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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. THE FOCUS OF THIS ISSUE IS ON TWO PRESENTATIONS AT THE AICPA AUTO DEALERSHIP CONFERENCE. It's been relatively quiet over the last few months ... However, a lot of excellent information was available at the AICPA National Auto Dealership Conference in Phoenix on Oct. 26-27, 2006.

Most of this issue of the *Tax Watch* is devoted to two major Conference update presentations ... one by the IRS Motor Vehicle Technical Advisor, Ms. Terri Harris ... the other, by attorney Rich Sox, who discussed dealer-manufacturer conflicts and issues. More about each of these a bit later... But, first, let's get caught up on some current IRS audit activity in the field.

#2. IRS AUDIT ACTIVITIES. Evidence of greater IRS audit activity is everywhere. Discussions with individual practitioners confirm this. Various Fall meetings of dealership CPA groups confirm this. And, Terri Harris, from the IRS, confirmed this in her presentation at the Conference.

It seems unanimous that these audits by the IRS are by no means being conducted by agents with uniformly high levels of experience. Nor are these agents looking into identical target issues on every audit. Some agents are examining selected technical issues relentlessly. Others barely give these issues a cursory glance or a nod. Despite the lack of IRS audit focus uniformity, we're comfortable making the following generalizations.

IRS target area - S corp. compensation. Where part of the IRS pre-audit activity involves a pair of human eyes scanning the tax returns, if a dealership is operating under Subchapter S and the tax return shows no deduction for salaries for officers, the absence of a deduction for officer compensation is very likely to trigger an audit. Why? Because the IRS is greatly concerned about the possibility of taxpayers playing games with payroll taxes.

One action that might possibly forestall an audit on this is preemptory disclosure. The suggestion is to attach an appropriate explanation or note in the tax return to justify the absence of a deduction for officers' compensation.

Many dealership officers are drawing salaries from other corporations or from management entities. If this is the case, explaining this in an attachment to the return may avoid an audit (at least, that's what one auditor told a CPA). We've also heard that some processing centers have routinely sent out computer-generated letters where the Form 1120-S

WATCHING OUT FOR

Dealer Tax Watch *Out* 1
AICPA Conference Tax Panel Topics 5
"The Franchise System" - *Auto News* Summary 9
Writedown Documentation Worksheet for Used Vehicles 11
IRS MVTA Update on Major Tax Issues 12
Observations on Sec. 62(c) Plans ... Guest Author 22
Dealer - Factory Conflicts ... Emerging Manufacturer Initiatives Impacting Automobile Dealers 24
- Guide to Factory Sales Incentive & Warranty Claims Audits ... a Checklist of Do's & Don'ts 30
- Selected Examples of Dealer Rights & Franchise Protection Provisions Under Florida & Illinois Law 36
- Practice Development Suggestions 40

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

(Continued from page 1)

did not show a deduction on the line for officers compensation.

IRS target area - Used vehicle writedowns. The IRS seems to be concentrating more heavily on inventory issues. In dealership audits, the valuation of used vehicles at year-end with writedown adjustments to the lower-of-cost-or-market is usually carefully reviewed by agents.

In one audit, the agent was very critical of the dealership's aggressive used vehicle writedowns. The agent pursued these vigorously, even though the writedown effect was a timing difference that was reversed in the following year when those vehicles were sold to customers or disposed of at auction.

In the situation under audit, the dealership had no documentation to support writedowns that it had taken in excess of amounts reported in the Official Used Car Guide that it was using. The agent firmly told the CPA and the dealer, "Now you have been warned about this." If there is an audit in a subsequent year, and aggressive year-end writedowns are found again, then the dealership can/should expect to face (under)valuation penalties.

Writedown worksheet. We've included a worksheet on page 11 that may be useful for defending ... or at least documenting ... the amounts of year-end lower-of-cost-or-market writedowns. You can be sure an IRS agent has his or her own version of this.

This worksheet reflects much of what came out of a recent dealership audit. Dates of acquisition are important because the IRS definitely frowns on writedowns of vehicles that were purchased near year-end, even though an Official Used Car Guide may indicate lower amounts are generally prevailing. With some agents, their thinking is that any vehicles bought during the last quarter of the year should not be written down from that acquisition cost at year-end.

The key is to have documentation - substantiation - support - for any unusual writedowns.

#3. UPDATE ON IRS AUDIT ACTIVITY - STRAIGHT FROM THE TOP. At the AICPA Conference, Ms. Harris spent over an hour discussing several key issues, and this year, she did have some "news" in connection with some of them. We've devoted considerable space to report what she said (beginning on page 12). We've also summarized some of her PowerPoint topic outlines, and added a few supplementary comments of our own.

IRS target area - Electronic recordkeeping requirements. The stand-out point in this year's discussion was that the IRS has recently become more aggressive in working with vendors. Ms. Harris suggested that now CPAs should be more assertive in asking their dealership clients' vendors whether they had recently had a "field test" or engaged in some other type of review with the IRS to determine if their products were sufficient to allow the dealer to comply with the requirements of Revenue Procedure 98-25.

It's surprising that the IRS hasn't come down hard on CPAs who have prepared dealership income tax returns based on information which the dealership and the CPA know cannot be supported if/when the dealership is audited in the future by the IRS.

In other words, if it is not possible to support the deductions claimed in the tax return (because of the lack of compliance with the requirements of Rev. Proc. 98-25), how can the CPA rationalize signing that tax return? What about tax return preparer responsibilities? How long can CPAs expect the IRS to be sympathetic, understanding or just plain "kinder and gentler" in putting up with this? This is a theme we'll return to elsewhere.

Maybe it's time for CPAs to put considerably more emphasis on this area in their year-end tax return checklists and discussions with their dealers.

I asked one of the vendors/exhibitors at the Conference (ADP) if their products had recently been "field tested" and "approved" as compliant by the IRS. In fact, they have been. For more on this, see page 3.

IRS target area - Section 62(c) accountable plans. Ms. Harris spent considerable time discussing service technician accountable/reimbursement plans. She again expressed hope for some substantial guidance for Section 62(c) plans in the near future. Overall, the tenor of Ms. Harris' remarks on these plans was not encouraging. She did say that in the near future, the IRS plans to revise the Coordinated Issue Paper that it released in 2000.

I had an interesting conversation in Phoenix with Steve Dockins, one of the pioneers of the much-fragmented tool plan industry (who is still around), after he heard Ms. Harris's presentation.

Steve told me that the more he listened to Ms. Harris's presentation, the clearer it became to him that there are many plan administrators offering just as many different versions of what they were marketing as qualified Section 62(c) accountable plans. All of this marketing was based upon the existence of alleged "secret formulas." Ten different third-party administrators ... ten different "accountable plans."

According to Steve, "The big secret is that there is no 'secret' formula." Kind of like when Dorothy, the Scarecrow, the Lion and the Tin Man (and, we'll add Toto, for you animal activists) finally arrived at Oz and

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Rev. Proc. 98-25

ADP SATISFIES IRS ELECTRONIC RECORDKEEPING REQUIREMENTS

At the AICPA Conference, Steve Hanusa, ADP's Accounting Product Marketing Manager, told me that ADP was one of the vendors to whom Ms. Harris referred and that ADP had recently completed one of the site visits / field tests with the IRS. Steve provided the following information.

ADP software now produces an audit file (automatically during fiscal year-end close) that will meet the electronic audit requirements of the Internal Revenue Service (IRS) and the Canada Revenue Agency (CRA).

Enhancements are available for 9200 and greater DMS upon load of the AC/GL981 or AC/GL990B releases.

This is now a standard part of ADP Accounting software and the file is created during the fiscal year-end close.

If the client uses the Month-13 feature of our software, the audit file is augmented with Month-13 data during the Month-13 close.

Files can be retained on the DMS for multiple years. The audit files can also be uploaded to a PC and written to a CD or DVD, and provided to the Internal Revenue Service or to the CRA during an electronic audit.

These enhancements have been validated during a Field Test with participation by IRS & CRA representatives.

We are in the process of obtaining letters from IRS and CRA stating that ADP clients on these releases who follow the ADP recommendations can be compliant [i.e., compliant with the requirements of Rev. Proc. 98-25].

Further information regarding this capability can be obtained by contacting Steve Hanusa, Accounting Product Marketing Manager for ADP, (847) 485-4097 or Steve_Hanusa@adp.com.

peeked behind the curtain to get a look at the "mighty Wizard of Oz." What did they find? Lo and behold, everything was based on human frailty.

Steve has been a pioneer in introducing and developing these technician reimbursement plans. And, he's closely followed the IRS pronouncements every step of the way. I told Steve that I'd welcome an article for the *DTW* from his perspective, and you'll find it on pages 22-23.

#4. "NEVER TAKE THE MANUFACTURER'S WORD FOR ANYTHING!" For any CPA advising (auto) dealerships, Richard Sox's update on dealer-Factory conflicts was a must. This quote was how Mr. Sox ended his presentation. He said that if there was only one idea he hoped every dealer and CPA would remember from his presentation, that was it ... in a nutshell. A report of Mr. Sox's presentation begins on page 24.

Whenever Mr. Sox's firm, Myers & Fuller, P.A., finds out from a dealer client that the manufacturer/ Factory is going to come in and do either a warranty claims audit or a sales incentive program audit, the Firm sends the dealer an advisory or checklist of *"do's and don'ts."* This is similar to how we CPAs advise our clients to behave when we find out that an IRS audit is about to start. His firm's checklist is reproduced, with permission, on pages 30-31. We've just modified the format a bit. The content is all theirs.

Not only was Richard's presentation filled with valuable information, it was loaded with practical examples of what he was talking/warning about. CPAs could not help but come away with ideas for practice development opportunities. We've noted these on page 40.

#5. OTHER THOUGHTS ON THE AICPA DEALERSHIP CONFERENCE. Two other presentations at the Conference that I found interesting were (1) the Tax Panel and (2) Larry Van Tuyl's overall comments on the *State of the Retail Industry*. (For a list of all of the Conference presentations, see page 4.)

Tax Panel. The Panel did an excellent job in providing some technical background that Ms. Harris had to skip over because of time constraints. A summary of the planning areas and issues they covered is on page 5.

Taking Ms. Harris's IRS Update and the Tax Panel presentation together, attendees came away with a comprehensive review of the IRS's activities as they relate to automobile dealerships.

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

Compilation of tax articles available. The tax issues covered by Ms. Harris and the Tax Panel have been discussed more comprehensively in recent issues of the *Dealer Tax Watch* and the *LIFO Lookout.* We've put all of these articles together in the special *Compilation* offered on page 6. If you'd rather not purchase the *Compilation*, the Table of Contents (on page 7) gives the full citations so you can find all of these articles.

"State of the Retail Industry." Mr. Larry Van Tuyl is the CEO and President of the Van Tuyl Organization, the largest non-public automobile dealership group. It is comprised of roughly 60 dealerships and 85-90 franchises. For 2006, its sales are expected to be $7-7½ billion.

Mr. Van Tuyl's organization is extremely optimistic about General Motors, particularly Chevrolet and Cadillac, which represent both ends of that manufacturer's product spectrum.

Mr. Van Tuyl is of the opinion that if General Motors is going to orchestrate a turnaround, it will have to be accomplished (primarily) through its

see **DEALER TAX WATCH OUT**, page 8

AICPA NATIONAL AUTO DEALERSHIP CONFERENCE - 2006

Pointe South Mountain Resort • October 26-27, 2006

Topics & Speakers

- ***State of the Retail Industry* ... Larry Van Tuyl**
- *Controller's Workshop* ... David R. Bower, Dennis MacInnes & Jeanette L. Reker
- ***Update from the IRS* ... Terri Harris**
- *Costly Mistakes that Can Kill Your Niche Development* ... Tracy Crevar Warren
- *Disaster Preparedness & Risk Management* ... Walter Gelnovatch & Rob Moody
- *How to Talk the Talk - Making Sense of Dealership Lingo* ... Jeff Sacks
- *Accounting & Auditing Update* ... Daryl Kaiser
- *Dealership Technology Panel* ... Walter G. Bambert, Jr., Peter Kneale & Al Omari
- *Understanding the Dealership Financial Statements and What to Look for* ... Jeff Sacks
- *Compliance and Profits! How to Achieve Profitable F&I Compliance* ... Gil Van Over
- *The A to Z to Profitable F&I Compliance* ... Thomas R. Stuker
- *Understanding Basic Dealership Benchmarks* ... Jeff Sacks
- *From Entrepreneurship to Intrepreneurship - Creating Maximum Value Faster and Smarter* ... Jim Canfield
- ***Emerging Manufacturer Initiatives Impacting Automobile Dealerships* ... Richard N. Sox, Jr.**
- *The Auto Industry: A Financial Analyst's View* ... John Murphy (Merrill Lynch)
- *Protecting Dealership Assets - Key Controls and Safeguards* ... Jodi Kippe
- *Used Cars - Sales Mix Analysis/Control* ... Donny Kretschmar
- ***A Beginner's Guide to Dealership Taxation* ... Mark Crumback**
- ***Tax Panel* ... Ed Blum, Joseph A. Magyar & Sid Tobiason**
- *How to Create (or Be) a Superior Controller!* ... Sandi Jerome
- *The ABCs of Dealership People Management* ... Deb Gammon
- *FTC Safeguards Rule - What Is Really Happening* ... Brian P. Bentz
- *Benchmarking the Collision Manager's Performance* ... Larry Edwards
- *Keeping Internal Controls Under Control* ... Daniel J. Cheyney & Matt Gettmann

2006 Panel Report	TAX PANEL TOPICS HIGHLIGHT PLANNING AREAS & ISSUES
Intro	*On the second day, one of the concurrent sessions was a 75 minute tax panel presentation. The presenters were Sid Tobiason (Moss Adams, LLP), Ed Blum (Morrison, Brown, Argiz & Farra, LLP) and Joe Magyar (Crowe Chizek & Co., LLC).* *This panel update was very useful in highlighting a number of planning areas and issues, and the range and depth of experience of the presenters was evident from their remarks. A overview of the topics presented is below.* *An audio CD of this presentation (Meeting #A10612 - Session 19) is available from Conference Copy (www.conferencemediagroup.com).*
IRS General Audit Issues *(Tobiason)*	• In general, many IRS auditors in dealerships today are inexperienced in dealership operations and tax issues ... in fact, many have just been recently hired. • Typical audit issues ... Related party transactions, passive vs. active activities (especially related party rentals), cash reporting and Forms 8300 filing, cost segregation studies, real estate lease rental rates, dealer compensation, advertising charges. • IRS seems to be checking closely to see whether dealerships are properly applying lower-of-cost-or-market rules to used vehicle ending inventories. *[Note: See our sample worksheet on this on page 11.]* • Personal goodwill ... citing *Martin Ice Cream*, Mr. Tobiason indicated that his Firm had been successful in dividing goodwill between corporate goodwill and personal goodwill. ◆ However, successful defense of an allocation between corporate and personal goodwill requires a specialized valuation to determine the respective amounts.
Section 263A *(Magyar)*	• This was a more detailed discussion of the dealer "reseller" vs. "producer" status under Sec. 263A. ◆ One area of difficult interpretation is the fact that the dealer cannot be a "producer" if it does not own the property ... citing *Suzy's Zoo v. Comm.* (114 T.C. 1). ◆ Guidance is anticipated in the form of GLAM (Generic Legal Advice Memorandum). ◆ Also, IRS may issue a TAM addressing twelve specific Sec. 263A dealer issues. • Other general Sec. 263A issues for dealerships ... ◆ Should dealer trades and used vehicles sold at auction be treated as "wholesale" sales? ◆ Off-site storage, including physical location of lot and accessibility by customers for vehicle selection.
LIFO *(Blum)*	• This discussion included a general review of the Alternative LIFO Method for New Vehicles. • Speaker suggested that consideration might be given to use of IPIC Method for LIFO. • Another issue ... Treatment of lease and loaner vehicles: Should they be included as inventory? • Discussion of various hybrid and other more fuel-efficient vehicles, including possibility that LIFO pools in the future may consist of a smaller number of vehicles having larger base costs. ◆ Also, base costs of these vehicles in the future might be subject to possible significant decreases over time as the vehicles include more electronic components and technology advances.
Like-Kind Exchanges *(Tobiason)*	• For personal property such as rental cars and lease fleets, Sec. 1031 like-kind exchange benefits are possible. ◆ The cost of these vehicles must be depreciated in order to use Section 1031 (Rev. Proc. 2003-39). • Depreciation significantly reduces the adjusted tax basis of rental fleet over time. Like-kind exchange treatment avoids depreciation recapture, but results in substituted lower tax basis for newer vehicles. • Practical barriers include need for extensive recordkeeping administration, specific identification of all vehicles, etc. ... in general, more "sophistication of staff."
Captive Insurance Companies *(Magyar)*	• *Captive insurance company* ... A term that is loosely used to describe any number of arrangements whereby risks that are borne by, or underwritten by, the dealer are insured or reinsured to a company owned in some fashion by the dealer. • There are many varieties of captive insurance companies, including on-shore and off-shore arrangements. • Four areas involve ... (1) underwriting profits, (2) commercial insurance savings, (3) investment income and (4) operational costs. • Various F & I products can be insured in a captive ... extended service contracts, GAP, Etch, tire & wheel, cloth protection, paint protection, credit life insurance and credit accident & health insurance. • For income tax purposes, manufacturers' warranties and prepaid maintenance arrangements do not qualify as insurance. • Many other types of dealership business risk can be covered by captive insurance arrangements.

