generally 180 day turnaround. Some GLAMs may be completed in less than 30 days. Most GLAMs will take more time, but relatively few should require more than 180 days. Facts and circumstances will determine the appropriate time frame for any given request. To the extent some general benchmark may be appropriate, a 180-day period was recommended by the Task Force.

Of course, if the priorities of the requestor necessitate a more rapid response, and the Associate or Assistant Chief Counsel is able to accommodate a shorter time frame, the parties should agree to a time frame shorter than 180 days. Similarly, if the issue is so complex or requires so much coordination with other offices that a longer time period is warranted, then the parties should agree to a time frame longer than 180 days.

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An Inside Look at What's Wrong with the TAM Process & How a New Form of IRS Technical Advice ... Generic Legal Advice Memorandum (GLAM) ... May Be More Effective

Under all circumstances, however, it is imperative that the parties discuss and agree on an appropriate date in good faith and confirm their agreement in a written memorandum or an e-mail message. This documentation would identify the issue(s) to be addressed, the expected date for completion, the projected dates for sharing preliminary drafts for review, and the turnaround time by which reviewers will submit comments. Any GLAM pending for more than 180 days would be briefed to the Deputy Chief Counsel (Operations) by the Associate or Assistant Chief Counsel and by the field counsel who are assisting the requesting office.

#2. Develop CLAMs ... Case-Specific Legal Advice Memoranda

The second recommendation of the Task Force is intended to provide IRS personnel with a vehicle for obtaining timely advice from National Office counsel or from field counsel concerning case development. IRS personnel already receive this type of advice from field counsel on a regular basis. However, there is a prevailing view that the TAM process is the means for obtaining similar advice from National Office counsel.

Consequently, the Task Force proposed the development of another new form of Technical Advice ... a ***Case-Specific Legal Advice Memorandum (CLAM)***. This guidance would be issued either by field counsel or National Office counsel to provide advice on case development. When issued by National Office counsel, such a CLAM would be the vehicle through which field counsel could obtain strategic, tactical, or other legal advice from National Office counsel. In general, responses by National Office counsel would be issued within 90 days. A stated time frame of 90 days enables National Office counsel to appropriately prioritize this type of advice.

In connection with this Form of guidance, the Task Force emphasized the following aspects ...

- A CLAM is not a TAM.
- A CLAM is based on facts provided solely by IRS personnel.
- The legal conclusion reached in the CLAM might differ if the facts are different from those presented for initial consideration.
- Time would be of the essence when providing CLAMs, and National Office counsel and field counsel should focus on answering the question presented in a concise manner, without setting forth an unnecessary history of the law or a detailed recitation of the facts. In this respect, a CLAM is intended to be somewhat similar in purpose to the FSA (Field Service Advice) that was used in prior years.

#3. Six (6) Recommended for Streamlining Existing TAM Procedures

The third recommendation of the Task Force was to streamline (not to abolish) the existing TAM procedures. TAMs do serve an important role in the resolution of disputes between taxpayers and IRS personnel. However, there appear to be a number of built-in impediments to timeliness in the process. For example, it is common for taxpayers to decide not to participate in the field's TAM request at the outset, only to request a conference later in the process to present information that was never presented to the examination team. This requires National Office counsel to reconsider its entire analysis, and negatively impacts the Service's efforts to reduce cycle time and improve currency in the examination process.

Accordingly, the Task Force made the following six recommendations ...

1. ***Eliminate the mandatory conference of right in cases where the taxpayer has not participated in the TAM from the outset.*** Instead, the National Office would have discretion to grant a conference in these cases.
2. ***Provide that, whenever there is a dispute between the taxpayer and the examination team about the facts, National Office counsel will issue the TAM based on the examination team's version of the facts.*** An important purpose of the TAM process is to advise IRS personnel. For this reason, the National Office should use the version of the facts developed by the examination team when advising it, and ***stop the time-consuming practice of issuing two TAMs - one based on the examination team's facts and one based on the taxpayer's facts.*** However, field counsel should be encouraged to assist the examination team in determining the facts.

   Interviews conducted by the Task Force showed that many disputes over facts were really disagreements about which facts were relevant, rather than which facts actually occurred, or about ultimate findings of fact. For these disputes, the examination team should submit all facts relevant to either position.

3.- 6. *Discussion of recommendations #3, 4, 5 & 6 is continued on page 28.*

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NADA'S *DEALER GUIDE TO FEDERAL TAX ISSUES*

NADA recently updated its *Dealer Guide to Federal Tax Issues* (April 2006). The introduction to the 2006 Edition candidly states that its purpose is to familiarize dealers with various tax issues and considerations without necessarily providing a comprehensive analysis.

