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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. AS WE GO TO PRESS WITH THIS ISSUE... There is nothing earth-shaking to report. But there have been developments in several areas that we want to bring you up-to-date on.

One thing, however, is for sure ... There are severe storm clouds quickly gathering for dealers in connection how the IRS believes the inventory cost capitalization rules should be applied to their dealerships. Read on...

#2. SECTION 263A ... IRS' GUIDANCE ON COST CAPITALIZATION FOR AUTO DEALERS. Do you remember all that we've said previously about the IRS' high hopes for "guidance" on the "producer" issue in the form of a GLAM? It now seems that the IRS has backed off of this entirely. But, there's been nothing official issued in which the IRS has "conceded" or confirmed this point.

The real bad news for dealers is contained in a Technical Advice Memorandum (TAM) that the IRS has already issued. However, we have nothing tangible to report at this time because this TAM still has not been made public under the *Freedom of Information Act.* So, we'll have to wait until next time to deal with that. But, we'll tell you now what we can about developments in that area. Fasten your seatbelts.

My conversations with CPAs representing dealers under audit suggest that you'll be incredulous once you understand how the IRS "thinks" Section 263A should be applied to dealerships. Unfortunately, the *Automotive Alert!* issued by the IRS in January (see page 8) gives you no hint of what's really in store.

From what we've heard (anecdotally) about current audits where the IRS is looking at how Section 263A should be applied to auto dealerships, it seems that every few days, the IRS comes back, wants more information, has another set of calculations and another set of interpretations. How can one kindly or politely say that it seems like the IRS is running around on this like a chicken with its head cut off? ***The bottom line*** seems to be that all of this apparent confusion will still add up to very large deficiencies and major changes that CPAs will have to reckon with when all of this stuff hits the fan.

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In addition to conversations with CPAs with dealerships under audit, I have had several recent discussions with NADA representatives and obtained permission to reprint the letter that NADA sent to the IRS in March on the so-called "producer" issue.

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

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

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

(Continued from page 1)

Our further comments in the update on page 4 will presume a familiarity with the *Dealer Tax Watch's* prior coverage of these Section 263A issues. However, Gentle Reader, you should understand that all interpretations and opinions expressed in the *DTW* on this subject and about how the IRS seems to be handling these Section 263A matters are entirely my own, and they are not those of NADA or its advisors.

#3. ELECTRONIC RECORDKEEPING REQUIREMENT UPDATE. Our last issue of the *Dealer Tax Watch* was devoted almost entirely to Revenue Procedure 98-25 and the "case study" discussion of the cooperation between ADP, Inc., and the IRS that permitted ADP to enhance its software so that dealers using ADP would be compliant with these recordkeeping requirements.

Since publication of that material, from our discussion with several readers and others, we have been told that apparently both Arkona and Reynolds & Reynolds enable their users to satisfy these requirements. We have been unable to verify this on our own, but we are certain of one thing ... To date, the dealer mentioned in our article is the only dealer in the country who has received a compliance letter on this from the IRS.

We believe that the IRS Computer Audit Specialists are very reasonable when engaged on this issue. They tend to be very reasonable in dealing with taxpayers who might not be in total compliance with all of the requirements of Rev. Proc. 98-25 if the taxpayers' efforts result in an "acceptable" ... although less than perfect ... level of compliance.

Our update on page 3 emphasizes two points that, perhaps, did not stand out more prominently in the last issue of the *DTW*. The third point was called to our attention by another alert reader, and it relates to the potential impact of tax return preparation software.

We do appreciate your input and comments on our coverage of this and other issues.

#4. TREATMENT OF PAYMENTS RECEIVED BY DEALERSHIPS FOR THE CANCELLATION OF THEIR DISTRIBUTOR AGREEMENTS. In Revenue Ruling 2007-37, the IRS has amplified its holdings in a previous Private Letter Ruling that was issued in 2002 concerning payments that (Oldsmobile) dealers received from manufacturers (General Motors) in exchange for the termination of their franchise (distributor) agreements.