Compilation Special

IRS AUDIT ISSUES, RULINGS & TAX CASES

In Depth Coverage of Tax Issues Discussed in the IRS Update at AICPA Dealership Conference in Phoenix, AZ - October 26, 2006

In the *"Update from the IRS"* session in Phoenix on October 26, 2006, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, had a very limited amount of time to talk about several important tax audit issues and hot topics.

In her one-hour presentation, Ms. Harris could only touch on the "highlights" of the following areas.

- ***IRS Audit Activity - Examinations, etc.***
- ***Electronic Records Retention Obligations***
- ***Service Technicians' Tool Programs***
- ***Section 263A Inventory Cost Capitalization Rules, with special emphasis on whether auto dealerships should be treated as "retailers" or as "producers"***
- ***Changes in the Form of IRS Guidance ... GLAMs, TAMs, etc.***

Although Ms. Harris did spend a little time discussing the alternative motor vehicle credit, she did not have time during her presentation to get into any depth on the two important the tax cases she mentioned ... *Tysinger Motors* (a case involving Form 8300 non-compliance penalties) and *Dow Huffman* (a case involving the IRS questioning a dealership's LIFO calculations and requiring a change in accounting method under Section 481(a)).

Also, one of the questions that arose in the brief Q & A session involved whether or not the improper handling of trade discounts might jeopardize the LIFO election for an auto dealership.

All of these areas are topics that have been covered in significant detail in recent issues of our publications, the *Dealer Tax Watch* and/or the *LIFO Lookout*. If you want to have more technical background and explanation of the topics that Ms. Harris mentioned in one handy reference volume, this 150-page compilation of articles is available for $175.

The Table of Contents for this Compilation appears on page 7.

IRS Audit Issues, Rulings & Tax Cases

TABLE OF CONTENTS

Discussed in the "Update from the IRS" *at the 2006 AICPA National Auto Dealership Conference*

I. IRS Audit Activity - Examinations, etc.

- *An Update on Current IRS Audit Activity* (*Dealer Tax Watch [DTW]* Sept. 2006, pp. 3-8)
- *IRS Updates Its Audit Technique Guide for Automobile Dealerships* (*DTW* March 2005, pp. 7-17)
- *Dealership Tax Return Compliance & Planning Opportunities Checklist* (*DTW* Dec. 2004, pp. 23-31)

II. Electronic Records Retention Obligations

- *Electronic Records Retention Requirements for Automobile Dealerships ... Revenue Procedure 98-25 (Automotive Alert)* (*DTW* March 2005, pp. 30-31)
- *If the Taxman Ever Knocks at Your Door ... Will You Be Ready?* (*DTW* Sept. 2004, p. 3)
- *IRS Is Zeroing in on Electronic Recordkeeping Requirements* (*DTW* June 2000, pp. 2-3)

III. Service Technicians' Tool Programs

- *Accountable Plans for Technicians' Tools under Sec. 62(c)* (*DTW* Sept. 2006, pp. 10-11)
- Namyst *in the Tax Courts ... Accountable Plan Rules Require Repayments of Excess Amounts Received* (*DTW* June 2006, pp. 4-5)
- *Service Technicians' Tool Reimbursement Plans (Automotive Alert)* (*DTW* March 2006, pp. 38-39)
- *Technician Accountable Plans ... Obviously Flawed Plans Take a Hit as a New Revenue Ruling (2005-52) Emphasizes Strict Compliance* (*DTW* Sept. 2005, pp. 11-14)
- *Technicians' Tool Reimbursement Plans under Section 62(c)* (*DTW* June 2005, pp. 4-48)

IV. Section 263A Inventory Cost Capitalization Rules ... Are dealerships "retailers" or "producers?"

- *An Update on Current IRS Audit Activity* (*DTW* Sept. 2006, p. 9)
- *Should Auto Dealerships Be Treated as "Producers" or as "Retailers" under Section 263A* (*DTW* March 2006, pp. 3-12)

V. Changes in the Form of IRS Guidance ... GLAMs, TAMs, etc.

- *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 than a TAM* (*DTW* Sept. 2006, pp. 16-17, 28)

VI. Cash Reporting on Form 8300 and the Tysinger Motors Case

- *Dealership Escapes Major Penalty for Not Filing Forms 8300* ... Tysinger Motor Co. v. U.S (*DTW* June 2006, pp. 10-21)
- *Cash Reporting & Your Dealership ... Questions & Answers on Form 8300 (Automotive Alert)* (*DTW* March 2006, pp. 40-45)

VII. *Dow Huffman* ... IRS adjusts dealership's method for computing LIFO

- *The IRS Adjusts Decades of "Errors" in Dealership's Link-Chain LIFO Calculations* ... Huffman et al. v. Comm. (*LIFO Lookout* June 2006, pp. 7-32)

VIII. Treatment of Trade Discounts as a Reduction of Inventory costs

- *Dealers on LIFO & Trade Discount Handling ... Risk of Loss of LIFO Election & LIFO Reserves if Trade Discounts Are Not Eliminated from Inventory Costs* (*LIFO Lookout* Sept. 2006, pp. 15)
- *Trade Discount & Advertising Expense CAMs May Be the Answer for Dealers Looking for Big, One-Time Tax Write-Offs ... With a Little More Background on These Changes* (*LIFO Lookout* Dec. 2002, pp. 1-2)
- *Auto Dealer Changes in Accounting Method for Trade Discounts, Floorplan Assistance, Advertising Fees & Expenses* (*DTW* Sept. 2003, pp. 10-15)

... 156 Pages in one handy compilation ...

 (Continued from page 4)

Chevrolet division because that's were the volume is and that product has been favorably positioned in the hearts of many Americans ... "baseball, hot dogs, apple pie and Chevrolet." He said that he thought Chevrolet had a huge upside and that it could be "a shocker."

He also observed that "on the luxury side, the Japanese eventually are going to own it all." Toyota, Honda, Nissan, Acura were all tops on his list.

Mr. Van Tuyl said that when his organization is considering acquiring new franchises, there are four critical questions it asks about the manufacturer.

MANUFACTURER QUESTIONS

First, can the manufacturer build "good value commodity cars" that can be sold in volume?

Second, can the manufacturer keep the interest of the customers by creating a "halo effect" for the company? ...Something like an outstanding reputation for technology or for safety in their products.

Third, has the manufacturer mastered "supply and demand?" Here, Honda and Toyota were given as the masters of managing their days' supply to 30 or less.

Fourth, can the manufacturer "partner up" with the retailer? In effect, does it have a good relationship of trust and confidence with its overall dealer body? In short, does the manufacturer keep its word? Toyota was cited again as the best example of a good manufacturer. Toyota's long-term "2011 vision" is the basis for its telling many of its dealers today that they need to significantly expand their existing dealership facilities so that they will be able to handle the future growth Toyota is projecting.

Needless to say, there were many areas where Mr. Van Tuyl's comments and Mr. Sox's comments call for thoughtful listener integration. (See Update #4.)

#6. TAKE YOUR PRACTICE TO ANOTHER LEVEL BY BECOMING (MORE) FAMILIAR WITH STATE DEALER FRANCHISE LAW. Here are two questions to ask any CPA who claims to be an advisor to auto dealerships. Have you read your state's dealer franchise law? Do you know what protection and/or rights a dealer has if the manufacturer tries to do some of the things Mr. Sox was warning about?

To supplement our reporting of Mr. Sox's presentation, we've included selected examples of dealer franchise protections under Florida and Illinois law to show some of the variation in state law. Although there are ***uniform*** state laws in many areas (for example, ***Uniform*** Gifts to Minors Acts, ***Uniform*** Commercial Codes, ***Uniform*** Partnership Acts, etc.), t***here is no "uniform" state dealer franchise protection law for all dealers.***

The information beginning on page 36 has been significantly edited/diluted, and it is only intended to give you some examples of what you may find when you look at your own state's law. If you haven't read these laws, perhaps you should. Not because you want to practice law ... (you know you can't do that unless you're a lawyer) ... but just so that you can broaden your horizons and be reasonably conversant. Who knows? ... Maybe you'll even be able to provide some valuable suggestions.

The provisions selected for both states (Florida and Illinois) reinforce Mr. Sox's statement that a manufacturer can legally deny a franchise to a dealer (or deny the transfer of a franchise by an existing dealer) based on only one of three reasons ... the dealer's ***lack of*** (1) "good" moral character, (2) sufficient capital or (3) adequate business experience.

#7. *"THE FRANCHISE SYSTEM"* ... HOW GREAT IT IS!? There's some interesting reading ... not necessarily "required" reading ... but, informative nonetheless, that gives a broad, historical perspective of the franchise system in which our dealership clients operate. The *Automotive News* had a special issue (Sept. 25, 2006) devoted entirely to *"The Franchise System."* The subtitle reads, "A century of factory-dealer cooperation, tension and prosperity - Why the franchise system dominates."

The articles in this 100-page special issue are fairly short. Most are not more than a page or two in length. Much of what is written about portrays only the brighter side ... no mention of GM and Ford on the brink of you-know-what (the "B" word), etc.

After skimming the table of contents, the article that I simply couldn't resist reading first was ... "Afterward, a Dealer Wonders, 'What Brought Me Down?'" If you really want an eye-opener, this tells how Honda's corrupt sales network drove (no pun intended) one dealer out of business.

Clearly, Mr. Sox's presentation in Phoenix elaborated on the ***"tension"*** aspect of the relationship between dealers and their manufacturers. From the *Automotive News*, one might conclude that everything is hunky-dory; from Mr. Sox, one might conclude that the relationships are very often contentious and adversarial. As the saying goes, with friends like that, who needs enemies?

see **DEALER TAX WATCH OUT**, page 10

100 Years Industry Perspective	***THE FRANCHISE SYSTEM*** ***A Century of Factory-Dealer Cooperation, Tension and Prosperity ... Why the Franchise System Dominates***	Page
How It Began	*The First Dealers: From Humiliation to Retail Success*	6
	Rise and Fall of Ford's Sales Network Architect: Prison, Success, Bankruptcy	12
How It Grew	*Between World Wars, GM Set Franchise Pace*	18
	Sloan, Durant Build GM on Firm Foundation of Dealer Base	20
Pendulum Swing	*Government Tips Scales for Dealers, Automakers*	26
	Tested Time and Again, System Survives and Thrives	27
Import Era	*Beyond the Sea: The Rise of the Imports and Distributors*	28
	Hahn Helped Americans Learn to Love VW	34
Modern Era	*Up to the Minute: System Survives Challenges, Emerges Stronger than Ever*	36
	For a Time, F&I Was Legal Battleground	38
	Dealers Are Winning the Warranty War	42
	Dealers Win Big Against Forced Arbitration	44
Future	*The Dealership in 50 Years: Large, Luxurious and High-Tech*	46
	Crystal Ball Gazing: Fewer Dealerships, Multiple Franchises	52
Detroit 3: GM	*GM Blazes a Trail for Dealer-Factory Relations*	54
	How Jack Smith Saved the Franchise System	60
	Saturn Is Now Sort-of-Different Car Company	62
	The Death of Oldsmobile	62
Detroit 3: Ford	*Despite Sales Woes, Ford Vows to Boost Its Dealers' Profits*	64
Detroit 3: Chrysler	*Chrysler Corp. Survived with Strong Leaders, Dealers' Help*	68
	Iacocca, Dealers Lobbied to Save Chrysler	70
Global: Europe	*Europe Dealer Network Still Relies on Factory's Stores*	72
	Daewoo's U.K. Factory Stores: Different, but Not Better	73
Global: Japan	*Japan's Franchise System Favors the Factories*	74
	Nissan's Revamp of Japan Sales Network Drags on	75
Global: China	*China's Emerging Dealer Networks Follow U.S. Model*	76
	Savvy Buyers Force Dealer Upgrades	77
Franchise Matters	*Honda Scandal ... Afterward, a Dealer Wonders: What Brought Me Down?*	78
	Too Many Dealers ... Thinning the Heard	82
	Then There's Phoenix	84
	Auto Advertising ... Factories, Dealers Battle Over Ad Spending, Content	86
	Incentive Plans Changed Ad Equation	88
	Dealer Diversity ... Minority Dealers Share Industry's Pain, Potential	90
	Failed Alternative ... Porsche vs. Dealers: No Contest	92
	Service and Parts ... Dealers, Factories Cooperate to Capture Repair Work	94
	Commentary ... It Isn't "Business as Usual" Anymore	95
	CPO Plans ... Certified Programs Boost Used-Vehicle Sales	96
	Postscript ... Longtime Dealers Say Change is Constant	97
Source	*Automotive News*, Special Issue, September 25, 2006. Single copy $14.95. For copies, contact Customer Service at (888) 446-1422 or subs@crain.com.	

(Continued from page 8)

#8. HOW ONE DEALER SAVED A SMALL FORTUNE ... BECAUSE HIS CPA BROUGHT IN A SPECIALIST. Most of our auto dealers are high net-worth individuals, and they often have very significant personal insurance needs. These needs can be very expensive to satisfy, and most CPAs have little, if any, competence to advise their dealers in this area (and that includes most, if not all, of the *financial planners* out there).

In the past, we've mentioned the excellent work in this area done by Tony Freeman, an objective, independent insurance advisor. He is often called in by CPAs to fix insurance problems. Recently, Tony saved an elderly dealer over $300,000 in a situation that the dealer, his two attorneys and his CPA (who ultimately brought Tony in as a consultant) thought was utterly hopeless.

The situation was not hopeless ... it simply required an expert who knows (!) what all of the options really are and (2) the ins and outs of the insurance industry.

#9. GAO FOUND A 100% ERROR RATE IN ITS LIMITED STUDY OF PAID TAX RETURN (FORM 1040) PREPARERS. This finding is from a study released April 4, 2006 by the Director of Strategic Issues of the U.S. GAO (Government Accountability Office).

The GAO had conducted 19 site visits to tax return preparers affiliated with chains, and it found errors in all 19 situations. "All of the tax return preparer visits we conducted produced errors, some with substantial consequences." It was reported that many of the problems that the GAO identified put preparers, taxpayers or both at risk of IRS enforcement actions.

Although this was a very limited study, involving a small sample of paid preparers (not CPAs), it may be a useful reference for training newer staff members who, in a few months, will be preparing individual income tax returns for the first or second time.

A full copy of the GAO report can be accessed at www.gao.gov/new.items/d06563t.pdf.

Dealer Insurance Savings

It's Almost 2007 ... Is Your Insurance Policy About To Lapse?

We all assume that once we have purchased a life insurance policy the coverage will be there when needed as long as we continue to pay the premium each year. Unfortunately, most policies purchased over the last 10 or more years are not living up to the financial projections made at the time they were issued. And that can mean financial disaster to a family if ignored.

A 74-year-old dealer and his 75-year-old wife purchased a $20-million Second To Die life insurance policy 16 years ago. Like most large policies, the proceeds were to be used to pay the couple's estate taxes. The required $95,000 annual premium was supposed to continue the coverage to the wife's 100th birthday.

The initial premium was paid and the dealer promptly placed the policy in his safety deposit box where it remained until the couple decided to update their estate planning. Their new estate planning attorney asked the insurance company for a printout of the policy's current financial position, an in-force ledger, and was ***shocked to learn the policy would lapse within the next five to six years unless the annual premium was increased to $585,000.***

The dealer was extremely upset and asked his insurance agent if he could get the insurance company to reduce the new premium to a more realistic level. When that failed, the dealer asked his new attorney to contact the life insurance company and make the same request. The attorney experienced the same results. It should be noted that the insurance company refused to pay the agent a new commission on the conversion of the old policy to a new policy.

The dealer then asked the original agent and two others to "shop" for a better deal. This created problems for the five life insurance companies fighting for the business because each needed a "reinsurance partner" to be able to offer the $20 million being applied for.

Recognizing an opportunity to save the dealer some meaningful money, his CPA firm asked our firm, Premium Advisors (PA), to complete an independent third-party review of the proposals being submitted by the five life insurance companies. When the analysis was completed, PA offered to re-contact the original insurer's business retention team (BRT), and those negotiations resulted in the original insurer issuing a new $20,000,000 policy with a "Guaranteed Level No-Lapse" annual premium of $110,000. The new policy offered by the original insurer cost almost $50,000 a year less than those proposed by the other five companies.

But there's more. The dealer took advantage of a proprietary program suggested by PA that provided an additional $250,000 savings the first year. This brought the total first year savings to more than $300,000.

The dealer and his CPA were both pleased with the results. There's little chance that CPA will ever lose that client.