The 1994 Edition of the *Dealer Guide to Federal Tax Issues* was reviewed in the December 1994 *Dealer Tax Watch* (page 6). Since the *Dealer Tax Watch* has been following the same IRS-industry developments for the same decade, this review of the 2006 Edition will refer, where appropriate, back to the 1994 Edition.

The 1994 Edition reflected the contributions of four CPAs and/or attorneys, with a final review by two additional CPAs (of which I was one). The 2006 Edition reflects only the views of two authors, both of whom are partners in the same CPA firm. Some might consider this a limitation on the perspective given to the issues that are discussed in this current NADA publication.

In the decade between 1994 and 2006, some of the "old issues" have been resolved, some "new issues" have been discovered by the IRS, and still other issues have been both raised and "settled" by the IRS in the period of time bookended by these two editions.

Some topics covered in 1994 were the result of (at that time) recent legislation and/or IRS Rulings. The Alternative LIFO Method for New Vehicles was only 2 years old (Rev. Proc. 92-79), and many "questions" about its application took some time to be resolved. Similarly, the issuance of Revenue Procedures 92-97 and 92-98 were given considerable attention in the 1994 Edition because of the importance of the proper tax treatment by auto dealerships for extended service contracts and the use of the SWIM method.

Another event that occurred just prior to the 1994 *Guide* was the passage of the *Revenue Reconciliation Act of 1993* that made significant changes to the top marginal tax rates for individuals, and (of course) shareholders in S Corporations.

The best example of an issue both raised and settled between 1994 and 2006 might be the LIFO financial statement conformity issue which is mentioned only in passing (on page 19 of the 1994 Edition) and receives recognition on page 28 of the 2006 Edition only in terms of spot references to Revenue Ruling 97-42.

Those of us who lived with our dealers through the great pain of the resolution of the "conformity issue" and the financial burden placed on dealers by Revenue Procedure 97-44 remember most vividly its aftermath. This aftermath was the IRS doing nothing really to penalize all the scofflaws and making many CPAs who took the high road on this issue with their dealers feel that they had been abandoned by the IRS in their efforts to suggest that dealers should comply with the "spirit" of the Regulation or possibly face serious consequences.

Some of the "hot" tax issues discussed in the 1994 Edition have cooled off or been clarified in the meantime. The proper treatment (or, the minimum treatment that the IRS would except as a "safe harbor") for handling dealership demonstrator vehicles was very much up in the air in 1994, but it has been addressed by Revenue Procedure 2001-56. Therefore, as of the 2006 Edition, little controversy exists and reference to a separate, stand-alone publication by NADA dealing with demonstrator vehicles is sufficient (in the minds of the authors) to dispose of the topic.

Similarly, the application of LIFO to used vehicle inventories (hardly even on the horizon in 1994 for some) has been addressed by the issuance of safe harbor calculation procedures in Revenue Procedure 2001-23.

One last example... Issues regarding vehicles subject to the luxury tax in 1994 warrant no mention in 2006.

Finally, several now current "hot" tax issues were not on the horizon (or were still below the IRS radar screen) in 1994, but they were "discovered" some time thereafter. Therefore, they are only "new" in the sense that the IRS became more aware of their existence and/or significance in the last 12 years.

Classic examples are evident in the 2006 *Guide's* discussions or chapters on (1) auto dealers' involvement with Producer-Owned Reinsurance Companies (PORCs), (2) expanding activities by many used car dealers in the areas of Buy-Here, Pay-Here (BHPH) operations and subprime financing, (3) the proper treatment for trade discounts and (4) the activities of dealers trying to use the accountable plan rules under Section 62(c) to reimburse their service technicians for the "costs" of their tools.

Suggestion: By the book... but don't expect too much from it.