Revenue Ruling 2007-37 discusses in detail the possibility that a significant amount of the gain that would otherwise be treated as long-term capital gain in these cancellations may instead be treated (either entirely or partially) as ordinary income.

It is possible that some CPAs may have overlooked these ordinary income recapture and/or recharacterization provisions in reporting dealers' gains in prior years. This is not an easy area to deal with because one has to navigate the provisions of Section 197, as well, to arrive at the correct result.

What about cancellation payments that were received and erroneously reported as long-term capital gain in income tax returns filed more than 3 years ago? In this regard, there is always the possibility that the IRS might try to reach back beyond the normal 3-year statute of limitations by taking the position that an adjustment to correct this treatment should be characterized as being in the nature of a change in accounting method. If this were the case, then under Section 446, a Section 481(a) adjustment would be required for consistency purposes.

Our coverage of this Revenue Ruling begins on page 13.

#5. UPDATE ON SEC. 62(c) ACCOUNTABLE PLANS FOR TOOL REIMBURSEMENTS. On page 20, our update on these plans includes comments made by different IRS representatives at different conferences. These should emphasize to you that the IRS is still actively challenging compliance of many tool/equipment plans with the provisions of Section 62(c).

#6. NATIONAL BUY-HERE, PAY-HERE (BHPH) CONFERENCE. The 9th Annual BHPH Conference was held in May in Las Vegas, and, as usual, a tremendous amount of important information for Buy-Here, Pay-Here dealers was exchanged.

On pages 22-23, we've reported on the presentation that Ms. Terri Harris, the Motor Vehicle Technical Advisor, made at that Conference. Also, you'll find some interesting financial information on selected BHPH dealer averages.

#7. STATIC POOL ANALYSIS ... ONE OF THE KEYS TO GREATER BHPH PROFITABILITY. One topic that I've always found interesting at BHPH Conferences in the past relates to how the more successful BHPH dealers analyze their loan portfolios. This analysis invariably involves procedures collectively referred to as ***"static pool analysis."*** The article on page 24 is a general summary of what I've learned about these techniques.

ELECTRONIC RECORDKEEPING REQUIREMENTS UPDATE

Our last issue of the *Dealer Tax Watch* discussed the IRS' electronic recordkeeping requirements set forth in Revenue Procedure 98-25 and the extensive cooperation between ADP, Inc., the IRS and Revenue Canada that permitted ADP to enhance its software so that users would be compliant.

Since the publication of our last issue, follow-up discussions with several readers suggest that we should ***emphasize*** three points ...

First ... *Rev. Proc. 98-25 trumps Rev. Proc. 97-22.* Advisors and taxpayers should be aware that the electronic recordkeeping requirements of Rev. Proc. 98-25 in some instances may not be satisfied by taxpayers even though they are in compliance with Rev. Proc. 97-22.

Rev. Proc. 97-22 addresses the use of electronic storage systems for books and records, and its requirements do not fully overlap those found in Rev. Proc. 98-25. Therefore, although compliance with the requirements of 97-22 is necessary, such compliance in many practical instances falls short of total compliance with the requirements of Rev. Proc. 98-25.

In short, Rev. Proc. 98-25 "trumps" Rev. Proc. 97-22 in terms of its characterization and treatment of taxpayers' electronic records as "books and records" under Section 6001. Accordingly, even though a dealership may be able to retrieve images of financial information stored electronically, that dealership must also be able to retrieve for the IRS all of the material underlying information in an audit situation, and not merely only imaged summaries of that information.

Second ... *The IRS probably will accept best efforts at compliance with Rev. Proc. 98-25 even though these good-faith efforts fall "a little bit" short.* The following appear to be safe generalizations based upon (1) comments made by various IRS representatives in various presentations and (2) from actual audit experiences where compliance with Rev. Proc. 98-25 was an issue and IRS Computer Audit Specialists (and their supervisors) were brought in to back up the Examining Agent.