Source

- *Premium AdvantEdge*, Vol. 1, No. 3.
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XYZ DEALERSHIP

USED VEHICLE WRITEDOWN WORKSHEET - AS OF DEC. 31, 200X

Stock Number	VIN Number	Model Year	Make, Model, Body Style, etc.	Date of (P) Purchase, or (T) Trade-In	P or T	Cost, Including Reconditioning, etc.	Official U/C Guide Average Wholesale Value	Writedown to LCM	Justification for Unusual Writedown at Year-End	Subsequent Disposition (Date & Amount)
			Des.________ Mileage ________ Condition ________ Options ________							
			Des.________ Mileage ________ Condition ________ Options ________							
			Des.________ Mileage ________ Condition ________ Options ________							
			Des.________ Mileage ________ Condition ________ Options ________							
			Des.________ Mileage ________ Condition ________ Options ________							
			Des.________ Mileage ________ Condition ________ Options ________							

NOTES

- *Dealers are required to use the same Official Used Car Guide from year-to-year.*
- *Some IRS agents take the position that ... unless the taxpayer can document the existence of unusual circumstances ... there should be no writedowns at all for vehicles purchased near the end of the year.*
- *Generally, IRS agents will review subsequent sales and compare those sales (or other disposition) prices with the lower-of-cost-or-market values used at year-end.*
- *If a dealer claims LCM writedowns that are substantially in excess of amounts that the IRS deems appropriate, the IRS may assert (under)valuation penalties as a result of those writedowns.*

IRS UPDATE ON MAJOR TAX ISSUES AT THE 2006 AICPA AUTO DEALERSHIP CONFERENCE

TAX UPDATE

Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, spoke again at the AICPA National Auto Dealership Conference held in Phoenix on October 26. In her one-hour presentation, Ms. Harris covered five major areas. This article summarizes her comments and includes some of the PowerPoint slides from her presentation.

1. IRS Audit Activity - Examinations, etc.
2. Electronic Records Retention Obligations
3. Technicians' Tool Reimbursement Programs
4. Application of Section 263A Inventory Cost Capitalization Rules to Dealerships
5. Changes in the Form of Future IRS Guidance

All of these areas have been covered at length in recent issues of our publications, the *Dealer Tax Watch* and/or the *LIFO Lookout*. (See page 7 for all citations.)

1. IRS AUDIT ACTIVITY - EXAMINATIONS, ETC.

Audit Technique Guide. Ms. Harris first clarified that the *IRS Auto Dealership Audit Technique Guide* has not been recently revised. The current revision is dated December 2004 (Catalog No. 85870Y [1-2005]). Alternatively, it may be dated January of 2005.

Ms. Harris wanted to clarify this because some of the research services that have reproduced this *Audit Technique Guide* may be showing it as having a more recent revision date, some time in 2006. In fact, the most current revision is the one dated Dec. 2004 (or possibly, Jan. 2005). She indicated that the Service would like to revise this *Technique Guide*, and said that comments or suggestions from practitioners in this regard would be most welcome.

Audits. On the subject of audits, Ms. Harris said that the Service has recently hired a significant number of new auditors. Some of these auditors do not have very much practical experience in working with, or understanding, dealership operations. About 30% of the auditors that would be examining dealerships in the Large and Mid-Size Business Group are new hires.

Ms. Harris reported that the number of IRS examinations of auto dealerships is definitely increasing. As a result of this increase in examinations, the scope may vary significantly from dealership to dealership. Also, she said that some audits are more in the nature of "a quick touch and move on," while other audits are more traditional (longer lasting, more in depth) audits.

The type of audit any given dealership may experience could vary according to the geographic location in which the dealership is located. It could also depend on whether that audit is part of a *local* project or part of a *national* project initiative.

2. ELECTRONIC RECORDKEEPING RETENTION OBLIGATIONS

Much of what Ms. Harris said on this subject, she has said at past Conferences. But, she added that in connection with having to go back to records in old years, the "good news" is that the Service is much more current in its audit status. It is now likely to be auditing 2005 returns, rather than returns for the year 2004 and prior.

The most critical points this year are as follows.

COMPLIANCE CONSIDERATIONS

First, the IRS is now leaning more and more towards assessing penalties for non-compliance.

Second, it is up to the dealer to take the initiative and press his/her software provider to find out whether that provider has received approval from the IRS regarding the compliance of its record retention with Revenue Procedure 98-25.

Third, nothing can change the fact that ... the sole responsibility for compliance with the requirements of Rev. Proc. 98-25 ... falls upon the dealership.

Fourth, the Service cannot work with data if that data is simply in a .pdf file format.

Fifth, during an audit, the dealership will be asked to provide the IRS auditors with terminal time and a dealership employee who can assist the Service in its record extraction activities.

As background for the issue, Ms. Harris indicated that dealerships, as a group, continue to be notoriously non-compliant. She indicated that many examining agents will typically request an IRS computer audit specialist (CAS) to assist them in dealership examinations. Even with this assistance, examining agents often run into significant difficulties.

The IRS has to be able to sort the dealerships' data, analyze it, manipulate it, print it, produce output. Ms. Harris reported that in many dealerships, the Service has found insufficient transactional level de- →

tail, and this prevents the agent from being able to trace amounts and/or taxpayer entries down to the underlying invoices and/or locate the related source documents.

Ms. Harris indicated that if a dealership has retained a "print" file (not a "printed" file), the IRS may be able to bring in its computer specialists to work with that "print" file. However, that does not necessarily mean that the dealership is compliant with the requirements of Rev. Proc. 98-25.

Rev. Proc. 97-22 also has to be considered. It applies to taxpayers who maintain their books and records using an electronic storage system, but who image their books using some format to transfer their records off to some type of imaging system.

Although Rev. Proc. 97-22 will allow the taxpayer to destroy its books and records (i.e., the hard copy, original), Ms. Harris suggested that dealerships should exercise extreme caution before destroying any records. Dealers should be absolutely sure that they have first tested their system in place and are confident that the information can be reproduced and be used by the IRS auditors during the course of their examination of the taxpayer.

see **IRS UPDATE ON MAJOR TAX ISSUES**, page 14

IRS MVTA 2006 Update	***ELECTRONIC RECORDKEEPING REQUIREMENTS***
Revenue Procedure 98-25	• Electronic records must be retained • Must be "capable of being processed" ◆ Retrieve, manipulate, print, produce output • Must contain sufficient transaction level detail • If data files stored in DBMS structure, **must convert to an ASCII/EBCDIC format**, or allow IRS to process historical DBMS files on taxpayer's computer equipment ◆ Retained "print" copy may be usable but not compliant
Revenue Procedure 97-22	• Applies to taxpayers that maintain books and records by using an electronic storage system that either: ◆ Images their hardcopy (paper) books and records, or ◆ Transfers their computerized books and records to an electronic storage media, such as an optical disk • Permits the destruction of the original hardcopy books and records and ◆ The deletion of original computerized records ◆ ***After*** a taxpayer completes ***testing*** of the storage system to ***establish*** that books and records can be ***reproduced***
MVTA & CAS Currently Working with Vendors at Vendor's Request	• Conducting architecture design discussion • Evaluating specific software applications at a detailed level • IRS prohibition against disclosing companies that IRS is working with • IRS will not endorse any vendor product
Meetings with Vendors	• IRS is now meeting with vendors ... Old & new, large & small • Compliance review of current programs • Technical discussions • Field test of old and new programs • 4 vendor's visited, 1 vendor appointment scheduled
Variances Between Systems	• Compliance available at additional cost • Compliant system made available with newest release • Compliance possible but required specific steps potentially unknown to dealer • Some vendors and third parties offer other options ... Imaging
Communications Continue	• Further system changes possible for some vendors • Discussions with other vendors
Dealers' Obligations	• Compliance is the ***dealership's obligation*** • Vendors make compliance available at varying levels of simplicity and cost ◆ Dealer *must* understand the purchased system and what must be done to comply.

 (Continued from page 13)

Some history ... IRS attempts that didn't work. Several years ago, the IRS attempted to bring most of the vendors of dealership software together. The Service's efforts began in 1998 with its intention to have an open discussion with dealership software vendors about the requirements of Rev. Proc. 98-25 and what could be done to improve the overall deplorable state of noncompliance. Unfortunately, this approach was not successful.

Since that general attempt by the IRS to work with the vendors as a group was not successful, the Service has changed its tactics. It is now adopting a new approach which Ms. Harris believes has resulted in significant progress over the past year.

The IRS' newer approach. The IRS is now trying to work with vendors on an individual basis. The IRS CAS Specialists will go in and sit down with the code writers in order to explain to them exactly what is required and needed and exactly where the Service believes the system currently is failing (i.e., where it is not meeting the recordkeeping requirements of Rev. Proc. 98-25). The IRS Specialists will also tell the code writers exactly what they would like to see as "fixes" or corrective measures.

Ms. Harris indicated that the Service does not have the authority to tell a software vendor that it must make these changes. Although the Service cannot force the vendors to comply, it can tell them what the IRS would like to see in the way of changes.

Some vendors have taken the initiative on their own and approached the IRS to express their interest in considering and making necessary structural or other changes to their architectural designs.

The IRS cannot disclose which companies have come forward for this assistance. Nor can the IRS say which companies may be (considerably) better, or worse, than others in this regard. Also, the Service cannot endorse any specific vendor or product. However, Ms. Harris indicated that a few vendors have taken the initiative in working with the IRS on this.

After working with a vendor, and often visiting a dealership (at the suggestion of the vendor) to look at live data on a live system, the IRS will critique the adequacy of the information that is available. After that, the Service will return to the vendor and describe what changes might be necessary. If the vendor makes these recommended changes, the Service will go back and re-assess the system. Once that reassessment is done, and if the Service finds that the dealership's system is compliant (as a result of these changes), then the IRS will issue the dealership a "records evaluation" letter. This letter will not necessarily apply to the entire recordkeeping system, but it will explain the various parameters or conditions within which the IRS has found the dealership's records to be compliant.

The IRS recognizes that some dealerships may have issues with what software vendors they can use - or are permitted to use by the manufacturers. Also, often, it is the software vendors who are "controlling" the data being retained and possibly limiting the dealer's ability to later access or retrieve that data.

Ms. Harris observed that in some instances, dealers not currently in compliance might be able to reach that level if they are willing to spend the additional money to purchase whatever "add-ons" may be available to the current system. Also, some vendors have indicated that they now have made changes or modifications so that their systems will be compliant with Rev. Proc. 98-25. Ms. Harris indicated that it will be necessary for the Service to test these changes to see if, indeed, they result in compliance with the Rev. Proc.

Questions to ask the vendor. With this in mind, she added that there were several questions that CPAs (and/or dealers) ought to be asking their current software providers. Probably the most obvious questions are ... "Have you recently met with the IRS, have you engaged in a process or a series of meetings [like those Ms. Harris described] and have you developed your products so that the dealership using them will be in compliance with the requirements of Rev. Proc. 98-25?"

Other questions might include ... Is the data stored in an unalterable format? (The IRS requires that archived data must be in an unalterable format.) Will the IRS be able to use ASCII / EBCDIC print reports versus the taxpayers' DBMS data files? (The IRS cannot convert .pdf files.) ... And there are also other questions of a similar nature.

As a result of mere repetition and some of these new informal procedures, there is now a greater level of awareness of the requirements of Rev. Proc. 98-25 in the automotive industry. The IRS is also now going directly to the vendors to explain the requirements, rather than waiting for the vendors to come to the IRS. Because of the variations between systems, the IRS may issue an "inadequate records" notice, and that, according to Ms. Harris, is "pretty much a guarantee that the IRS will be back."

Threat of penalties. To the extent a dealer can achieve compliance by spending more money or training personnel, that becomes a decision the dealer has to make. In this regard, the dealer should be aware that the Service seems to be loosing patience with non-compliant dealers, and to stress that point more forcefully, it may possibly try to assess penal- →

ties for non-compliance with Rev. Proc. 98-25 in the future. This is not a new point; Ms. Harris said the same thing last year. But, this year, she said it more forcefully.

Apparently, there is now a mandate on the CAS (Computer Audit Specialist) side of the IRS "to get the dealership industry into compliance." This would be where monetary non-compliance penalties in the future could become a significant force in pushing for greater dealer compliance.

3. SERVICE TECHNICIANS' TOOL PROGRAMS

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

Ms. Harris provided a brief review of the accountable plan rules and of the generally negative Coordinated Issue Paper on this subject that the IRS had issued in 2000. Last year, her presentation was shortly after the issuance of Revenue Ruling 2005-52. This Ruling pretty much shocked many third-party administrators by its emphasis on strict compliance with the requirement that an employee who receives an excess disbursement (or reimbursement) must return the amount of any excess to the employer.

This Revenue Ruling was not based on any one specific taxpayer's plan. Instead, the fact pattern in the Ruling was a blend or combination of facts taken from several plans that the IRS National Office had "seen" or reviewed over the past several years. The employer's reimbursement plan involved a formula approach (i.e., it was a rate-based determination plan) with several very obvious defects.

Ms. Harris said, ***"The IRS is taking these programs very seriously. The compliance level with Section 62(c) is problematic, and we have grave concerns. You may not be seeing a lot of activity right now, but we're taking this very seriously....*** I can't say that I've seen all of the plans that are available out there, but I can say that I have not yet seen a plan that complies with Section 62(c)."

She added that the issue of "wage recharacterization" is still critical, notwithstanding the assertions of a number of third-party administrators / plan providers who are saying that they have changed their plans to comply with Section 62(c). In other words, under most (if not all) plans in operation, before the "tool plan" is put into effect, the technician is being paid $20 per hour. With the plan in place, the technician is still receiving a total of $20 per hour ... only under the plan he or she is receiving $15 per hour for labor and $5 per hour for the tools. The same total hourly payment is still being paid to the technician ... it has just been divided into two pieces that add up to the same pre-plan total ($15 + 5 = $20). "That's a bit of a concern!"

Ms. Harris said that technicians must be able to provide receipts, and that plans must reimburse for actual amounts that technicians have paid for their tools. In some instances, where a technician could not provide receipts, the plan administrators attempt to make up for that deficiency by referring to price lists.

Ms. Harris indicated that this is not an acceptable approach because it does not reflect the amount the technician actually paid for that tool. In addition, in setting a reimbursement rate, the Service position is that it is not acceptable for the dealer to rely on "national averages," which are sometimes buried in third-party administrators' proprietary formulas.

Finally, she emphasized that in connection with excess reimbursements, the technician has to "give it back," and the employer cannot simply treat the excess as additional wages (to be reported on Form W-2) or as other income paid (to be reported on Form 1099) at the end of the year.

Ms. Harris observed that (even though it does not involve an automobile dealership reimbursement situation), the recent *Namyst* decision further emphasizes much of what we already know about the need for strict compliance with all three of the requirements of Section 62(c).

This topic continues to be extremely controversial, and the IRS has had 12 requests for IIR (Industry Issue Resolution) treatment. Ms. Harris indicted that the previous Coordinated Issue Paper is currently being revised.

Ms. Harris opined that sooner or later she would like to be able to go to a Conference and say either (1) "These plans are never going to work," or (2) "You can make these plans work (i.e., comply with Section 62(c)) if you do this or that." Obviously, taxpayers need some *real* guidance from the Service on this, and not simply guidance based on oversimplified (usually adverse) hypothetical fact patterns.

Ms. Harris' PowerPoint outline on tool plans (somewhat edited) is on pages 16-17.