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Review & Observations	**NADA Management Guide** **A Dealer Guide to Federal Tax Issues (April 2006)** *Page 1 of 2*
Overview	• The April 2006 Edition of this publication (39 pages) replaces the 1994 Edition (76 pages). • Some of the differences between the 2006 Edition and its predecessor are discussed in the accompanying text. • Readers will be disappointed if, in glancing at the chapter titles, they expect to find a uniform level of discussion for each subject. Some issues are dealt with more thoroughly than others. • ***Bottom line …*** NADA's *A Dealer Guide to Federal Tax Issues* (April 2006 Edition) is useful as a general, inexpensive reference to add to your library. However, you should probably still keep the 1994 Edition right next to it on the shelf.
Chapters	1… Introduction 2… Accounting Methods & Method Changes 3… Advertising Expense & Manufacturer Programs 4… Airplane Expenses 5… Cash Reporting (incl. Money Laundering) 6… Choice of Entity 7… Compensation to Owners 8… Computerized Records 9… Demonstrators 10 … Depreciation of Dealership Property 11 … Employee vs. Independent Contractor 12 … Environmental Issues 13 … Estate & Gift Tax 14 … Excise Tax 15 … Extended Service Contracts 16 … Factory Franchise Agreements 17 … Finance Companies 18 … Insurance & Reinsurance Companies 19 … Inventory (incl. LIFO) 20 … IRS Examinations 21 … Manufacturers' Deduction (Sec. 199) 22 … Miscellaneous 23 … Records Retention: Suggested Schedule 24 … Tool Plans 25 … Sec. 263A Inventory Capitalization (UNICAP)
Take Note …	• The airplane expenses chapter (#4) contains no discussion; it simply refers the reader to information on the NADA web site. • The demonstrators chapter (#9) contains no discussion; it simply refers the reader to Rev. Proc. 2001-56 and the NADA *Guide to the Federal Tax Treatment of Demos* (L.17) which contains several sample policy statements and forms, as well as a discussion of the pertinent requirements. • Some might argue that some of the chapters are of considerably less relevance (i.e., #7 - Compensation to Owners, #11 - Employee vs. Independent Contractor issues, and #12 - Environmental Issues, which basically discusses clean fuel vehicle deductions and credits.
In My Opinion (even though the discussions are brief), the Better Chapters Are …	• #15 - ***Extended Service Contracts*** … Discussions include third-party obligor contracts, dealer obligor contracts and dealer-owned warranty companies. • #16 - ***Factory Franchise Agreements*** … Discussions include goodwill, damage to goodwill, franchise termination and personal goodwill. • #17 - ***Finance Companies*** … Discussions include finance contracts, related finance companies, Buy-Here, Pay-Here operations and subprime financing (with unrelated finance companies). • #18 - ***Insurance & Reinsurance Companies*** … Discusses PORCs and charts PORC relationships. • #22 - ***Miscellaneous*** … Discussions include 12-month capitalization rule, like-kind exchanges, deferred third-party exchanges, passive activities, repairs and travel &entertainment.
Good Charts & Tables	• Entity comparisons for C Corp. - S Corp. - Partnership - LLC (pages 8-9) • Typical dealership asset depreciation (pages 12-13) • Typical auto dealer arrangement re: insurance and reinsurance companies (page 26) • Records retention … schedule of suggested retention periods (pages 34-35)
Endnotes	• Pages 40-43 list 135 footnotes providing citations to the Code Sections, Regulations, cases, Rulings, etc. • As a matter of convenience to technical readers of this publication, placement of the footnotes or citations on the page where the discussion or text appears would eliminate the need to flip back and forth between the text and the corresponding footnote, located many pages later.
Source	• *NADA Management Guide: A Dealer Guide to …Federal Tax Issues* (part of the NADA Management Series), April 2006. • Published by the National Automobile Dealers Association, 8400 Westpark Drive, McLean, VA 22102. Cost to NADA Members is $40; Non-members, $75.