If a taxpayer has retained all material data and, upon exam, is able to provide the files which the IRS has identified, in generic terms, in various IDRs, that should be sufficient to enable the IRS to proceed with its audit without considering the need for other strenuous Rev. Proc. 98-25 compliance initiatives or written warnings to the taxpayers about "inadequate records."

General experience in audit exam situations suggests that the files identified on the IRS' generic lists will be the ones that Examining Agents will be requesting. These generic lists of files have cut the overall universe down to the level of a few, manageable, "common sense" files that should typically yield about 90-95% of what an Examining Agent will be requesting. In many instances, given various complexities and changing tax laws, there may be that extra 5% or so that will need to be produced by other means, but that should not mitigate a conscientious overall effort by the taxpayer to comply.

You can get a good idea of these files by referring to the March 2007 issue of the *Dealer Tax Watch* ... see page 20 (for the appendix to the IRS letter to ADP), page 22 (for the Information Document Request (IDR Form 4564)), and/or page 23 (for the *Generic Listing of Computer Files* (taken from the IRS *Automotive Alert!*)).

Third ... *Don't overlook the importance of tax return preparation software.* This is a point not mentioned in our previous coverage. In more recent audits, IRS Agents and IRS Computer Audit Specialists have begun to request that taxpayers provide information that the Agents' believe is essential for them to be able to follow critical audit trails. In many instances, the information that Agents are requesting in connection with "how the income tax return was put together" can only be provided by/from the taxpayer's tax return preparation software.

If a taxpayer (or the taxpayer's preparer) uses a tax return software product, then it will be important to retain any files that are critical to following and/or analyzing entries on Schedule M-1 or M-3 ... or to analyzing account groupings and/or reclassifications from the taxpayer's chart of accounts to line items in the tax return.

The procedure now more commonly being employed by Agents is to have the Computer Audit Specialist load taxpayer's tax software file(s) into an IRS "front-end" program. This IRS program will provide the Agent with an interactive screen which lists each tax return line item and corresponding amount. The Agent will then be able to select a tax return line item and "drill down" directly back to the underlying transactional book accounting information that supports the amount entered on that line item.

SEC. 263A COST CAPITALIZATION UPDATE

IRS issues an Automotive Alert! In January 2007, the IRS Motor Vehicle Technical Advisor issued an *Automotive Alert!* entitled "IRC Section 263A ... Auto Dealership Questions & Answers." In prefatory remarks, it states that it is only an overview of the application of Sec. 263A to auto dealerships, and it is not intended to be a comprehensive discussion. And, indeed, it is not ... as you can see for yourself on pages 8-12.

The first page of the *Alert* pretty much summarizes what Ms. Harris has previously said about the IRS agreeing to "stand down" and to not start new audits involving the "producer" issue.

The 13 Q & As simply repeat portions of the Regulations with little real elaboration as to their application in dealership settings. Questions #1-3 are general, #4 discusses purchasing costs, #5 discusses handling costs and #6 discusses storage costs.

Questions #7, 8 and 9 discuss off-site storage and the "dual (storage) facility" rules. These are extremely important and are the basis for many of the significant dollar adjustments that the Service is proposing in connection with current dealership audits.

Question #10 discusses general and administrative costs ... #11 discusses the allocation methods for mixed service costs ... #12 discusses the Simplified Resale Method and #13 discusses the Historic Absorption Ratio election.

NADA expresses significant concerns. In a recent letter, NADA asked the IRS/Treasury to reconsider its position with respect to the "producer" issue. This letter stated NADA's expectation that the issuance of a Generic Legal Advice Memorandum (GLAM) would address the problem in a reasonable way. NADA's letter asking for an expeditious review, is reprinted, with permission.

Status of GLAM guidance from the IRS. It appears that the GLAM ... which was supposed to "answer everything" ... has fallen far behind its scheduled issuance date (June 15). Frankly, some of us are beginning to doubt whether this GLAM will ever be issued.