4. APPLICATION OF SEC. 263A INVENTORY COST CAPITALIZATION RULES TO DEALERSHIPS

Simplified resale method questions. The first part of this discussion related to the questions that many CPAs are asking in dealerships to determine to what extent the simplified resale method might be applicable.

see **IRS UPDATE ON MAJOR TAX ISSUES**, page 18

IRS MVTA 2006 Update	SERVICE TECHNICIANS' TOOL REIMBURSEMENT PROGRAMS Page 1 of 2
Tool Programs Remain an Area of Considerable Concern for the IRS	• Compliance with Requirements of IRC 62(c) • Apparent endorsements by major companies and associations • Accountable Plan Requirements - IRC 62(c) ◆ 3 Requirements for a qualified plan ▪ Business Connection … A valid business connection ▪ Substantiation … Substantiation of expenses ▪ Return of excess payments
Overview	• Technician is an employee and is required to provide and maintain tools • Employer compensates technician with hourly wage and a tool reimbursement • Program providers generally maintain programs are compliant with Accountable Plan rules of IRC Section 62(c)
Advantages of an Accountable Plan	• Amounts paid under a qualifying plan are not subject to income or employment tax ◆ No income or employment tax for technicians ◆ Reduced employment tax for employer
Major Questions	• What are the requirements to qualify as an accountable plan? • What is the IRS position on service technicians' tool reimbursement plans? • Is your plan compliant?
Accountable Plan Rules … Section 62(c)	• Employee expense must be ordinary and necessary • Employee must actually pay or incur an expense • Employee must provide adequate accounting to employer ◆ Written documentation & receipts • Employee must account for all amounts received • Excess amounts must be returned to employer
IRS Position	• Current IRS position is expressed in the Coordinated Issue Paper that was issued in 2000 • Concluded that generally amounts paid under such plans don't meet the accountable plans requirements • Amounts paid under a non-accountable plan are: ◆ Included in the employee's gross income ◆ Must be reported on employees' Form W-2 ◆ Are subject to the withholding and payment of federal employment taxes
Activity Between 2000 & 2005	• Several requests for Private Letter Rulings • Many requests for inclusion in the Industry Issue Resolution Program • Issuance of Revenue Ruling and Revenue Procedure on rig welders • Notice with additional requirements for IIR • Unofficial coalition of plan providers formed ◆ Lobbying activity • Plan providers changing their plans to comply
Revenue Ruling 2005-52 *(Aug. 3, 2005)*	• *Facts* ◆ Employees required to provide and maintain various tools ◆ Employees receive hourly wages and a tool allowance ◆ Tool allowance is determined using national survey data and technician questionnaires ▪ Not dollar for dollar reimbursement ◆ Employees not required to substantiate actual expenses ◆ Employees not required to return any part of allowance that exceeds actual expenses • *Conclusion* - Tool allowance arrangement fails to meet the accountable plan requirements ◆ No substantiation required ◆ No return of excess • Amounts paid under such a plan are: ◆ Includible in technician's income ◆ Subject to employment taxes • Re-characterization issue: ◆ Even if employees substantiated actual amounts and any excess paid is treated as wages by employer, the plan does not qualify

SERVICE TECHNICIANS' TOOL REIMBURSEMENT PROGRAMS

Recent **Namyst** *Decision*	• *Steven J. and Terry L. Namyst vs. Comm.* (T.C. Memo 2004-263 [Nov. 7, 2004]) ◆ U.S. Court of Appeal for the Eighth Circuit ▪ Affirmed Tax Court Decision - January 2006 • Taxpayer agreed to work for reimbursement of expenses only as an accommodation to employer ◆ Previously was a W-2 Employee ◆ Employer informed taxpayer that it could no longer afford to pay taxpayer wages • Taxpayer incurred various expenses reimbursed by employer (travel, equipment purchases) ◆ Amounts not reported on W-2 ◆ Taxpayer argued payments were expense reimbursement and proceeds from selling old tools to employer as part of an accountable plan • Government position - Not a valid accountable plan although deductions were allowed (under Section 162) for many of the expenses ◆ ***Business connection*** - expense reports represented valued expenses directly connected to the employer's business ◆ ***Substantiation requirement*** - requires substantiation to employer within a reasonable time ▪ Detailed annual list and receipts submitted ▪ Substantiation requirement deemed met ◆ ***Return of excess requirement*** ▪ Actual reimbursement amounts exceeded expenses substantiated ▪ No correlation between receipts and payments made ◆ Plan did not fulfill all three requirements of accountable plan requirements • Other issues regarding sales of old tools ◆ No basis for tools provided ◆ Attempted to establish basis with pictures and estimated value ▪ Pictures do not provide evidence of cost of tools when purchased ★ Same would apply to service technician's tool reimbursements ★ Treated as long-term capital gain ★ Court was unable to differentiate between purchase of old tools and expense reimbursements • Taxpayer argued that substantiated payments were part of an accountable plan; and that unsubstantiated payments were part of a non-accountable plan ◆ Court determined that such a holding would invalidate the 3rd prong of the requirements - Return of excess • Lessons form the *Namyst* decision can be applied to the service technician tools issue ◆ ***Return of excess is crucial*** ◆ ***Photos and estimates of cost are not acceptable*** ◆ ***Substantiation is required***
Other	• Numerous IIR Submissions - Various industries • IIR in general addresses frequently disputed or burdensome issues • *Notice 2005-59* - Additional criteria for IIR submissions on accountable plans ◆ An established industry history of high turnover in the labor force or short-term employment with multiple employers is typical ◆ Large expenses for maintenance, although infrequent, are predictable relative to the compensation paid to the employees for their services ◆ Individual employers are unwilling to reimburse in full for sporadic expenses for equipment maintenance because a significant portion of the reimbursement will accrue to the benefit of a later employer/competitor

(Continued from page 15)

Ms. Harris referred to some of the current articles and CPA practices on dealership compliance with Section 263A which suggest that favorable answers to 3 simple questions (see page 20) could make all of a dealership's Section 263A problems "go away."

Here, Ms. Harris said she thought that some CPAs (in asking these questions) might be "leading the witnesses" and not pursuing all of the facts that are required to be considered to the proper or appropriate extent.

She said that IRS auditors could raise potential Section 263A issues in connection with purchasing and storage activities and the "retail" nature of the facilities. She did acknowledge, however, that in many instances an IRS agent may be content to simply review and accept the short-cut approaches many CPAs have developed for making this analysis.

Here's one real question ... What happens if there is someone in the dealership who spends 40% or 60% of his or her time on the purchasing function? This is more than one-third (the cut-off point below which all costs can be excluded/ignored) but less than two-thirds (the cut-off point above which all includable costs must be allocated 100% to inventory). This is a gray area where, according to Ms. Harris, there is a tremendous amount of inconsistency in how the industry is handling these questions and issues.

In a current audit, if the agent is questioning the application of Section 263A and the dealership's determination of capitalizable purchasing, off-site storage or other costs, then the IRS will continue to press these issues.

Reseller vs. producer status. The second part of her comments in the Section 263A area addressed the specific issue of whether auto dealerships, under certain circumstances, should be treated as "resellers" or as "producers." Technically, the issue is whether dealerships should be treated as "resellers with production activities" under the Regulations. Apparently, this issue may come into play in connection with a dealership's service department and/or body shop activities ... or, it may be related to certain activities when vehicles are taken in trade.

The resolution of this issue determines whether the dealership would be permitted to use a simplified resale method (which allocates far fewer costs in dollar amount to the ending inventory) or a simplified production method (which allocates considerably more costs in dollar amount to the ending inventory). This issue has the potential to be very expensive for dealerships if the conclusion is that they are not permitted to use the simplified resale method, but instead must use the simplified production method.

Ms. Harris said that currently there are two different schools of thought on this issue within the IRS and that the IRS, for the present time, has agreed to stand down on the "reseller with production activity" issue. The IRS is currently in a holding pattern, waiting for further technical guidance on this issue only. This naturally leads into her next topic which provides hope for answers to this issue.

5. CHANGES IN THE FORM OF IRS GUIDANCE ... GLAMs, TAMs, etc.

Ms. Harris referred to a new guidance process that is now being developed within the IRS. This would involve non-taxpayer-specific advice to an industry director, service center program manager or other national program manager intended to resolve audit issues that affect multiple taxpayers in a particular industry.

The formal name (or at least the working name at the present time) for this advice is Generic Legal Advice Memorandum ... or GLAM, for short.

Ms. Harris added that the National Auto Dealer Association (NADA) has been granted permission to submit a "whitepaper" on the Section 263A "retailer with production activities" issue. The Service will take this submission into consideration in its eventual issuance of a ruling under the GLAM format and procedures. This GLAM, when issued, will have a higher level of authority than a Technical Advice Memorandum (TAM) because a TAM may only be cited as precedent by the taxpayer to whom it is issued.

OTHER TOPICS

Ms. Harris briefly mentioned some of the newer developments relating to the new Alternative Motor Vehicle Credits under Section 308 and two recent tax cases ... (1) *Tysinger Motors* (a case involving Form 8300 non-compliance penalties) and (2) *Dow Huffman* (a case involving the IRS questioning a dealership's LIFO calculations and requiring a change in accounting method under Section 481(a)).

Finally, one of the questions she was asked in the brief Q&A period was whether or not the improper handling of trade discounts (which are required to be eliminated from inventory cost) might jeopardize an auto dealership's LIFO election. Ms. Harris' answer to this question is on page 21.

IRS MVTA 2006 Update	SECTION 263A & AUTOMOBILE DEALERSHIPS
General	• Requires certain taxpayers to capitalize direct and indirect costs related to inventory • Applies to retailers with sales of $10,000,000 or more and all producers ◆ Average over 3 years • Requires dealerships to capitalize certain indirect costs • Method of accounting
Potential Dealership Issues	• Purchasing costs and handling costs ◆ Direct labor, indirect labor, expense, supplies, other general and administrative (G&A) expenses ◆ 1/3-2/3 Rule - All or nothing? ◆ Direct labor, indirect labor, occupancy expense, supplies, other G&A • Storage - Offsite; onsite; dual purpose facility ◆ Reseller with production activities
Purchasing	• Who purchases for the dealership? New, used, parts • Purchasing Department, office, personnel • If no purchasing department look to individual employees • Dispersed enough to meet the 1/3-2/3 test? ◆ No - Reasonable allocation
Storage	• Off site storage - Not on site storage • On site storage ◆ Physically attached to, integral part of retail storage facility ◆ Retail customer makes purchases in person • Dual storage facility ◆ Serves as both off site and on site storage ◆ Costs must be allocated based on functions
Recent IRS Activity	• Overall increase in auto dealership examinations ◆ Resulting increase in potential 263A issues • Dealerships as resellers with production activity issues raised in limited areas ◆ No specific guidance on this issue
If Dealers Are Resellers with Production Activity ...	• Do activities in the service department and in the body shop qualify as production? ◆ Simplified Production Method is the only simplified method available ▪ Requires allocation of costs to ending inventory including vehicle inventory • Raised in a limited number of examinations ◆ Geographically concentrated • Technical Advice request submitted • Industry raised concerns to service executives ◆ Service has committed to securing guidance on this issue • IRS has agreed to (temporarily) stand down on the "producer" issue *only* ◆ Other IRC 263A issues may continue to be considered • General Legal Advice on the "producer" issue has been requested • NADA allowed to provide "white paper"
Generic Legal Advice	• Formal procedures not yet issued • Generally - ◆ Non-taxpayer-specific advice to an industry director, service center program manager or other national program manager ◆ Purpose - resolving audit issues that affect multiple taxpayers in a particular industry ◆ Executive-level signature ◆ Represents the Office of Chief Counsel's view of the law • Generally issued without input from any particular taxpayer or industry ◆ Exception - automobile dealerships and producers for IRC Section 263A issue • Timeline

Section 263A	**_Are CPAs Oversimplifying the "Simplified" Resale Method?_** **_Determining Amounts to Be Capitalized & Avoiding Capitalizing Unnecessary Amounts_**
How Simple Can It Get? **_1 - 2 - 3_**	• The IRS recently has expressed some concern over the possibility that CPAs may not going as far as they should be in trying to determine costs that dealers should capitalize under Section 263A. (That wouldn't have anything to do with the complexity of the rules, would it?) • On balance, the concern of the Service seems to be reasonable, given the fact that in many cases, the "cookie-cutter" approach to Section 263A is one that reduces pages of mind-numbing text down to the outcome of the answers to three simple questions.
_#1_ **_Storage_**	• **_Does the dealership have any off-site storage facilities?_** • Off-site storage facilities would be any places where the customer cannot go to view the vehicles available for sale. • Generally, unless there is separate building that is totally locked-down where the customer cannot go (because it involves a rather remote or inaccessible storage lot location), most dealers will not have what is called "off-site storage facilities." • If the answer to this question is, "No," then would be no Sec. 263A **_storage_** costs to be capitalized. • **_ONE DOWN, TWO TO GO ..._**
_#2_ **_Purchasing_**	• **_Does anyone within the dealership spend more than one-third of his or her time engaged in purely purchasing activities?_** • Many dealers do not have any employees who spend more than one-third of their time involved in these purchasing activities. ◆ Typically, the counterperson in the parts department usually is also involved in selling and in other activities. Also, automatic order entry software significantly reduces the amount of time that an employee otherwise might have to spend attending to the purchasing function. • Therefore, usually most dealerships do not have employees who spend more than one-third of their time engaged in "purchasing" activities, and therefore, there would be no Section 263A **_purchasing_** costs to be capitalized. • Unless the dealership has a fairly large used vehicle operation, it's unlikely that any employee would spend more than one-third of his or her time involved with purchasing activities at various auctions. ◆ One day a week at the auction usually amounts to 20%, at most. ◆ However, dealerships with larger used vehicle operations may require a more detailed analysis of how much time employees spend involved in buying/purchasing vs. how much time is spent involved in sales/disposition of inventory. ◆ Similarly, this would hold true for acquiring inventory via dealer trades. • A potential problem area arises if closer examination results in finding that the employee expends more than one-third, but less than two-thirds, of his or her time engaged in purchasing activities. Less than one-third time ... nothing is capitalized. More than two-thirds time ... all (associated) costs are capitalized. Anywhere in between one-third and two-thirds time ... prorations are required. • **_TWO DOWN, ONE TO GO ..._**
_#3_ **_"Retail Facility"_**	• **_Is the dealership basically a "retail facility?"_** • In other words, are 90% or more of the dealership sales made to customers who (physically) come into the dealership to purchase vehicles? • If the answer to this question is, "Yes" (i.e., more than 90% of the sales are to customers who come into the dealership to purchase vehicles), then there would be no Section 263A costs to be capitalized with respect to the "retail facility" aspect of the dealership. • **_THREE DOWN, NONE TO GO ... and little, if any, capitalized costs under Sec. 263a._** • But, there are some knotty problem - interpretation areas... ◆ **_Internet selling._** In connection with this question, how should a dealer's internet presence (i.e., activities directed to selling over the internet) be taken into consideration in this overall analysis? ◆ **_Used vehicle department activities._** It is important to determine how used vehicles disposed of by selling them at the auction (or by other means) would factor into this analysis. Often, wholesale sales of used vehicles are considerably in excess of 10% of the total sales of the used car department ... but these sales may be less than 10% of the dealership's overall (new and used vehicle) sales. In this case, how should the Section 263A calculations be adjusted or modified, if at all?
Conclusion	• In summary, if the answers to the first two questions are, "No," and if the answer to the third question is, "Yes," then **_the correct amount to be capitalized by the dealership under Sec. 263A is zero._**

LIFO & Trade Discounts	Eliminating Trade Discounts from Inventory Cost & LIFO Eligibility An Informal Answer from the IRS

The Question

- During the Question & Answer portion of Ms. Harris' presentation at the 2006 AICPA National Auto Dealership Conference in Phoenix, she was again asked the following question ...

  Is an automobile dealership that is using the LIFO method to value its new vehicle inventories risking the termination of its LIFO election (because of a violation of the cost requirement) if that dealership is not eliminating trade discounts and floorplan assistance payments from its year-end inventory costs?

The "Answer"

- Ms. Harris's answer this year was exactly the same as it was last year.
- She indicated that she had discussed this question with "someone" in the Chief Counsel's Office and that she had received the following informal answer from that person ...

  The taxpayer would ***not*** *be considered as being in violation of the LIFO eligibility cost requirement (listed in Rev. Proc. 79-23 as one of several LIFO eligibility requirements).*

- Ms. Harris did not provide any rationale for this position.
- Nor did she identify the individual who provided this answer to her.

Query

- Is anyone in the National Office of the IRS willing to "go on the record" as the source for this answer?

Our Reflections on the IRS' Answer

- As we have said previously, we find this answer both illogical and inconsistent.
- In arriving at this conclusion, what is the basis for the IRS ignoring
  - The plain language of Reg. Sec. 1.471-3(b), and
  - The plain language of Revenue Ruling 84-481?
- Consider the following ... In discussing its demand for total and complete compliance with the accountable plan rules (in Section 62(c)) and with Revenue Ruling 2005-52, the IRS is always emphasizing that there are three requirements in the Regulations and that all three of them must be met, not merely one or two.
- Clearly, Code Section 472 imposes four requirements on taxpayers if they want to be eligible to use the LIFO method.
  - Compliance with the ***cost requirement*** is one of these eligibility requirements.
  - So, why in the area of LIFO inventories (where there is tremendously more at stake), is the IRS willing to be more lenient than when it is policing the accountable plan rules? What is the IRS' rationale here, and is there a precedent for it?
- ***Lack of consistency?*** On this LIFO question, the Service's answer portrays it like Dr. Jekyll (the "kinder, gentler" chap, who would seem to be sympathetic to taxpayers who inadvertently failed to fully comply with the LIFO cost requirement where trade discounts are concerned).
  - But, on the other hand, where accountable tool reimbursement plans are concerned, the Service's rigidity seems to portray it more like Mr. Hyde (the guy you wouldn't want to meet in a dark alley, especially if your accountable plan wasn't exactly 100% up-to-snuff).
- Shouldn't we be able to expect the IRS to consistently display the same temperament (or tolerance for less than full compliance by taxpayers) in interpreting various sections of the Code?
  - If we shouldn't, then where should one draw the line as we go section-by-section through the Code?

Our Advice

- Until the IRS provides an "official" answer, we continue to strongly caution taxpayers against relying on this informal, undocumented answer to this LIFO question.

Guest Author

A SECOND CHECK ON TOOL REIMBURSEMENT PLANS

by Steve Dockins

WHAT IS THE PROBLEM WITH TOOL REIMBURSEMENT PLANS?

I spoke at length with Ms. Terri Harris at the AICPA Auto Dealership Conference in Phoenix this year. She is the Motor Vehicle Industry Specialist for the IRS. She said that the IRS does not want to put these plans and providers out of business, that is not the goal of the IRS, and it is not good for anyone (including the IRS). She made it very clear, that if a plan conforms to the accountable plan rules, then the IRS should not have a problem.

To answer the question, ***the biggest problem*** in the tool reimbursement industry isn't the IRS, it ***is the industry itself***! ***The problem stems from the variety of plans being offered by providers that are unwilling to modify methods, to comply with the law and current IRS attitudes.***

Some are still operating under rental methodologies, some are paying reimbursements to infinity, and there is even a group that formed a coalition that seems to be attempting an end-run around the IRS rather than conform.