Review & Observations	**NADA Management Guide** **A Dealer Guide to Federal Tax Issues (April 2006)** *Page 2 of 2*
Chapter 19 *Inventory*	• Discussions in this chapter include ... ◆ Trade discounts ... See facing page for additional comments ◆ Lower-of-cost-or-market ◆ LIFO inventory: general concepts ◆ Alternative LIFO Methods for new and for used vehicles ◆ Financial statement conformity requirement ◆ C corp to S corp and other transfers ◆ Pooling ◆ Inventory Price Index Computation (IPIC) method ◆ LIFO termination
Chapter 19 *Inventory* ***Warning on Estimating Changes in LIFO Reserves***	• In the discussion of general LIFO inventory concepts, the authors state ... "It is possible to roughly estimate the increase to a LIFO reserve for a year if the inflation index for the year is known or can be reasonably estimated. ***Simply multiply the inflation index for the year to the beginning inventory amount (non-LIFO).***" [Emphasis added.] • This generalization is woefully inadequate. The correct way to "roughly estimate" the increase would be to multiply the inflation index ***by the lower of the beginning or the ending inventory***, with each expressed in base dollars. ◆ The problem with the authors' generalization is that it will produce an estimate that is too high in cases where the ending inventory level turns out to be (considerably) lower than the beginning inventory level. Expressing these levels in base dollars is critical where a LIFO election has been in place over a long period of time.
Chapter 19 *Inventory* ***Alternative LIFO Item Categories*** ***... Be Careful Here, It's Harder than It Seems***	• In its discussion of the Alternative LIFO Method for New Vehicles and the extent (or degree of detail) to which item category differentiation had to go, the 1994 Edition included the following cautionary note ... "... One principle is clear: *If item categories are continually stratified and base model code numbers must be further subdivided by other vehicle characteristics such as option packages and promotional features, your LIFO reserves will build up more slowly.*" • The 2006 Edition discusses the Alternative LIFO Method in generalities only. It also includes the following statement ... "To assist in the identification of 'new item categories' as required under the method, the IRS Motor Vehicle Technical Advisor produces and distributes to dealership associations an unofficial list of 'new item categories.'" • ***Our Observation...*** The IRS' new items lists indicate how extensive the level of detail must be in order to comply with the item category definitions promulgated for users of the Alternative LIFO Method. See *IRS Publication 1947 (Rev. 01-06, Catalog No. 24599W)* & Rev. Proc. 97-36. ◆ Many dealerships and CPAs still have not "got the message." They are employing short-cut spreadsheet and/or downloading techniques that, although they may satisfy some level of differentiation, still do not go as far as they should go in order to ***fully*** satisfy the IRS requirements. ◆ Every year, the *LIFO Lookout* includes detailed comparisons of our determinations and the IRS'.
Chapter 20 *IRS Examinations*	• This chapter contains discussions of floor plan assistance, image upgrades and franchise assistance, salesperson incentive bonuses, holdback, warranty advances and rebates. • The placement of these discussions in a chapter titled *"IRS Examinations"* seems awkward or puzzling. These discussions would seem to be better placed in a chapter with other planning suggestions. • The discussion of rebates includes reference to manufacturers' rebates that are trade discounts and emphasizes that the proper treatment for these is generally as a reduction in the cost of the vehicle in the year it is purchased. If the manufacturer attaches other conditions to the receipt of the rebate, then the dealer may have to (or usually must) wait until those conditions are satisfied or fulfilled.
Chapter 24 *Tool Expense Reimbursement Plans*	• One of the "hottest" of the current "hot" topics is whether dealerships can make available to themselves and to their service technicians the benefits of Section 62(c). • The reader will not find anything "new" or revealing in this chapter. It simply summarizes the IRS' concerns and rulings which, to date, have been uniformly negative.

Caution	***Risk of Loss of LIFO Election & Trade Discount Treatment***
Chapter 19 *Inventory* ***NADA's Warning About Treating Trade Discounts if the Dealership Is Using LIFO ...*** ***(We Feel It Is Insufficient)***	• In discussing the treatment of trade discounts, the authors state ... "The proper method for recording these trade discounts is to reduce the cost of the inventory." ◆ Authority cited is Reg. Sec. 1.471-3(b) and Revenue Ruling 84-41. • With respect to LIFO calculations and this proper treatment of trade discounts, the authors (on page 27) add the following ... "Some practitioners have questioned whether taxpayers utilizing the LIFO method for their new-vehicle inventories would be in violation of the requirement to value inventories at cost if they are not reducing the cost of their inventory for trade discounts. ***Informal comment from the IRS Chief Counsel's Office indicates that this would not be deemed to be a violation of the cost requirement.***" [Emphasis added.] ◆ Thus, the authors are suggesting that, based upon "informal comment ..." dealers shouldn't have to worry about losing their LIFO elections if they are not properly valuing their LIFO inventories. • It would seem that the authors' statement - without further qualification - may reflect their own Firm's position ... but it could seriously lull auto dealerships on LIFO that are not reducing their inventories by trade discount amounts into a ***false sense of security***.
In the Absence Of Precedential, Written Confirmation, We Believe the LIFO Election Could Be in Jeopardy	• Without any specific citation to a pronouncement by the IRS that has precedential value, we believe dealers and their CPAs should have been more strongly cautioned that the IRS has gone on record saying that it is never/not bound by any "informal" advice given by its employees. ◆ The IRS' even disclaims the accuracy of its own Forms and Instructions. (See Update #4 on page 2 regarding LTR 200328001, etc.) ◆ What if this "informal" advice were rendered by a inexperienced technician with a cup of coffee in his or her hand rushing for an elevator to attend a meeting for which he or she was already late? Were any IRS internal approval processes circumvented in giving this "informal" advice? • We have heard others express the same reliance on "informal comment" by someone in Chief Counsel's Office. Until that person is identified and there is a written precedential document to this effect, we believe dealers who are not reducing inventory cost by trade discounts do risk losing their LIFO elections. • ***Query:*** Wouldn't it be interesting if the same IRS technicians ... who focused so narrowly and unsympathetically in interpreting other parts of the LIFO Regulations in 1994 in urging strict interpretation of the financial statement LIFO conformity requirements ... were to seize this technical (trade discount) issue and raise it to the level of a request for a Revenue Ruling or a TAM? How quickly do you think the IRS might disavow this reported "informal" comment? ◆ "Just because everybody else is doing it ..." is hardly a defense these days, especially when the Regulations explicitly require otherwise.
Here's What We Tell Our Clients	• In this regard, our own practice is far more conservative. We want the dealer to be fully advised as to the risk he or she may be taking if he or she is on LIFO and not properly treating trade discounts. ◆ Here's our written disclaimer whenever we submit LIFO computations to our clients... *"... your LIFO calculations and reports have been processed in accordance with your instructions to us related to the dealership's accounting methods currently in place for the treatment of trade discounts, including floorplan assistance payments, and certain advertising fees and expenses. If the dealership is currently eliminating trade discounts (including floorplan assistance payments) from inventory costs in accordance with Reg. Sec. 1.471-3(b) and Revenue Ruling 84-41, and/or if the dealership is currently eliminating certain advertising fees and expenses from inventory costs, our LIFO computations reflect the information provided to us, at your request, by parties with whom you have contracted for the determination of the amounts to be excluded from year-end inventory cost based on an invoice-by-invoice analysis.* *"**If the dealership is not currently eliminating trade discounts** (including floorplan assistance payments) from inventory costs in accordance with Reg. Sec. 1.471-3(b) and Revenue Ruling 84-41, we have, on several previous occasions, either discussed or attempted to discuss with you or your CPA the serious potential adverse tax effects of this incorrect treatment on your LIFO election and computations. We urge you to further initiate a discussion on this subject with your CPA so that you will be sure to understand the risks you are assuming in failing to comply with Generally Accepted Accounting Principles (which impacts your reporting to the manufacturers) and with the Internal Revenue Code (which affects your income tax returns)."*