Status of TAM guidance from the IRS. The IRS has, in fact, issued a Technical Advice Memorandum addressing the application of Section 263A to a dealership. We understand that the conclusions expressed in the TAM are quite unfavorable to the dealership. We also understand that the "producer" issue is not addressed in this TAM's issues and holdings. As we go to press, the TAM has not yet been made available under the *Freedom of Information Act*, so our analysis will have to wait until next time.

IRS audit problem areas. In audits already underway, it seems that very large potential deficiencies are being generated as a result of the positions (i.e., interpretations) being taken by the IRS on whether certain dealership transactions should be treated as retail or as non-retail sales.

These transactions involve: (1) vehicles taken in trade and immediately sold at auction or to other wholesalers, (2) vehicles removed from inventory - which are sold at auction or to other wholesalers - after they have been on the dealer's lot for a prolonged period of time, (3) vehicles leased to customers in situations where the leases and the vehicles are subsequently sold to finance companies, (4) new vehicle dealer trades among dealerships, (5) fleet sales and (6) internet sales.

We are hearing that Agents and their "supervisors" seem to be continually changing their thoughts ... almost from day to day ... on the application of Section 263A to these transactions. Some Agents have issued "partial reports" which contain nothing more than recitations of blocks of text from the Regulations. As for numbers ... they're just not sure yet. Or, they're reluctant to provide details ... although some claim their proposed adjustments are consistent with the TAM (which, of course, they can't discuss, either). It really makes one wonder how the Service will be able to say with a straight face, "Here's how the Section 263A Regulations are supposed to be applied to auto dealerships," as if this should have been crystal clear to all concerned from Day 1.

Anticipated ramifications. First, there will be wailing and gnashing of teeth, wringing of hands ... and many very large dollar adjustments once "everyone gets on the same page" regarding off-site storage and the dual facility rules and interpretations.

Second, there will be confusion over how dealers (and many other retailers) should correct the errors of their ways in the past. Will there be countless Forms 3115 to be filed? Will these be automatic changes in accounting method? What about Section 481(a) adjustments? You get the point ... There's lots of technicalities here.

Third, there will be confusion over the ramifications for auto dealers using LIFO. How will the Section 481(a) adjustments be handled in this situation? Will they be embedded in LIFO layers, etc.?

There's a (Section 263A) jungle out, and we're about to be thrown into the thick of it.