Over the years the IRS has gathered bits and pieces of information from these groups and tried to issue guidance, but by the time it puts all these pieces together, it got so far away from a viable tool reimbursement plan, that it ended up with Rev. Ruling 2005-52. Talk about a smorgasbord! Other than the title, I could barely tell what industry the IRS was supposed to be addressing in the Ruling, and I have been in this industry from the very first day, 18 years ago.

The more I listened to Ms. Harris's presentation, the clearer it became to me that there are at least 10 different plan administrators offering 10 different versions of what they are trying to pass off (to the IRS and their customers) as a qualified Section 62(c) accountable plan. And, of course, each of these providers thinks that its plan is the best, and that it holds the "secret formula" to compliance.

All those secrets. For years, third-party administrators have tried to fool the market into thinking that without using a third-party to administer a tool reimbursement plan, there would be no compliance, and the IRS would stomp the customers into bankruptcy. Third-party providers are in competition for that same customer, so they use this fear based selling tactic, along with their "secret proprietary formula" to convince those customers to buy their product.

Of course the big secret is that ***there is no secret*** ... Figure that one out. Some of these so-called secrets are kept hidden because the provider is well aware that if its secret were discovered, they would be out of business. ***That's the real secret!!***

When guidance is attempted by the powers that be (i.e., the IRS), and the industry is playing hide and seek, then the results come out like Revenue Ruling 2005-52.

Another secret that is kept from the market is that the dealer/customer can "Do-It-Yourself." Just buy some software that has all the rules 'secrets' built right in and point and click your way to those benefits. Of course, there is a variety of factors that one would have to know in order to administer the plan without some guidance from a software application or third-party provider.

QUESTIONS THAT SHOULDN'T EVEN BE QUESTIONS

Many of the outstanding questions and concerns being raised about dealership reimbursement plans are simply a matter of law, and posing some of these questions only seems to cause confusion and uncertainty, and fuel the fear and hurt the benefit.

Depreciation. The most pressing question seems to be, "Can a reimbursement be made for depreciation expenses?" Why is this even a question? CPAs, tax attorneys and so-called industry experts, should just read the Code. It provides that depreciation is an allowable deduction under Sections 167 and 168, and as an allowable deduction, it is an expense that can be reimbursed for under an accountable plan. This is right there in black and white ...

Quick example. If I am a service technician and I purchased my $700 air ratchet 3 years ago, I still have 4 years or $400 of depreciation left. (Most tools in our industry have a 7-year life.) So, when I go to work tomorrow morning, my air ratchet is depreciating in value by the hour, and I am incurring that depreciation expense while I am work for my current employer in the current tax year. (Does any of this sound familiar?)

Our Company, *Second Check*, has this simple feature built right into it. The software automatically calculates the remaining balance on depreciation (whether taken or not) and allows reimbursements only for the remaining deductible depreciation expenses.

A SECOND CHECK ON TOOL REIMBURSEMENT PLANS

by Steve Dockins

THE *"WAGE RECHARACTERIZATION"* ISSUE

At first, "wage recharacterization" was a concern, then it wasn't, then it was again and then not and now it seems to be gaining more attention again.

I have studied these questions for almost two decades. (Yes, that's 18 years.) I have conducted surveys and researched tax case law and revenue rulings, and I have met with several of the largest firms of tax consultants and attorneys in the world. My conclusion is that, if an employer hires an employee who is required to bring his or her own tools of the trade, and those tools are considered as part of the employer's compensation decision, the tools have an intrinsic value to the compensation plan and, no doubt, have a business connection to the dealership. This is absolutely common knowledge and standard practice in the auto service business and is supported by several Revenue Rulings and Procedures.

I have recently found what I would consider to be one of the best writings and arguments on the question of the wage recharacterization issue, in a letter authored by Morgan Lewis, Counselors at Law, on June 1, 2006.

*"Under Rev. Proc. 2002-41, a portion of the rig reimbursement is deemed to be a reimbursement under an accountable plan. There is no indication in Rev. Proc. 2002-41 that an employer desiring to take advantage of the $8 or $13 per hour 'safe harbor' must pay the employee $8 or $13 per hour **in addition** to what was formerly paid to the employee as 'wages.'*

"Rather, it is fairly clear from Rev. Proc. 2002-41 that an employer may simply begin treating $8 or $13 of the hourly 'wages' - formerly paid to the employee under a non-accountable plan - as reimbursement for rig expenses under an accountable plan, so long as the employer 'reasonably anticipates that the employee will incur rig-related expenses in connection with the performance of services for the employer,' and therefore meets the business connection requirement.

"... this statement provides a fairly strong clue that the 'recharacterization' issue arises only in situations in which the business connection is not otherwise satisfied."

See Revenue Procedure 2002-41 for very clear guidance on this issue.

Dealers and employers should ask themselves this question, "Is a part of the money/compensation that is paid to the service technicians, paid in consideration for the value of their tools that they bring with them to the job?" If the answer is, "Yes" ... which it most likely will be ... then changing the payment method from a non-accountable payment for that value, to an accountable plan payment, would seem to follow current IRS guidance.

"IF A TOOL PLAN FOLLOWS THE ACCOUNTABLE PLAN RULES, IT CAN WORK"

This is a direct quote from Ms. Harris in Phoenix, and I regard it as a giant step in our search for guidance.

Follow the rules. The accountable plan requirements are simple, they are not burdensome, and they are quite clear. Whether you use a software product to self-administer your own plan, or you choose to outsource to a third-party provider, make sure the plan follows the rules.

- ***Tool reimbursement payments cannot go on forever.*** There is no deemed substantiation rate, so don't be fooled by secret formulas that claim to have figured out how to make this method work.
- ***You cannot pay for expenses that were incurred prior to current employment.*** It doesn't matter how this is presented, if the expenses are not related to your business, then they do not meet compliance.
- ***You cannot pay for expenses that were incurred prior to the current tax year.*** Only current tax year expenses are acceptable under the IRS position - certain safe harbor rules apply.
- ***Substantiation is a requirement.*** Proof of purchase documents are required for every dollar paid out to the employee as a reimbursement.

Steve Dockins is the Chief Executive for Second Check, LLC with offices in Laguna Niguel, CA & Tucson, AZ. Second Check, LLC has developed a "Do-It-Yourself" tool reimbursement software product which the Company claims incorporates/complies with the most recent IRS interpretations and allows customers to self-administer their own tool reimbursement plans. For more information, Mr. Dockins can be contacted at (949) 500-4491 or sdockins@cox.net or through www.secondcheckonline.com.

EMERGING MANUFACTURER INITIATIVES IMPACTING AUTOMOBILE DEALERSHIPS

FACTORY CONFLICTS

At the AICPA Auto Dealership Conference, Richard N. Sox, Esq., a partner with Myers & Fuller, P.A., discussed "Emerging Manufacturer Initiatives Impacting Automobile Dealerships." Mr. Sox's comments covered a wide range of dealership issues, concerns and complaints relating to various manufacturers' activities.

WHAT BANKRUPTCY (BY GENERAL MOTORS OR FORD) COULD MEAN TO DEALERS

What are the potential consequences to a dealership if the manufacturer were to file for bankruptcy protection? Mr. Sox said that it is critical to understand that bankruptcy judges have almost unlimited power to control the outcome of the bankruptcy proceedings. For example, a bankruptcy judge has the power to cancel union contracts, and this could be a major benefit for a troubled manufacturer in a bankruptcy situation.

One important issue is whether a dealer's franchise agreement is technically an "executory contract." In an executory contract situation, both parties are performing pretty much in lock-step at the same time (i.e., neither party is performing way out ahead of the other party). A bankruptcy judge has the power to declare executory contracts void and that would cancel any further activities under the contract.

Mr. Sox's firm concluded that it was more than likely that a dealer's franchise agreement with the manufacturer would be considered to be an executory contract. What this means is that, in effect, a bankruptcy judge could simply cancel or terminate any further obligations the manufacturer has under the selling agreement with the dealer.

With this background discussion, Mr. Sox made several points.

#1 ... An entire linemake could be extinguished. It might be possible for the manufacturer to terminate or extinguish an entire *unprofitable* linemake by declaring bankruptcy. That would be the result if the manufacturer were able to convince the bankruptcy judge that its best chance of coming out of bankruptcy as a viable entity would occur if it were permitted discontinue that entire unprofitable linemake.

In other words, if the manufacturer could show that it is not making money in producing and selling a particular linemake (such as Pontiac, Buick, Lincoln or Mercury), then the bankruptcy judge might agree to cancel the franchise agreements between the dealers and the manufacturer. This first point is really addressed to all dealers, as a class, who might be involved with an unprofitable linemake of a manufacturer in bankruptcy.

#2 ... A select few "under-performing" dealers could be eliminated. Mr. Sox next made a point that could affect some individual dealers who might be involved with a profitable linemake of a manufacturer in bankruptcy.

With the concurrence of the bankruptcy judge, the manufacturer might be able to eliminate - cherry-pick or otherwise weed out - some individual dealers within an existing *profitable* linemake. This could →

2006 — *Emerging Manufacturer Initiatives Impacting Automobile Dealers*

- *What Bankruptcy (by General Motors or Ford) Could Mean to Dealers* 24
- *Incentive Programs & Advertising Groups* 25
- *Image / Exclusive Facilities Programs* 27
- *Manufacturer/Factory Audits ... Sales Incentive Programs & Warranty Claims Audits* 29
  - *Guide to Manufacturer's Incentive Warranty Audits ... Some Do's & Don'ts* 30
- *Terminations of Franchises ... Actual & Constructive, and Variations on the Theme* 32
- *Add Points & Relocations* 35
- *Chinese Vehicles* 35
- *Know Your Rights & Get Involved* 35
- *Supplementary Information*
  - *Selected Examples of Dealer Franchise Protection Provisions under Florida & Illinois Law* 36
  - *Causes for Termination ... Actions by a Dealer that Can Result in the Loss of the Franchise* 39
  - *Practice Development Suggestions for CPAs Based on Mr. Sox's Presentation* 40

happen if the manufacturer (GM or Ford) could persuade the judge that (1) a particular dealer was not performing or (2) it would be unprofitable for the manufacturer to try to maintain the current number of dealers in a particular metro market area.

#3 ... State termination protections and benefits for dealers are all trumped by the Bankruptcy Courts. In other words, from the foregoing, the point was that bankruptcy might be an event which would result in the manufacturer being able to select and eliminate a few under-performing dealers.

It would be possible for a "target" dealer to appear before the bankruptcy judge to plead for the continuation of his or her franchise agreement with the manufacturer. However, that dealer's argument would have to be that he or she was being treated differently than other dealers in the dealer body.

In this case, the bankruptcy judge would have the ultimate power in making this decision because the protections and benefits available to dealers under state franchise law are all superseded or "trumped" by the powers given to the bankruptcy court judge.

As a result, the special benefits that would otherwise be available to a dealer under the more protective state franchise law would not be available if the termination is due to the manufacturer's bankruptcy. Consequently, if a dealer's franchise agreement were terminated by a bankruptcy judge, the dealer would probably lose such protections that would otherwise be available under a "good cause for termination" protection statute. These lost benefits would include requirements that the manufacturer buy back/repurchase special tools at prescribed prices, buy back/ repurchase certain low mileage vehicles, and reimburse the dealer for certain other items such as special signage.

During a bankruptcy proceeding, monies in transit and warranty reimbursements become part of the bankruptcy estate. The judge has ultimate disposition powers over these funds. Typically, the bankruptcy judge will enter an order directing the manufacturer to continue making payments, such as those related to floorplan in transit and various other claims, to the dealership so long as those payments are being made in the "ordinary course of doing business." So, if the dealer has claims of this nature against the manufacturer, those monies owed would have to be paid to the dealer.

What about monies held in the manufacturer's offset account? It appears that those monies potentially become part of the bankruptcy estate. Unfortunately, there is no clear answer concerning the treatment of these monies, and the dealer's monies in this account could be at risk.

#4 ... Dealers should avoid any unnecessary capital expenditures. Mr. Sox gave the general advice that in the current environment, dealers should avoid any unnecessary capital expenditures ... even resist the manufacturers demands for more improvements under "image programs" ... because potentially those monies could be partially or completely lost.

Under these circumstances, if the manufacturer were to execute a side agreement with the dealer saying that it would pay the dealer a specified amount ($XXX) for upgrading of facilities, if the dealer were to upgrade his facilities in reliance on that side agreement with the manufacturer, the bankruptcy judge could throw out that side agreement.

The result would be that the dealer would be treated as a creditor just like any other creditor of the manufacturer. As a creditor, the dealer would be simply standing in line with all the other creditors, hoping to receive some percentage of his claim against the assets of the bankruptcy estate. Settlement of that claim would be likely to be just a few cents on the dollar for the dealer.

#5 ... Some opportunists see bankruptcy clouds as a significant depressant on franchise prices. Mr. Sox indicated that in this uncertain climate, some larger, growth-oriented dealers are still willing to make acquisitions at this time. However, they see the clouds hanging over certain franchises because of potential manufacturer bankruptcies as an opportunity to offer dealers with these franchises significantly depressed amounts for their dealerships.

In other words, the difficult financial and economic circumstances that a manufacturer finds itself in, including the possibility of bankruptcy proceedings, could be a significant depressant on the value of certain franchises.

INCENTIVE PROGRAMS & ADVERTISING GROUPS

In this area, Mr. Sox discussed the (1) Kia and Hyundai Multi-Tiered Incentive Programs, (2) the GMAC Platinum Dealer Incentive and (3) BMW's Value-Added Incentive Program.

Basically, there are several types of incentive programs. One type includes sales incentive programs which may be multi-tiered, target-based programs. Under these programs, the manufacturer sets some kind of arbitrary objective that is expressed in terms of sales volume. If the dealer reaches that objective, then the manufacturer will pay the dealer a

see **EMERGING MANUFACTURER INITIATIVES**, page 26

 (Continued from page 25)

per car cash bonus. If the incentive program sets a subjective sales target or leaves discretion in its administration to the manufacturer's representative, the program may be illegal.

A second type of program is a finance company incentive program which rewards dealers for steering customers to the manufacturer's finance captive for financing the purchase of their vehicles. These plans might offer the dealer a better floorplan rate and/or a willingness to buy deeper into the customer paper if the dealer showed sufficient sales performance and/or CSI levels on the sales side.

A third type of program, such as Chrysler's, may involve incentives provided to dealers on a per-vehicle basis for purchasing larger inventory quantities than the dealer would otherwise order.

Finally, programs such as BMW's Value-Added Incentive Program center around paying dealers bonuses based on additional monies invested in facilities beyond the minimum standard amounts required by the dealer's Facility Addendum or other agreement.

Dealers are not legally required to participate in these programs. Dealers often ask if they really have to participate in these incentive programs. The answer to this question every time is ... "No."

A dealer cannot be forced into participating in these programs. The franchise laws in every state protect the dealer from being coerced by the threat of a termination into participating in these programs.

Under state franchise protection laws, once a dealer has been granted a franchise agreement, that agreement is, in essence, perpetual. The manufacturer must have "good cause" in order to terminate a dealer's franchise agreement.

There are only three reasons why a manufacturer can legally remove a dealer's franchise, prevent a transfer, or fail to renew a franchise agreement. These three reasons are (1) bad moral character (i.e., this usually means a felony conviction), (2) insufficient business experience and/or (3) insufficient capital.

A common ploy used by manufacturers is to grant a new dealer a franchise agreement with a term of only 1 or 2 years. Then, after the dealer has been operating for a while, the manufacturer will tell the dealer that in order for the manufacturer to extend or renew the franchise agreement with a standard 5 or 6-year agreement, the dealer must participate in a given incentive program or provide additional facilities. Although the pressure exerted on the dealer by the manufacturer and its representatives may be great, the dealer cannot lose the franchise if he or she elects not to participate in the incentive program.

Is the program legal? The important question concerning these incentive programs is whether or not they are legal.

For example, Kia's multi-tiered program set arbitrary targets for sales per month. If a dealer sold 15 cars in the month, that dealer received a $500 bonus retroactive back to the first vehicle sold. If the dealer sold 30 cars in a month, the bonus was increased to $1,000 per car, retroactive back to the first vehicle sold for that month. And, that went on for several additional higher levels of sales.

The problem with the program is that the per month sales target has been set arbitrarily. There are many dealers who, because of the opportunity in their market area or because of the lack of opportunity in their market area, may never be able to reach even the second tier. A smaller dealer (who may only be able to reach the first tier level of sales) may be competing against a larger dealer in the same market area (who can readily reach the higher tier levels of sales). Obviously, the larger dealer can expect to receive considerably more money under this incentive program from the manufacturer. This will permit the larger dealer to under-price the smaller dealer every time because the receipt of the additional incentive monies will subsidize the lower selling price and gross margin on the sale.

Another problematic part about the operation of the program which further disadvantages the smaller dealer is that the additional cash bonus amounts per car are, or may be, paid retroactive back to the first car sold each month.

The smaller dealer's position vis-à-vis the manufacturer is that the arbitrarily set sales targets make that program illegal because their arbitrary nature violates both state and Federal price discrimination laws.

"Unfairness" is not necessarily "illegal." Some programs may be unfair, but that unfairness may not necessarily make them illegal. Some plans provide for the same amount of cash bonus to be paid to the dealer on a per car sold (or on a per car ordered) basis. Although these plans may unfairly benefit larger dealers vis-à-vis smaller dealers, the operation of these plans, although unfair, may not necessarily be illegal.