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COST SEGREGATION CAN DIRECTLY IMPROVE CASH FLOW FOR AUTO DEALERS

by Scott Zarret

Auto dealers stand to gain substantial increases in cash flow by accelerating depreciation deductions on their dealerships through cost segregation studies. Typically, nearly 30-45% of the cost of a dealership can be reclassified from property depreciable over 39 years to personal property and land improvements depreciable over 5, 7 and 15 years.

For both new and existing dealerships, a cost segregation specialist can identify and reclassify qualified components into the shorter-lived asset classes, thereby minimizing a dealer's overall tax liabilities.

WHY DEALERSHIPS ARE UNIQUE

Dealerships are unique in that they can have significantly more personal property than the average commercial building because they require special service equipment, state-of-the-art showrooms, advanced computer systems, vehicle display areas and specialized electrical components.

They also contain much higher than average percentages of 15-year property due to the asphalt paving, drainage, site lighting and electrical dedicated to the outside areas.

Additional components that can be reclassified to personal property include compressed air systems, floor drains and piping, carpeting, data cabling and specialty lighting in the showroom/office areas. Thus it is critical for clients who own or are constructing auto dealerships to find a cost segregation firm with the right combination of engineering and tax expertise to properly dissect construction information, compute industry standard estimates, and identify and segregate the subcomponent costs.

Additionally, depending on how they're constructed, parking decks can comprise one the most significant elements for reclassification in a cost segregation study.

COST SEGREGATION DEFINED

Engineering-based cost segregation studies allow commercial real estate owners to reallocate real property (Code Sec. 1250) to personal property (Code Sec. 1245), which results in a substantially shorter depreciable tax life and accelerated depreciation methods. By engaging a cost segregation expert, non-structural building components can more accurately be classified into the 5, 7, or 15-year depreciable lives assigned to personal property and land improvements. The taxpayer not only benefits from reduced recovery periods, but can also apply the accelerated declining balance depreciation methods (150% and 200%) available under MACRS, thus generating tremendous cash flow benefits in both current and future years.

While many CPAs are aware of the benefits surrounding newly constructed properties, they often do not employ true engineering-based methods, and therefore only a minimal amount of building components are reclassified into the shorter tax lives. For existing properties, where building cost information is unavailable, the entire cost of the building is commonly depreciated over the 39-year life assigned to real property. In both situations, the property owner is not taking full advantage of the benefits currently allowed by the IRS.

BENEFITS

The example on the facing page illustrates the benefits that can be realized by a typical dealership.

A schedule showing the range of benefits that 12 dealerships realized from cost segregation studies undertaken by our firm is also included. These reflect an assumed effective tax rate of 40% and a discount rate of 8%.

HISTORY OF COST SEGREGATION

The legislation and procedures used in an engineering-based cost segregation study have been in existence since the enactment of the Investment Tax Credit (ITC) in 1962. When this Act was repealed in 1986, most companies assumed that cost segregation studies provided no further benefit under the new tax law. However, in a landmark 1997 Tax Court case, *Hospital Corporation of America* successfully defended the application of engineering-based cost segregation as a method to differentiate real and personal property under existing tax law.

Several recent rulings have been issued by the Internal Revenue Service to spur economic growth, which can have a major impact for those clients with previous construction and acquisitions.

Under Rev. Proc. 2002-09, the IRS automatically consents to changes in method of depreciation, reported on Form 3115, and filed with the income tax return in the year the change is elected. Following the 9/11 (i.e., September 11, 2001) tragedy, the Internal

see **COST SEGREGATION**, page 24

EXAMPLE OF BENEFITS FOR AN AUTO DEALERSHIP

Constructions Costs $4 Million
Facility Placed into Service 5 Years Ago
Original Depreciation Method: 39-Year Life, Straight Line Method

Reclassified Amounts Resulting from Cost Segregation Study
5-year property - $480,000
15-year property - $800,000

Increased Deductions in the First Year and Resulting Tax Benefit

Depreciation Deductions w/ Study (through the current year)	$ 1,209,310
Depreciation Deductions w/o Study (through the current year)	568,440
Increased Deductions (through the current year)	$ 640,870
Assumed Tax Rate	40%
Tax Benefit of Cost Segregation Study (through the current year)	$ 256,348

PERSONAL PROPERTY & LAND IMPROVEMENT EXAMPLES

Personal Property with a 5 or 7-Year Life

- Air Filtration Systems
- Auto Service Task Lighting
- Auto Service Water, Oil & Waste Piping
- Car Lifts & Foundations
- Carpeting
- Compressed Air Piping
- Decorative Lighting
- Decorative Wood Work
- Folding Partitions
- Pull Pots, etc.
- Public Address System
- Security System
- Signs & Graphics
- Tele/Data Communication
- Window Treatments

Property with a 15-Year Life

- Curbs and Gutters
- Dumpster Enclosure
- Fencing
- Grading
- Irrigation
- Land Preparation Costs
- Landscaping
- Parking Lot
- Site Lighting

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 (Continued from page 22)

Revenue Service issued Rev. Proc. 2002-19, which allows taxpayers to catch up on all deductions from previous years for items reclassified into the shorter tax lives as a result of a cost segregation study. Prior to Rev. Proc. 2002-19, the beneficial adjustment had to be spread out across four years, but this can now be expensed entirely in the year of the change. The resulting Section 481(a) adjustment is reported as a reduction to the current year taxable income and amended returns are not required.

Under Rev. Proc. 2004-11, the IRS reversed the two-year waiting period required to change the method of calculation for depreciation on their property, allowing taxpayers to change the method in any year. Previously, if a taxpayer purchased a property and elected to depreciate it over 39 years, it had to wait two years before it could change depreciation methods and utilize a cost segregation study to take advantage of the shorter-lived personal property asset classes.

The combined effect of the recent tax law changes make now the ideal time for dealership owners to have a cost segregation study performed.

IDEAL CANDIDATES FOR COST SEGREGATION

Dealers who have purchased or constructed a facility since January 1, 1987, with capitalized costs in excess of $750,000 (excluding land), or who have made improvements in excess of $350,000, will likely benefit from having a cost segregation study performed. The taxpayer must also plan on retaining the property for the next few years and have net income that is currently taxable.

While the IRS puts no limitation on the number of years a building owner is allowed to go back and reclaim the depreciation lost by not utilizing a cost segregation study (Rev. Proc. 2002-19), generally it is not advantageous to go back further than 1987, as most of the property cost has already been depreciated.

WHY COST SEGREGATION STUDIES SHOULD BE DONE BY A SPECIALIST

No specific industry guidance exists for auto dealerships (as it does for other industries - i.e. casinos, restaurants, retail facilities, biotech / pharmaceutical). However, the IRS does provide general guidance for what it feels constitutes a ***quality*** cost segregation study and what the Service is looking for in an audit for any building type.

By employing the services of a specialized engineering-based cost segregation firm that understands and meets the IRS's *"13 principal elements of a cost segregation study,"* dealerships can achieve considerable increases in after-tax cash flow.

[Note: The IRS' expectations in this regard are summarized on the last 2 pages of this material.]

For new construction, a review of construction invoices alone is not sufficient and for existing properties, construction cost information is frequently not available, or it may be incomplete. In either case, the same specialist must be engaged to perform the comprehensive analysis that must take place to ensure all the eligible personal property components are identified. Engineering-based cost segregation studies provide the CPA with the information and detailed supporting documentation necessary to comply with strict IRS regulations and requirements for audit defense.

CONCLUSION

Cost segregation represents one of the most valuable tax planning strategies available to auto dealership owners today. An understanding of the benefits of cost segregation and an affiliation with an engineering-based cost segregation provider can have a direct and sizeable impact on an auto dealer's cash flow, and often for the CPA firm as well. By working with a cost segregation specialist, CPAs can achieve the maximum tax benefit allowed by law for their clients.