However, if "discretion" enters into the administration of a program, then the exercise of that discretion - or even the *possibility* that discretion may be exercised - may trigger questions as to the legality of the program.

The determination of whether an incentive program is unfair or illegal rests on whether under the program, a smaller dealer is functionally or effectively →

able to achieve the targets that are set. If the targets have been set arbitrarily, the smaller dealer cannot effectively compete against a larger dealer, and that would make the plan illegal. Typically, the dealer's sales would plummet almost immediately after the manufacturer started the new program.

Damages. If the smaller dealer were to successfully challenge the manufacturer's program, that dealer most likely would be entitled to receive a damage award based on a per-car-lost-profits damage model. Generally, this would involve computations showing a comparison of (1) the dealer's sales before the program was put in place with (2) the dealer's actual sales after the implementation of the program.

Then, a computation would be made projecting or extrapolating from the dealer's historic sales trends (i.e., what the dealer's sales might have been if (1) a legal program had been implemented or (2) if the manufacturer had not implemented any program). The difference between those results and the dealer's actual sales during the program period would provide the basis for the lost-profits-per-car damage award. In addition, since this would be a "price discrimination" case, the plaintiff's attorney's fees would also be paid by the manufacturer.

If every dealer is subject to the same performance criteria in a manufacturer's program, then that program that would not be considered to be "arbitrary." For example, the manufacturer may base the sales incentive amount (per car) on a performance factor, such as sales in excess of 110% or 120% of a dealer's planning volume or market potential. That program would be "all right" (i.e., the plan should not be considered to be "arbitrary") because that criteria is directly related to the individual, specific planning potential for each dealer in his or her own market area.

However, if the manufacturer or the manufacturer's local representative(s) are permitted to exercise some discretion in connection with the operation of the program, then although that program (as written) might have been set up in a legal manner, ***the ability to exercise discretion in its operation*** may be sufficient to move that program into the realm of being an illegal program.

Advertising programs. Dealers ask basically the same question regarding advertising programs ... i.e., does the dealer have to participate in these advertising programs? Again, the answer is, "No." But, here again, it is common knowledge that manufacturers are likely to exert significant pressure on their dealers to participate in their programs.

How to decline gracefully. If a dealer does not want to participate in the manufacturer's advertising program, Mr. Sox recommended that dealer send a letter to the advertising group, with a copy to the manufacturer and/or to the local marketing representative. In the letter, the dealer should explain in detail why the dealer doesn't think that he or she would be receiving any (significant) benefit from the monies spent by the group on advertising at the present time. It would be prudent for the dealer to seek the assistance of an experienced attorney in drafting this letter.

IMAGE / EXCLUSIVE FACILITIES PROGRAMS

Nothing beyond the minimum facility requirements or guidelines is required. Various image and/or exclusive facilities programs generally produce the same question from dealers ... "Do we have to participate in the manufacturer's image facility program?"

Here again, the answer is, "No." The manufacturer cannot force the dealer to invest any amounts beyond the minimum facility guidelines or requirements that were initially agreed upon. The dealer is only required to comply with the provisions and specifications set out in the Dealer Facility Addendum. These typically relate to minimum square footage that must be provided for sales operations, service operations, number of service bays, parking, etc.

With respect to some of the newer image programs that some manufacturers are "presenting to dealers," ***the dealer cannot be terminated or non-renewed for not agreeing to comply with a manufacturer's new image or increased square footage program.*** The dealer protection laws in all states protect dealers from being coerced by the manufacturer into participation in these types of programs.

Similarly, a manufacturer cannot demand that a dealer agree to an "exclusive" facility arrangement. However, it is not uncommon for some dealers to agree to grant this exclusivity in return for other "considerations" received from the manufacturer on a *quid pro quo* basis. Therefore, if a dealer does agree to give the manufacturer "exclusivity," then that agreement or concession made by the dealer is an enforceable agreement.

"Site control" should be distinguished from "exclusive use." If a manufacturer has "site control," the manufacturer has total control over the use of the land. On the other hand, "exclusive use" relates to the use of the land only for the operation of a specific franchise on it.

Dealers cannot be forced to undual or divest an existing dual franchise. On the other hand, however, dealers cannot bring in a new franchise to add it to an existing dual store, without first securing permission from the manufacturer.

see **EMERGING MANUFACTURER INITIATIVES**, page 28

 (Continued from page 27)

Ultimately, participation by the dealer is "negotiable." Mr. Sox explained that in these situations, despite the pressure by the manufacturer or the actions taken by the manufacturer assuming that the dealer is going to (or can be made to) participate, just about everything is "negotiable." And, the manufacturers know this as a fact, even though they may not publicly admit or acknowledge it.

If the manufacturer wants the dealer to make the facility upgrade badly enough ... and the dealer resists firmly enough (knowing that, ultimately, the manufacturer cannot force the dealer to comply) ... usually a compromise can be reached that is satisfactory to both sides.

For example, if the manufacturer wants an exclusive showroom, the dealer may counter with a willingness to provide that exclusive showroom, but not to provide exclusive service operations.

The dealer should engage the manufacturer in a (written) dialogue, in order to find out (1) what commitment the manufacturer might be willing to make in order to go forward and (2) what expectations it has for the near future. Here again, this should be done in writing with the assistance of counsel.

The manufacturer may be pressuring the dealer to increase the facility by telling him or her how those improvements or upgrades will result in increased sales based on the manufacturer's market data and projections. In this case, the dealer might try to negotiate with the manufacturer to receive an increase in vehicles allocated ... so that the anticipated increased sales level can be met. Sometimes, this negotiation results in a one-time increase (or "bump") in the number of vehicles that will be allocated to the dealership when the new facility is opened.

In this case, there are several related considerations. ***First,*** it is important to reduce any agreement or other "understanding" with the manufacturer to a written document. ***Second,*** it is important to specify what models will be included in the increased allocation, since the dealer would want to be sure that the vehicles it will receive will be those which can be more readily sold (i.e., the more popular models, and not the dogs or the sleds). ***Third,*** expanding on this second point, it may be necessary to clarify how the additional vehicles in the allocation may affect the calculation of the dealer's "turn and earn" performance in the future.

Another letter. After all this preliminary maneuvering has been reduced to writing and evaluated, the dealer may decide that it is not in his or her best interests to invest more money in the facilities in accordance with the manufacturer's requests. If this is the case, Mr. Sox's advice is that the dealer (with professional, legal assistance) should write a second (rejection) letter to the manufacturer.

In this letter, the dealer should not say that he or she would never participate in such a program. Instead, the dealer should just say that, at the present time, it is not a good financial choice for the dealer and then explain in detail why it is not appropriate. For example, the dealer might be able to explain that this is not the right time to participate in the program because (1) a cost-benefit analysis shows insufficient benefits or (2) the dealer cannot find sufficient additional property at a reasonable price to accommodate the expansion under consideration.

As indicated in his discussion on incentive programs and ad groups, Mr. Sox emphasized that manufacturers cannot reject or withhold approval for dealership transfers, making them contingent upon the dealer meeting new imaging or facility requirements. As noted previously, manufacturers must permit or reject potential dealership transfers only based upon the three criteria set forth in the state franchise law relating to moral character, business experience and sufficient capitalization.

Relocation of dual franchises. If a dealer has dual franchises and the dealer wants to relocate and bring the dual franchises to the new location, will the manufacturer permit the relocation of both franchises onto the new site? Mr. Sox's experience is that the manufacturers almost always will not permit this; instead, the manufacturers will require that the franchises be separated if the dealer wants to relocate.

What becomes critical here is what the particular state's franchise law says about (1) the dealer's rights in connection with its request to relocate and (2) what reasonable standards the manufacturer can apply in turning down (or evaluating) the dealer's request to relocate.

Many states have provisions that are favorable to dealers in this situation. These provisions may limit the manufacturer's analysis of whether that relocation is appropriate if the relocation will be within a certain, small, mileage radius of the dealership's present location. Where these provisions exist under state law and are extremely favorable to the dealer, there may not be much that a manufacturer can legally do to prevent the dealer's relocation of both franchises.

But, these provisions vary by state. Mr. Sox emphasized the importance of dealers knowing what their rights are under their specific state law. He also pointed out that this is a significant area where CPAs advising dealerships can help by informing their clients that they should seek competent, experienced legal assistance on these matters. ⟶

MANUFACTURER AUDITS ... SALES INCENTIVE PROGRAMS & WARRANTY CLAIMS AUDITS

Factory "audits" have become a major profit center for certain manufacturers. The financial impact of these audits has become more and more significant ... "huge," to quote Mr. Sox.

In one case, the adjustment from the Factory's audit was so large ... $850,000 ... that it forced the dealership to go out of business.

The importance of these audits to manufacturers, and to dealers, arises because of the way that some sales incentive programs are structured.

For example, assume a program where if a dealer sells 30 additional vehicles, that entitles him or her to receive $1,000 for each vehicle sold. If less than 30 additional vehicles are sold, the dealer is entitled to no payment. Assume further that the dealer under this program each month has just been reaching the minimum sales threshold for the incentive money to kick in (and thereby receives $1,000 per car sold instead of nothing).

In this case, there is a large financial incentive for a manufacturer to audit, especially if it can find that just a few of the dealer's sales do not comply with the provisions of the program. For example, perhaps a buyer was not really "qualified," or the program procedures were not followed to the letter). Should this happen, ***the disallowance of just a few sales would result in the disallowance of all of the incentive money paid*** by the manufacturer to the dealer under the program for that month. In this case, it may be an "all or nothing" situation.

Similarly, under other programs a dealer may be just barely getting to the next higher level of sales in order to qualify for the larger per vehicle bonus at that higher level. In this instance, a manufacturer's auditor again may have a strong incentive to find just enough "disqualifying" sales to eliminate the bonus monies that were paid on the sales that fell within the higher paying tier(s).

Mr. Sox said that what is "new" about these audits is the extremely large amounts/adjustments being found by the auditors. Under deposition, some auditors working for the manufacturers have admitted that they go into a dealership audit with a certain "number in mind."

Under most state franchise laws, the manufacturer is permitted in these audits to go back and review transactions over the last 18 or 24 months.

It is critical for the sales and accounting staff to understand all of the rules of the various sales and incentive programs. Often, these programs involve complex procedures, and these procedures may change on a regular basis.

Mr. Sox indicated that, generally, it may be possible to negotiate with the manufacturer to minimize the alleged technical or non-substantive chargebacks. And, realistically, in some cases, the dealer's basic objective (when on the defensive) may be to simply negotiate with the manufacturer to try to reduce the amount of the audit adjustment to an amount that the dealer finds to be "tolerable" ... or affordable ... under the circumstances.

"Cutting the corners." Unfortunately, there have been situations where a dealer knew that he or she did not fully comply with all of the requirements and/or procedures of a program. And, in some of these cases, the manufacturer's representatives (may have) told them to "just get the sale done before the end of the month, and we'll fix up the loose ends later."

In other words, in some instances, the manufacturer's representatives may have encouraged (or discounted the impact of) less than full compliance with the specific requirements of the plan in order to allow the dealership to reach the sales quotas that had to be met by the end of the month.

In these situations, significant problems could arise in a subsequent audit by the manufacturer, especially if the local representative were later to claim ignorance, or disavow any knowledge of the dealer's lack of compliance with all of the procedures, and there was no evidence in writing (i.e., a written record) to the contrary. This situation has happened in several cases in the past, and the dealers were left "holding the bag."

Warranty audits. Much of what Mr. Sox said about sales incentive audits also directly applies to warranty claims audits. It is equally important here for service managers (as well as personnel in the accounting department) to fully understand all of the manufacturer's warranty claims procedures.

Self-audits as preventative measures. As a preventative measure, Mr. Sox urged CPAs to go into dealerships and perform a "self-audit" for the dealership. The intent is for the dealership to try to correct problems before the manufacturer's auditors come in.

At a minimum, CPAs can simply go into the dealership, pull some deal files, review the terms and conditions of the incentive program or warranty requirements, and see if "all of the i's have been dotted and all of the t's have been crossed."

Depending on what is discovered in this activity, further corrective measures can be taken.

see **EMERGING MANUFACTURER INITIATIVES**, page 32

DEALER/PRINCIPAL'S GUIDE TO MANUFACTURER'S INCENTIVE / WARRANTY AUDIT*

Background	• Manufacturer letters providing notice that a dealership has been selected as an eligible candidate for an incentive or warranty audit are critically important and should never be taken for granted. • An audit may be the prelude for other goals a manufacturer may wish to accomplish, from the recovery of expenses to setting the stage for a notice of termination. • Increasingly, manufacturers are using audits as a tool to recoup revenues (charge backs) and to discipline dealers with whom the manufacturer may have issues. • The real issues that may underlie an audit may range from performance to demanded capital improvements which have not been agreed to by the dealer.
How a Dealership Is Selected for an Audit	• It is most often the case that a dealer is chosen for a warranty audit because a computer program at the manufacturer's general accounting office selected the dealer based upon a number of varied statistical measurements. • These identifiers vary by manufacturer and can be manipulated internally to achieve a desired result. Generally, the eligible audit candidate criteria measures the activity of dealers in a designated region, one against the other, or utilizes some statistical standard which measures multi (metropolitan) points and single points one against the other. • The parameters of these measurements are limited only by a manufacturer's imagination. Every manufacturer has exceptions to these standards which allow for audits when fraud is reported by a customer, employee, or manufacturer's representative. • Notice of the audit is sent out accordingly.
Contact Experienced Legal Counsel	• Once you learn that an audit will be occurring the most important next step is to contact experienced legal counsel. • An experienced franchise lawyer who has counseled dealers through prior audits will have a clear understanding of the rights the auditor has as well as the rights you have a dealer. • It is important to understand whether your State motor vehicle franchise law contains any restriction on the length of time an auditor can go back in auditing prior claims. • Most States provide some limitation in this regard which is typically 2 years and may have the time period delineated separately for a warranty audit versus a sales incentive audit. • Experienced legal counsel can guide you through the audit process with the ultimate goal being to minimize the resulting chargebacks.
The Initial Contact with the Auditor	• The auditor or specialist will usually attempt to meet with the dealer principal or general manager before the audit actually commences. • If the manufacturer sends a letter confirming the date of the audit, as should be the manufacturer's normal practice, respond to the letter in writing and ask for additional information about the audit. • Points of interest should be: ◆ The identity of the auditor; ◆ The period of time to be examined; ◆ The expected length of time the auditors will be on-site; and ◆ Whether the audit will be a claim-by-claim or an extrapolation audit. • Incentive and warranty audits are generally not random events and a manufacturer typically has a specific purpose and plan for the audit. • The assigned auditor will have studied your incentive or warranty claims processes and relative audit statistics before ever setting foot on dealership property.
Questions to Ask at the Initial Meeting	• At the initial audit meeting, you should ask: ◆ Again, how your dealership was selected for audit; ◆ Again, the specific purpose of the audit; ◆ Was the audit discussed with manufacturer field personnel; and ◆ Can the auditor provide you with copies of the warranty reimbursement procedures or incentive program procedures, whichever is applicable, which will be the basis for the audit.
Importance of Written Notes	• It is important that a dealer maintain detailed <u>written</u> notes of the initial interview in order to keep future recollections accurate. • In the event of a controversy, accurate notes can be used to refresh recollection or as evidence if the notes qualify as business records. • It should become a routine practice to make notes anytime you have a business discussion with a manufacturer's representative. • Thorough notes are particularly critical when the discussion involves a manufacturer's complaint relating to a matter addressed in your franchise agreement.