Scott Zarret is the Director of Business Development for KBKG, Inc. in Pasadena, CA.

In addition to being one of the leading educators in the field of Cost Segregation, KBKG specializes in performing engineering-based Cost Segregation studies that allow commercial property owners to depreciate their buildings in the shortest amount of time permissible under existing tax laws. Since 1999, KBKG's tax and engineering professionals have performed thousands of cost segregation studies nationwide, meeting the "13 Principle Elements of a Quality Study" as outlined by the IRS. For a full brochure of the Firm's range of services and other information, please contact Mr. Zarret at (303) 221-4100 or visit www.CostSegregation.biz.

The accompanying information summarizing the IRS Cost Segregation Audit Techniques Guide *is adapted from material previously included in the December, 2004* Dealer Tax Watch. *For a listing of previous coverage of cost segregation studies in the* Dealer Tax Watch, *see www.defilipps.com.*

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COST SEGREGATION STUDY BENEFITS FOR RECENT "TYPICAL" DEALERSHIPS *

Dealership Type	Total Cost	Year Placed in Service	Increase in Depreciation Expense in Year 1	INCREASE IN CASH FLOW ** Year 1	Years 1-5	NPV (after-tax)
Honda Service Center	$ 6,591,736	2006	$ 105,132	$ 42,053	$ 169,275	$ 132,238
Nissan Dealership	4,836,745	2006	98,064	39,226	178,414	173,255
Oldsmobile/Cadillac Dealership	2,266,063	2006	45,086	18,034	88,843	96,657
Used Car Dealership	1,881,465	2006	20,434	8,173	39,844	42,772
Nissan Remodel	2,301,092	2006	121,447	48,579	194,898	151,170
Audi Dealership	3,000,000	2005	339,220	135,688	243,983	202,873
Chevrolet Dealership	4,880,034	2004	391,650	156,660	232,986	216,017
Chevrolet Dealership	2,800,000	2004	268,499	107,400	148,861	127,488
Ford Dealership	8,674,519	2003	118,836	473,535	572,779	480,020
Ford Dealership	3,817,532	2003	503,771	204,508	271,092	254,758
Suzuki Dealership	2,452,704	2003	265,044	106,018	135,856	121,535
Ford Dealership	4,070,554	1999	89,021	358,809	366,747	278,958

* Cost segregation studies completed by the author's firm, KBKG, Inc., Pasadena, Cal.

** Increases in depreciation expense and cash flow are based on the following assumptions ...
(1) Effective tax rate: 40%
(2) Discount rate: 8%

What the IRS Wants

COST SEGREGATION STUDIES
IRS AUDIT TECHNIQUES GUIDE

Thirteen (13) Principal Elements of a "Quality" Report

(... What the IRS Is Looking for)

1. ***Preparation by an individual (or firm) with expertise and experience.***
2. ***Detailed description of the methodology.***
3. ***Use of appropriate documentation***, including
   - Explanation of the treatment of land and land development costs.
   - Site visit to gain better perspective and understanding of the design and purpose of the project, as well as the use of specific assets.
   - Land and site preparation costs are also documented by before-and-after photographs.
   - Review of all pertinent construction documentation, blueprints, construction drawings and contract payments.
   - Review of the general contractor's Applications for Payment (American Institute of Architects ... AIA ... forms).
4. ***Interviews conducted with appropriate parties.***
5. ***Use of a common nomenclature or terminology*** that is consistent with the other project documents (i.e., contract specifications, pay requests, etc.).
   - No creative descriptions that try to disguise the true nature or character of the underlying assets.
6. ***Use of a standard numbering system*** that is consistent with the contract bid documents and pay requests.
7. ***Explanation of the legal analysis***, including relevant citations, to support Section 1245 property classifications.
   - If applicable, a reconciliation of the classification treatment with possibly conflicting judicial decisions should be included.
8. ***Determination of unit costs and engineering "take-offs."***
   - "In a quality study, engineering 'take-offs' are carefully documented to show derived unit costs, and individual property units are clearly identified or highlighted on the 'as built' blueprints."
9. ***Organization of assets into lists or groups*** that directly tie into the taxpayer's fixed asset ledger.
10. ***Reconciliation of total allocated costs to total actual costs.***
    - This reconciliation ensures accuracy of the allocations and should list separately-acquired Section 1245 property to prevent possible duplication.
11. ***Explanation of the treatment of indirect costs***, including an explanation of the purpose of each indirect cost, its allocation and any deviations from commonly accepted practice.
12. ***Identification and listing of Section 1245 property.***
13. ***Consideration of other related aspects***, such as
    - Elements of cost capitalization (Section 263A),
    - Changes in accounting method(s) and
    - Sampling techniques employed in the study.

Report Format - Contents

- A cost segregation report should include the following:
  - Summary letter/Executive summary
  - Narrative report discussing the theory, definitions and the rationale behind the study in the narrative section
  - Schedule of assets,
  - Schedule of all direct and indirect costs associated with the project
  - Schedule of property units and costs (with property descriptions) that are segregated into land, Section 1245 property and Section 1250 property
  - Engineering procedures
  - Statement of assumptions and limiting conditions
  - Certificate
  - Exhibits

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What the IRS Wants	***COST SEGREGATION STUDIES*** ***IRS AUDIT TECHNIQUES GUIDE*** ***Page 2 of 2***
IRS Audit Procedures ***(... What the Agent Is Supposed to Do)***	• Review a copy of the cost segregation study and report. • Verify the cost basis and reconcile depreciation records. • Conduct a risk analysis to evaluate audit potential. • Interview the preparer. • Inspect the property. • Review and verify the classes of property. • Perform a cost analysis. ◆ Newly-constructed property ◆ Existing property • Review sampling techniques if sampling techniques were used. • Consider IRC Section 263A. ◆ All direct costs and certain indirect costs properly allocable to real property and to tangible personal property (produced by the taxpayer) must be capitalized. ◆ In addition, Section 263A(f) requires the capitalization of certain ***interest expenses***, and changes to real and tangible personal property costs may impact the amount of capitalized interest. • Consider possible change in accounting method issues. • Research the law, the Regulations and appropriate rulings. • Summarize the findings and discuss the challenged assets with the taxpayer. • Prepare the final report or the Notice of Proposed Adjustments.
Information Document Requests (IDRs)	• The Appendix to this *Techniques Guide* contains sample IDR language to ... ◆ Identify the participants and their respective roles in the preparation of the cost segregation study / analysis. ◆ Identify the specific properties involved. ◆ Locate the source of property blueprints, drawings and other information. ◆ Obtain a copy of the cost segregation study. ◆ Secure a copy of the study computations and formulae. ◆ Ask specific questions about segregated properties. ◆ Request specific items and amounts in question.
Sources	• IRS *Cost Segregation Audit Techniques Guide* Revision date: January 14, 2005. • See especially *"Industry Specific Guidance"* included at Chapter 7.2 for restaurants and Chapter 7.3 for retail industries. ◆ *Field Directive on the Planning & Examination of Cost Segregation Issues in the **Restaurant** Industry*, December 27, 2004, memorandum for Industry Directors, LMSB. This contains a detailed matrix recommending the categorization and general depreciation system recovery period of various restaurant assets falling within both Secs. 1245 & 1250. ◆ *Field Directive on the Planning & Examination of Cost Segregation Issues in the **Retail** Industry*, December 16, 2004, memorandum for Industry Directors, LMSB.

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GLAMs, TAMs & CLAMs

An Inside Look at What's Wrong with the TAM Process & How a New Form of IRS Technical Advice ... Generic Legal Advice Memorandum (GLAM) ... May Be More Effective

(Continuation of the Task Force's six recommendations for streamlining existing TAM procedures ...)

3. ***Shorten the periods of time during which taxpayers may provide additional information and appear at conferences.*** The goal here is to encourage taxpayers to gather and submit all relevant information at the time the TAM is requested. A maximum of 10 calendar days is proposed for additional submissions of information, with extensions available in appropriate cases. In addition, any written brief by the taxpayer after a conference should be submitted in appropriate cases at the discretion of the National Office and not submitted as a matter of right by the taxpayer. Similarly, the deadline for submitting them should be set at the discretion of the National Office.
4. ***Eliminate the prohibition on requesting a TAM when the issue is pending in Appeals.*** Settlement of an issue by Appeals in an earlier audit cycle should not necessarily prevent an examination team from seeking a TAM for a later cycle.
5. ***Establish a 120-day time frame for any TAM issuance.*** Currently, there is both a 120-day and 180-day time frame for TAMs.
6. ***Eliminate the TEAM process.*** The "TEAM" process was announced a few years ago in IR-2002-133 as part of the IRS' then newly streamlined examination process known by the acronym of ***LIFE*** (***Limited Issue Focused Examination***). As part of this LIFE initiative, the Service intended to issue more timely guidance under a similar - but not identical - ***TEAM*** (***Technical Expedited Advice Memorandum***) approach. The IRS now recognizes that since it was first established, the TEAM process has rarely been used. In light of the other changes to the formal advice process recommended by the Task Force, the continuation of the TEAM process would seem to be unnecessary.

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