Factory Audits Do's & Don'ts	DEALER/PRINCIPAL'S GUIDE TO MANUFACTURER'S INCENTIVE / WARRANTY AUDIT* Page 2 of 2
Limiting Auditor Contact with Dealership Personnel	• At the initial meeting the auditor will ask you to identify a person or persons from whom they can request assistance. ◆ The person you designate should be a person with managerial status who is familiar with your internal audit process and records. ◆ The person selected should neither offer nor withhold information from the auditor. • The auditor may inspect the premises before the audit commences to observe the work environment, number of employees present, location of business records, etc. • Some auditors may attempt to interview dealership employees. ◆ Although this is permitted, employees who are not designated by the dealer/principal to assist the auditor should not engage in conversation with an auditor except in the presence of the designated employee or the dealer/principal and only after an interview is requested by the auditor.
Review of Dealership Processes	• In a warranty context, the auditor will review how information is transmitted from the customer to the service manager and finally to the dealership's warranty computer system. • Improper dates and mileage are generally ripe areas upon which an auditor can focus. • Such discrepancies, even though the product of innocent human error, can be claimed to be false or fraudulent claims by a manufacturer. • The lack of an authorized signature on a repair order will be claimed as a charge back even though the work was performed. • Repair order signatures, proper dating, and accurate mileage recording, should be emphasized by the dealer and monitored on a daily basis even if done so simply by checking a representative sample. • If a customer has not signed a repair order, at a minimum, have the order signed by the service manager. • In an incentive audit scenario, the auditor will be primarily concerned with the contents of the deal file, including customer signatures and required proof of customer eligibility for the incentives claimed. • The absence of required documentation is often classified as fraud by the manufacturer. • Fraud constitutes a stated basis for termination of the dealership's franchise by the manufacturer.
Audit Methodology	• Once the full-blown audit commences, the auditor will either evaluate claims individually (claim-by-claim) or evaluate a series of claims and then extrapolate or multiply the results to achieve a charge back number based upon the extrapolation sample versus the entire number of transactions for the audit period. • Claim-by-claim analysis is utilized when an auditor is attempting to identify false or fraudulent claims. • Extrapolation audits are used when an auditor is seeking to generate a substantial charge back or even spot check for fraud.
The Exit Meeting	• After the audit is completed, the auditor should meet with the dealer principal or general manager and explain the audit results. • Generally, a final audit report will be prepared at a later date and transmitted to management for further review and comment. • If a charge back or allegations of fraud are at issue, generally a meeting is held with the manufacturer's upper level management and the dealer/principal to discuss the audit results. The dealer/principal should attend this meeting. • If possible, the dealer should obtain a copy of the audit report in advance and review the claims in question under the audit. If additional documentation can be gathered then assemble such documents and take them to the audit meeting.
Appeals Process	• Most manufacturers have an internal appeals process through which audit results can be challenged. The extent of these appeal rights vary by manufacturer. • Additionally, most states have enacted laws which grant varying degrees of protection to dealers against manufacturer audit practices. • Every dealer should be familiar with his or her manufacturer's audit process and state law. • Prompt action can also result in the charge backs being stayed pending an appeal.
* Source	• Reprinted with permission from Myers & Fuller, P.A.'s advisory report to its dealership clients. • *Contact: Richard Sox, Esq., rsox@dealerlawyer.com, (850) 878-6404* • *Myers & Fuller, P.A., 2822 Remington Green Circle, Tallahassee, Florida 32308*

(Continued from page 29)

Often, if a dealer has found and voluntarily corrected prior infractions or problems before the manufacturer's audit process begins, the dealer may be able to negotiate a complete forgiveness of, or a substantial reduction in, the potential adjustments and chargebacks.

Once the audit begins ... Where a manufacturer's audit has started, Mr. Sox recommended that the dealership employees be separated from the manufacturer's auditors (just as if this were an IRS examination).

He cautioned that "loose lips sink ships." See pages 30-31 for the Advisory/Checklist that Mr. Sox's firm gives their dealers when they come under audit by the manufacturers.

TERMINATIONS OF FRANCHISES ... ACTUAL & CONSTRUCTIVE

In this area, there are four major points.

FRANCHISE TERMINATIONS

First, it is permissible for a manufacturer to discontinue a linemake. It is not illegal for them to do so.

Second, if a manufacturer is going to discontinue a linemake, the manufacturer must pay the dealer for its failure to perform under the Franchise Agreement where there has been a complete market withdrawal by the manufacturer.

Third, in an increasing number of circumstances, a dealer may have a claim against the manufacturer for actions taken (by the manufacturer) to constructively terminate his or her franchise if the action taken has effectively resulted in the dealer's loss of a viable franchise.

Fourth, "constructive termination" of dealer franchises is becoming more of a concern as manufacturers implement various new practices and strategies.

In discussing construction terminations, Mr. Sox used the industry's recent experience with GM / Oldsmobile as an example. Prior to that, similar mass termination situations were few and far between ... Plymouth and Volvo (medium-duty trucks) many years ago.

General Motors & Oldsmobile. Recently, when General Motors phased out its Oldsmobile linemake, it did not send its Oldsmobile dealers official letters telling them that their franchises were going to be terminated. Instead, GM simply sent letters to the dealers telling them that GM was planning to discontinue the Olds linemake some time in the future. Shortly after that, GM distributed a memo to all dealers which disclosed the remaining production schedule for various Olds models. This memo showed that over a few years, production of Oldsmobile vehicles would be tapering off, by model, down to nothing.

Mr. Sox's firm, Myers & Fuller, P.A., filed numerous lawsuits on behalf of Oldsmobile dealers. The attorneys argued that even though General Motors had not sent out official termination letters, the effect of what GM had done was to constructively terminate the dealers' franchises under state law without due cause. Their argument was that these (Oldsmobile) franchises essentially became worthless as soon as GM said that it would no longer be making Oldsmobiles.

GM offered its Oldsmobile dealers a financial settlement that amounted to the rough equivalent of one year's lost profits. Some dealers quickly accepted buy-outs on this settlement basis ... many others successfully negotiated far better financial settlements for themselves.

When General Motors communicated its plan to terminate a linemake in the future and followed that up by publishing future production schedules that showed decreasing output over a period of years, this created an obvious problem. The problem was that this action by GM made a reasonable computation of "one year's lost profits" unduly difficult and subjective. The longer a dealer postponed making that computation, the less profit there would be in the previous annual periods because of the declining sales. In other words, as GM's production and availability of vehicles decreased, so did the amount of annual profit which was supposed to be the measure of the payment that the manufacturer would be liable to make for the loss of the dealer's franchise.

Mr. Sox's firm was successful in advancing the theory that dealers had a claim against the manufacturer for the constructive termination for their franchises.

Variations on the "constructive termination" theme. There are several important variations on the constructive termination theme. It is not difficult to recognize them across the landscape.

Perhaps a dealer had bargained with the manufacturer for a viable franchise involving a particular segment of the population, and servicing that segment of the population required that the dealer have two franchises (A and B). If subsequently, the manufacturer unilaterally took away one of the franchises (A), leaving the dealer with only the other (B), then it could be argued that the overall viability of the franchise to the dealer would be significantly damaged ... What remained after this action certainly would not be the equivalent of what the dealer originally had with both franchises in operation. →

Here's another situation in the context of constructive terminations. In some instances, a dealer might have two franchises (A and B) and the manufacturer might tell the dealer that in order to be "viable," the dealer will have to add a third franchise (C). If this is done, the resulting entity (A + B + C) will be "viable" and satisfactory to the manufacturer.

Here, one might substitute Pontiac, Buick and GMC for A, B and C. And, in this case, the manufacturer further indicated that its intention was to reduce the model offerings in each franchise to the extent that the combined franchises would, in effect, be operating as a single franchise (small cars through Pontiac, mid-size cars through Buick, and trucks, vans and SUVs through GMC). In one instance, a spokesman for the manufacturer even went so far as to say that if a dealer did not have all three franchises, that dealer would be "lucky to be viable."

It can be argued here that the effect of what the manufacturer would be doing is to constructively terminate ***each*** of the three franchises. The manufacturer is effectively taking away model offerings and thereby more narrowly limiting the consumer segment to which that franchise appeals. As a result, it's very unlikely (almost no way?) that the dealership could "make it" if the dealership has product that is only focused on only one or two segments ... and not on the aggregate combination of ***all*** of the segments of the intended target market.

What the manufacturer is leaving the dealer with is vastly different from what the dealer bargained for years ago when he or she had initially entered into the agreements.

What should a dealer in this case do? ... Step #1 ... Try to buy. Mr. Sox's advice to the dealer would be that the dealer should go out into the marketplace and attempt to acquire the franchise (C) that the manufacturer has said it needed to obtain in order to be "viable." The dealer should document his or her efforts to acquire the "missing" franchise.

What many dealers have found in this situation is that they are unsuccessful in their efforts because other dealers they contact who currently have the desired franchise (C) may be unwilling to sell or trade it on acceptable terms. In some cases, the dealer who owns the desired franchise (C) may counter by suggesting that the "buyer" instead agree to sell or trade his or her A and B franchises to C. Result? ... stalemate.

Step #2 ... Write a letter. After unsuccessfully attempting to acquire the "missing" franchise, the dealer should then write a letter to the manufacturer (with professional, legal assistance, of course). This letter should explain, in detail, that the dealer has tried, but has not been successful, in all attempts to acquire the franchise (C) that the manufacturer said it would need to obtain in order to be "viable."

Step #3 ... Ask for something reasonable. The dealer should probably also request that the manufacturer agree to appoint the next (C) franchise that becomes available to the dealer and justify that request by citing the manufacturer's (own written) statement that without all three franchises, the dealer won't be "viable" in the future. Realistically, the manufacturer's letter of response to the dealer may say that it has no intention of establishing any more franchises in the dealer's area, so there is no possibility that the dealer can obtain the missing franchise in the future.

Step #4 ... Prepare to negotiate. All of this preceding activity more likely than not sets the stage for subsequent negotiations between the dealer and the manufacturer. Although the dealer could always bring a lawsuit, it is more reasonable to expect that, ultimately, the issue will come down to the manufacturer and the dealer agreeing on a determination of the dealer's lost profit as a result of the manufacturer's unilateral change in plans.

How should these profits be measured? And, how should they be paid for? ...Cash payment? ...A new franchise somewhere else? ...Other "considerations" given to other franchises that the dealer currently owns? ...Or what?

Step #5 ... What about a lawsuit? If negotiations fail, there is always a possibility of a lawsuit. Under these circumstances, one might think that there could be a class action by the dealers against the manufacturer. As it turns out, however, this is not a practical possibility. In order to qualify as a class action, among other requirements, all of the dealers would have to be operating under the same set of facts.

What is significant here is the fact that different state laws afford their dealers different degrees of protection. This results in fragmenting the large number of disadvantaged dealers to the point of their not being able to unite technically as a "class" in a class action suit.

However, Mr. Sox did indicate that, for some dealers, it might be possible to create a "class" of dealers within a particular state, or alternatively, by combining several states if those states have identical protections for their dealers in their statutes.

Isuzu. Isuzu was cited as a manufacturer whose practices were particularly troublesome for dealers.

see **EMERGING MANUFACTURER INITIATIVES**, page 34

(Continued from page 33)

What Isuzu did was to slowly reduce the numbers of vehicles available to dealers. The result was that, much like the GM/Olds scenario, the dealers had steadily declining profits over several years.

Worse yet, even if all of the Isuzu dealers could have banded together in a class action, the practical problem is/was that although they might win on the liability issue (that Isuzu constructively terminated their franchises), that win would not be worth the effort. The reason is because these dealers might receive little, if any, monetary damages because the steadily declining profits over the years would result in a very small amount of "lost profits" under the lost profits model that would be the reference for computation purposes. (Reminds one of the frog in the pan of water as the heat was slowly turned up on the stove.)

Nissan & Chrysler. Another variation on the "constructive termination of a franchise" theme is illustrated by recent actions taken by Nissan and/or Chrysler. These manufacturers sent letters to some smaller dealers in rural areas telling those dealers that they (i.e., the manufacturers) had concluded that maintaining that dealers' franchises in that geographic area was no longer viable.

These manufacturers did not say that they were terminating the franchises at the present time. Instead, they said that, if the dealers wanted to transfer their franchises *in the future*, the manufacturers would not approve such transfers at that time.

Mr. Sox said that a letter of this nature from the manufacturer is in clear violation of every state dealer franchise law. He reiterated that a manufacturer can only turn down the conveyance of a franchise if one of the three criteria previously mentioned is not satisfied. The fact that the manufacturer finds it uneconomical to service and administer a franchise point is not the proper legal basis for the manufacturer to terminate an existing dealer's agreement. This is where legal assistance becomes paramount for the dealer in order to protect his or her rights.

It would be unfortunate for the dealer to simply concede the matter and accept the manufacturer's letter as something that cannot be challenged just because the dealer was not aware of his or her rights under the applicable state franchise laws. Ultimately, if a dealer fully understands his or her rights (and knows the only legal reasons that justify a manufacturer's denial of the franchise transfer request), then the resolution of this issue will involve ***negotiation*** with the manufacturer. And that negotiation will take place at some future date when the dealer submits its transfer request and the manufacturer finds itself confronted with the impenetrable protection that the dealer has under the state law.

Allegations of dealer "nonperformance." Here's another ploy used by some manufacturers... In support of the manufacturer's intention to not permit a future transfer of an existing franchise, the manufacturer may send the dealer a default letter stating that the dealer is not (in essence) performing pursuant to the sales expectations of the manufacturer. Mr. Sox's advice in this case is that dealers should always respond to any and every letter that they receive from manufacturers which give notice of alleged deficiencies in sales or in CSI performance.

Generally, manufacturers use computer models and sales registration information in making these determinations. These models or criteria may not realistically or properly take into account such factors as possible geographic barriers (such as a river and the distance to the nearest bridge). Other factors that might not be properly weighted or that may possibly be completely ignored in the computer models might be ... (1) distance to, or the convenience of the dealership location, especially in terms of existing traffic patterns, (2) the proximity of the dealer's location to the nearest competing dealer, and (3) the presence or absence of a nearby military base or the location of some other single significant employer whose presence somewhat dominates that local area.

Mr. Sox emphasized that dealers should never take the manufacturer's word that the dealer is not performing up to standards for sales or CSI. It is critical for dealers to (1) always respond in writing to letters from the manufacturer alleging deficiencies in dealership performance, (2) understand how the manufacturer has measured its expectations of sales and/or CSI performance, and (3) try to identify any anomaly that may exist in their market area that could be impacting their performance, and thereby discredit the manufacturer's criteria by showing them to be unrealistic.

Finally, a manufacturer cannot deny a dealer's request for the transfer of his or her existing franchise to another otherwise qualified individual on the basis of there being insufficient representation of a particular minority in the dealership body. Some manufacturers may try to refuse a dealer's request to transfer the franchise and give "insufficient minority representation" as the reason for the denial.

Dealers should know that there is no state law that permits a manufacturer to deny the transfer of an existing franchise in order to attempt to accomplish that objective, even though, as a matter of broad social policy, it may be desirable to have balanced representation of minority dealers within a larger dealer group.

ADD POINTS & RELOCATIONS

Add point controversy usually arises in the context of the manufacturer wanting to either (1) add a new point that did not previously exist or (2) relocate an existing dealership into another dealer's market area. Despite all the press to the contrary, all manufacturers are continuing to try to add new dealerships, even in some places where the manufacturers have already admitted that they are "over-dealered." "Everyone is just feeding off of smaller and smaller pieces of pie."

In most states, the franchise protection laws give the dealer certain protest rights. These rights may include protection from the manufacturer's addition of a new point within a radius around the existing dealer's point (i.e., within a radius of a specified number of miles). The length of the radius may depend on the population or geographic size of the county, or on other factors.

The degree of protection afforded to a protesting dealer will vary by state. Unfortunately for protesting dealers, one of the hazards of litigation is that some judges find it difficult to understand why a dealer is protesting because the judge may believe that more competition should be permitted, especially in growing areas.

Dealers should almost always exercise their protest rights. Mr. Sox said that he has rarely encountered a situation where a dealer would not want to exercise his or her protest rights. In some states, once a dealer files a protest, that filing will stay or delay the addition of that new point, or a relocation, until the dealer's protest has been resolved.

From the dealer's standpoint, a cost-benefit analysis may show that, if a dealer has a legitimate reason to protest, it makes sense to file that protest because the existing dealer will be avoiding exposure to that competition and lost sales (to the new add point) for as long as the opening of the new point can be delayed.

Ordinarily, a manufacturer will not want to have to wait through a long delay process while the protest is being litigated. Therefore, often a settlement can be reached or negotiated between the dealer and the manufacturer that will make the protest "go away." Sometimes these settlements are based on a per-car-lost-sales dollar amount.

Alternatively, that settlement with the dealer may not be in the form of an immediate cash settlement or compensation. The "settlement" of the dealer's protest might result in the dealer being able to negotiate the receipt of a letter of intent from the manufacturer stating that the dealer will receive the next add point to be added in a neighboring market.

Another possible basis for settlement could be that the manufacturer agrees (in writing, of course) to grant the dealer some other concession(s) or right(s), or perhaps to release the dealer from some adverse concession that the dealer had previously made to the manufacturer.

The bottom line is that add points should always be protested if the dealer believes that he or she can support the argument that an additional point is not necessary. And, the manufacturer will generally negotiate a settlement ... "in almost 9 out of 10 cases."

CHINESE VEHICLES

A relatively new issue arises out of the expectation that in the foreseeable near future, Chinese vehicles (i.e., vehicles manufactured in China) will be marketed here in the U.S. That time may come soon after Chinese vehicles are able to overcome certain barriers, including satisfying U.S. safety and emissions requirements.

Mr. Sox's firm has received many calls from dealers saying that they have "this great opportunity" to obtain a franchise to sell Chinese vehicles in the U.S. The concern here is that some dealers may be simply jumping into these situations without knowing what they are really getting into. It is important for these dealers to be able to make informed decisions when buying rights to any franchise.

Here, the advice is that dealers better know what they are getting into when they buy rights in a franchise for Chinese vehicles. Any amounts that dealers are required to deposit initially for franchise fees should be placed only in a secure and refundable escrow account.

Next, the dealer's attorney should review the dealer agreement (in writing, of course) that the Chinese manufacturer is planning to use and wants the prospective dealer to sign. This agreement should include a written commitment as to the assignment of an exclusive geographic territory to the dealer.

Furthermore, the dealer's attorney should also review the agreement between the distributor and the Chinese manufacturer. Dealers who are considering involvement with a Chinese manufacturer should make sure that they have adequate protections and rights as franchisees within the agreement between the distributor and the Chinese manufacturer. Recently, U.S. Daewoo dealers did not have this protection, and they lost their investments completely.

KNOW YOUR RIGHTS & GET INVOLVED

One point of emphasis that came up again and again in Mr. Sox's presentation was the fact that dealers should be aware of their rights and protec-

see **EMERGING MANUFACTURER INITIATIVES**, page 40

Florida **SELECTED PROVISIONS FROM MOTOR VEHICLE FRANCHISE ACT**

Actions by a Manufacturer (Licensee) that Are Grounds for Revocation of License A Manufacturer Is Prohibited from Committing the Following Acts

- The manufacturer (i.e., the applicant or licensee) has coerced or attempted to coerce any motor vehicle dealer into accepting delivery of any motor vehicle or vehicles or parts or accessories therefor or any other commodities which have not been ordered by the dealer.
- The manufacturer … causes a termination, cancellation, or nonrenewal of a franchise agreement by a present or previous distributor or importer unless, by the effective date of such action, the (manufacturer) offers the motor vehicle dealer whose franchise agreement is terminated, canceled, or not renewed a franchise agreement containing substantially the same provisions contained in the previous franchise agreement or files an affidavit with the department acknowledging its undertaking to assume and fulfill the rights, duties, and obligations of its predecessor distributor or importer under the terminated, canceled, or nonrenewed franchise agreement and the same is reinstated.
- … The manufacturer prevents or refuses to accept the succession to any interest in a franchise agreement by any legal heir or devisee under the will of a motor vehicle dealer or under the laws of descent and distribution of this state; provided, the manufacturer is not required to accept a succession where such heir or devisee does not meet manufacturer's written, reasonable, and uniformly applied minimal standard qualifications for dealer applicants …

  Nothing contained herein, however, shall prevent a motor vehicle dealer, during his or her lifetime, from designating any person as his or her successor in interest by written instrument filed with and accepted by the manufacturer. A manufacturer who rejects the successor transferee … shall have the burden of establishing in any proceeding where such rejection is in issue that the rejection of the successor transferee complies with this subsection.
- The manufacturer has established a system of motor vehicle allocation or distribution or has implemented a system of allocation or distribution of motor vehicles to one or more of its franchised motor vehicle dealers which is unfair, inequitable, unreasonably discriminatory, or not supportable by reason and good cause after considering the equities of the affected motor vehicles dealer or dealers.

  A manufacturer shall maintain for 3 years records that describe its methods or formula of allocation and distribution of its motor vehicles and records of its actual allocation and distribution of motor vehicles to its motor vehicle dealers in this state.
- The manufacturer … has delayed, refused, or failed to provide a supply of motor vehicles by series in reasonable quantities, including the models publicly advertised by the manufacturer as being available, or has delayed, refused, or failed to deliver motor vehicle parts and accessories within a reasonable time after receipt of an order by a franchised dealer.
- The manufacturer has undertaken an audit of warranty payments or incentive payment previously paid to a motor vehicle dealer in violation of this section or has failed to comply with s. 320.696. An manufacturer may reasonably and periodically audit a motor vehicle dealer to determine the validity of paid claims. Audit of warranty payments shall only be for the 1-year period immediately following the date the claim was paid. Audit of incentive payments shall only be for an 18-month period immediately following the date the incentive was paid. An manufacturer shall not deny a claim or charge a motor vehicle dealer back subsequent to the payment of the claim unless the manufacturer can show that the claim was false or fraudulent or that the motor vehicle dealer failed to substantially comply with the reasonable written and uniformly applied procedures of the manufacturer for such repairs or incentives.

Transfer, Assignment or Sale of Franchise Agreements

- A manufacturer shall not, by contract or otherwise, fail or refuse to give effect to, prevent, prohibit, or penalize or attempt to refuse to give effect to, prohibit, or penalize any motor vehicle dealer from selling, assigning, transferring, alienating, or otherwise disposing of its franchise agreement to any other person or persons … unless the manufacturer proves at a hearing … that such sale, transfer, alienation, or other disposition is to a person who is not, or whose controlling executive management is not, of good moral character or does not meet the written, reasonable, and uniformly applied standards or qualifications of the manufacturer relating to financial qualifications of the transferee and business experience of the transferee or the transferee's executive management.
- A manufacturer shall not, by contract or otherwise, fail or refuse to give effect to, prevent, prohibit, or penalize, or attempt to refuse to give effect to, prevent, prohibit, or penalize, any motor vehicle dealer … from selling, assigning, transferring, alienating, or otherwise disposing of, in whole or in part, the equity interest of any of them in such motor vehicle dealer to any other person or persons … unless the manufacturer proves at a hearing pursuant to a complaint filed by a motor vehicle dealer under this section that such sale, transfer, alienation, or other disposition is to a person who is not, or whose controlling executive management is not, of good moral character.

SELECTED PROVISIONS FROM MOTOR VEHICLE FRANCHISE ACT

Proposed Add-Points

Any manufacturer who proposes to establish an additional motor vehicle dealership or permit the relocation of an existing dealer to a location within a community or territory where the same line-make vehicle is presently represented by a franchised motor vehicle dealer or dealers shall give written notice of its intention to the department.

Such notice shall state:

- The specific location at which the additional or relocated motor vehicle dealership will be established.
- The date on or after which the licensee intends to be engaged in business with the additional or relocated motor vehicle dealer at the proposed location.
- The identity of all motor vehicle dealers who are franchised to sell the same line-make vehicle with licensed locations in the county or any contiguous county to the county where the additional or relocated motor vehicle dealer is proposed to be located.
- The names and addresses of the dealer-operator and principal investors in the proposed additional or relocated motor vehicle dealership.

Determinations Whether Dealer Is Providing Adequate Representation in the Community Factors & Evidence to Be Considered ... When a Dealer Files a Protest Against an Add-Point

In determining whether the existing franchised motor vehicle dealer or dealers are providing adequate representation in the community or territory for the line-make, the department may consider evidence which may include, but is not limited to:

1. The impact of the establishment of the proposed or relocated dealer on the consumers, public interest, existing dealers, and the licensee; provided, however, that financial impact may only be considered with respect to the protesting dealer or dealers.
2. The size and permanency of investment reasonably made and reasonable obligations incurred by the existing dealer or dealers to perform their obligations under the dealer agreement.
3. The reasonably expected market penetration of the line-make motor vehicle for the community or territory involved, after consideration of all factors which may affect said penetration, including, but not limited to, demographic factors such as...
    - Age
    - Income
    - Education
    - Size class preference
    - Product popularity
    - Retail lease transactions
    - Other factors affecting sales to consumers of the community or territory.
4. Any actions by the licensees in denying its existing dealer or dealers of the same line-make the opportunity for reasonable growth, market expansion, or relocation, including the availability of line-make vehicles in keeping with the reasonable expectations of the licensee in providing an adequate number of dealers in the community or territory.
5. Any attempts by the licensee to coerce the existing dealer or dealers into consenting to additional or relocated franchises of the same line-make in the community or territory.
6. ***Distance, travel time, traffic patterns, and accessibility between the existing dealer or dealers of the same line-make and the location of the proposed additional or relocated dealer.***
7. Whether benefits to consumers will likely occur from the establishment or relocation of the dealership which cannot be obtained by other geographic or demographic changes or expected changes in the community or territory.
8. Whether the protesting dealer or dealers are in substantial compliance with their dealer agreement.
9. Whether there is adequate interbrand and intrabrand competition with respect to said line-make in the community or territory and adequately convenient consumer care for the motor vehicles of the line-make, including the adequacy of sales and service facilities.
10. Whether the establishment or relocation of the proposed dealership appears to be warranted and justified based on economic and marketing conditions pertinent to dealers competing in the community or territory, including anticipated future changes.
11. The volume of registrations and service business transacted by the existing dealer or dealers of the same line-make in the relevant community or territory of the proposed dealership.

Illinois — *SELECTED PROVISIONS FROM MOTOR VEHICLE FRANCHISE ACT*

Unfair Competition & Practices (by a Manufacturer)

- It shall be deemed a violation (i.e., it shall be illegal) for any manufacturer, factory branch, factory representative, distributor or wholesaler, ... or motor vehicle dealer to engage in any action with respect to a franchise which is arbitrary, in bad faith or unconscionable and which causes damage to any of the parties or to the public.
- (It shall be deemed a violation for a manufacturer) ... To coerce, or attempt to coerce, any motor vehicle dealer:
  - To accept, buy or order any motor vehicle or vehicles, appliances, equipment, parts or accessories therefor, or any other commodity or commodities or service or services which such motor vehicle dealer has not voluntarily ordered or requested except items required by applicable local, state or federal law; or to require a motor vehicle dealer to accept, buy, order or purchase such items in order to obtain any motor vehicle or vehicles or any other commodity or commodities which have been ordered or requested by such motor vehicle dealer;
  - To order or accept delivery of any motor vehicle with special features, appliances, accessories or equipment not included in the list price of the motor vehicles as publicly advertised by the manufacturer thereof, except items required by applicable law; or
  - To adopt, change, establish or implement a plan or system for the allocation and distribution of new motor vehicles to motor vehicle dealers which is arbitrary or capricious or to modify an existing plan so as to cause the same to be arbitrary or capricious;
  - To fail or refuse to advise or disclose to any motor vehicle dealer having a franchise or selling agreement, upon written request therefor, the basis upon which new motor vehicles of the same line make are allocated or distributed to motor vehicle dealers in the State and the basis upon which the current allocation or distribution is being made or will be made to such motor vehicle dealer;
  - To refuse to deliver in reasonable quantities and within a reasonable time after receipt of dealer's order, to any motor vehicle dealer having a franchise or selling agreement for the retail sale of new motor vehicles sold or distributed by such manufacturer, distributor, wholesaler, distributor branch or division, factory branch or division or wholesale branch or division, any such motor vehicles as are covered by such franchise or selling agreement specifically publicly advertised in the State by such manufacturer, distributor, wholesaler, distributor branch or division, factory branch or division, or wholesale branch or division to be available for immediate delivery. ...;
  - To coerce, or attempt to coerce, any motor vehicle dealer to enter into any agreement with such manufacturer, distributor, wholesaler, distributor branch or division, factory branch or division, or wholesale branch or division, or officer, agent or other representative thereof, or to do any other act prejudicial to the dealer by threatening to reduce his allocation of motor vehicles or cancel any franchise or any selling agreement existing between such manufacturer, distributor, wholesaler, distributor branch or division, or factory branch or division, or wholesale branch or division, and the dealer. ...;
  - To require a franchisee to participate in an advertising campaign or contest or any promotional campaign, or to purchase or lease any promotional materials, training materials, show room or other display decorations or materials at the expense of the franchisee;
  - To cancel or terminate the franchise or selling agreement of a motor vehicle dealer without good cause ... to fail or refuse to extend the franchise or selling agreement of a motor vehicle dealer upon its expiration without good cause ... or, to offer a renewal, replacement or succeeding franchise or selling agreement containing terms and provisions the effect of which is to substantially change or modify the sales and service obligations or capital requirements of the motor vehicle dealer arbitrarily and without good cause ... .
  - To prevent ... any motor vehicle dealer from changing the executive management control of the motor vehicle dealer or franchisee unless the manufacturer, having the burden of proof, proves that such change of executive management will result in executive management control by a person or persons who are not of good moral character or who do not meet the manufacturer's existing and, with consideration given to the volume of sales and service of the dealership, uniformly applied minimum business experience standards in the market area.
  - To prevent ... any motor vehicle dealer from establishing or changing the capital structure of his dealership or the means by or through which he finances the operation thereof; provided the dealer meets any reasonable capital standards agreed to between the dealer and the manufacturer ... who may require that the sources, method and manner by which the dealer finances or intends to finance its operation, equipment or facilities be fully disclosed;

Illinois — SELECTED PROVISIONS FROM MOTOR VEHICLE FRANCHISE ACT

Franchise Transfers

- (It shall be deemed a violation for a manufacturer) … To refuse to give effect to or prevent or attempt to prevent … any motor vehicle dealer or any officer, partner or stockholder of any motor vehicle dealer from selling or transferring any part of the interest of any of them to any other person or persons or party or parties unless such sale or transfer is to a transferee who would not otherwise qualify for a new motor vehicle dealers license under "The Illinois Vehicle Code" or unless the manufacturer, having the burden of proof, proves that such sale or transfer is to a person or party who is not of good moral character or does not meet the manufacturer's existing and reasonable capital standards and, with consideration given to the volume of sales and service of the dealership, uniformly applied minimum business experience standards in the market area.

  However, nothing herein shall be construed to prevent a manufacturer from implementing affirmative action programs providing business opportunities for minorities or from complying with applicable federal, State or local law.

- (It shall be deemed a violation for a manufacturer) … To prevent or refuse to give effect to the succession to the ownership or management control of a dealership by any legatee under the will of a dealer or to an heir under the laws of descent and distribution of this State unless the franchisee has designated a successor to the ownership or management control under the succession provisions of the franchise.

  Unless the manufacturer, having the burden of proof, proves that the successor is a person who is not of good moral character or does not meet the franchiser's existing and reasonable capital standards and, with consideration given to the volume of sales and service of the dealership, uniformly applied minimum business experience standards in the market area, ***any designated successor of a dealer or franchisee may succeed to the ownership or management control of a dealership under the existing franchise if … the designated successor agrees to be bound by all the terms and conditions of the existing franchise.***

Add Points

- (It shall be deemed a violation for a manufacturer) … To grant an additional franchise in the relevant market area of an existing franchise of the same line make or to relocate an existing motor vehicle dealership within or into a relevant market area of an existing franchise of the same line make.

  However, if the manufacturer wishes to grant such an additional franchise to an independent person in a bona fide relationship in which such person is prepared to make a significant investment subject to loss in such a dealership, or if the manufacturer wishes to relocate an existing motor vehicle dealership, then the manufacturer shall send a letter by certified mail, return receipt requested, to each existing dealer or dealers of the same line make whose relevant market area includes the proposed location of the additional or relocated franchise at least 60 days before the manufacturer grants an additional franchise or relocates an existing franchise of the same linemake within or into the relevant market area of an existing franchisee of the same linemake.

- "***Relevant Market Area***" (Definition) … the area within a radius of 10 miles from the principal location of a franchise or dealership if said principal location is in a county having a population of more than 300,000 persons;

  If the principal location of a franchise or dealership is in a county having a population of less than 300,000 persons, then "relevant market area" shall mean the area within a radius of 15 miles from the principal location of said franchise or dealership; or the area of responsibility as defined in the franchise agreement, whichever is greater.

In General — *Causes for Termination of a Dealer's Selling Agreement*
Actions by a Dealer that Can Result in the Loss of the Franchise

A manufacturer cannot arbitrarily (i.e., without "good cause") terminate its Selling Agreement with a dealer unless the dealer has…

- Bad moral character (i.e., this usually applies if the dealer has a felony conviction),
- Insufficient business experience, and/or
- Insufficient capital (financing).

Circumstances (that are essentially within the dealer's control) which can result in the dealer's loss of the franchise include…

- Poor sales performance
- Commission of a fraud related to warranty or sales incentive program claim submissions
- Failure to meet/maintain minimum capital requirements
- Failure to meet/maintain minimum facility requirements
- Filing of bankruptcy by the dealer

 (Continued from page 35)

tions under their own state franchise laws. He urged dealers to get involved with their state dealer associations and to work for changes in their state franchise laws if those laws currently were not providing protection for dealers in areas where they may be vulnerable.

Dealer associations need to have dealers bring to their attention those areas where the state laws should be updated in order to stay current with, or get out ahead of, various manufacturer initiatives.

In closing, Mr. Sox said that if there was only one thing he could tell dealers and their CPAs, it would be ... ***"Never take the manufacturer's word for anything!"***

That's worth repeating ... over and over again.

Factory Conflicts	***Special Services CPAs Can Provide for Dealers (Practice Development Suggestions Based on Mr. Sox's Presentation)***
"Lost Profits" Calculations	• Any time dealers are negotiating with the manufacturer, lost profits calculations are obviously the CPA's specialty area. It is possible to go far beyond just this level of service to dealers.
"Self-Audits" for Dealership Compliance with Manufacturer Programs	• With respect to various ***manufacturers sales incentive programs and warranty claims procedures,*** as a preventative measure, CPAs can go into dealerships and perform "self-audit" special engagements. The intent is to review and evaluate the dealership's compliance with various manufacturer program requirements and to try to correct problems before the manufacturer's auditors come in. • At a minimum, CPAs can simply go into the dealership, select (randomly) some deal files, review the terms and conditions of the manufacturer's incentive program or warranty requirements, and see if the all of the dealership paperwork is in order and in compliance. • Depending on what is discovered in this activity, corrective measures can be evaluated. • Often, if a dealer finds and voluntarily corrects prior infractions or problems before the manufacturer starts an audit, the dealer may be able to significantly mitigate his exposure.
Become Familiar with State Franchise Laws	• CPAs should read the state franchise law which affords various rights and protections to their dealers. After reviewing the applicable state franchise law, CPAs can discuss with dealers and their attorneys those areas where the dealer may be able to minimize potential exposures. ◆ When there are disputes involving a dealer's rights under his Dealer Agreement with the manufacturer versus the dealer's rights under state franchise law, the state franchise law provisions supersede the language in the dealer's agreement with the manufacturer. • CPAs can obtain high visibility for their dealership practice specialties by sharing their expertise with their respective state dealer associations. This is a practice development opportunity that should not be overlooked.

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