263A

NADA's Letter to the Treasury/IRS on the "Producer" Issue ... March 2007

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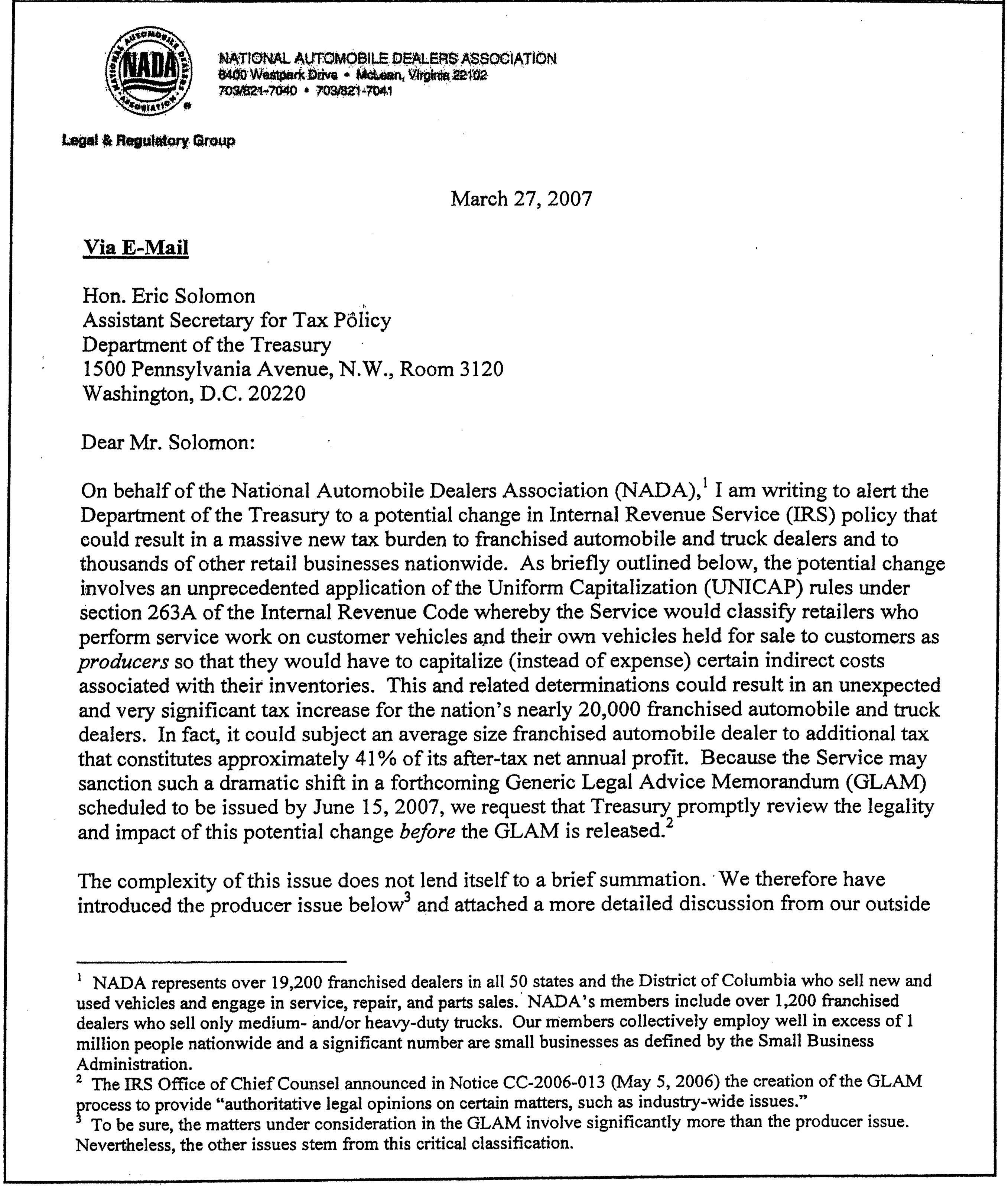

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Legal & Regulatory Group

March 27, 2007

Via E-Mail

Hon. Eric Solomon
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W., Room 3120
Washington, D.C. 20220

Dear Mr. Solomon:

On behalf of the National Automobile Dealers Association (NADA),[1] I am writing to alert the Department of the Treasury to a potential change in Internal Revenue Service (IRS) policy that could result in a massive new tax burden to franchised automobile and truck dealers and to thousands of other retail businesses nationwide. As briefly outlined below, the potential change involves an unprecedented application of the Uniform Capitalization (UNICAP) rules under section 263A of the Internal Revenue Code whereby the Service would classify retailers who perform service work on customer vehicles and their own vehicles held for sale to customers as *producers* so that they would have to capitalize (instead of expense) certain indirect costs associated with their inventories. This and related determinations could result in an unexpected and very significant tax increase for the nation's nearly 20,000 franchised automobile and truck dealers. In fact, it could subject an average size franchised automobile dealer to additional tax that constitutes approximately 41% of its after-tax net annual profit. Because the Service may sanction such a dramatic shift in a forthcoming Generic Legal Advice Memorandum (GLAM) scheduled to be issued by June 15, 2007, we request that Treasury promptly review the legality and impact of this potential change *before* the GLAM is released.[2]

The complexity of this issue does not lend itself to a brief summation. We therefore have introduced the producer issue below[3] and attached a more detailed discussion from our outside

[1] NADA represents over 19,200 franchised dealers in all 50 states and the District of Columbia who sell new and used vehicles and engage in service, repair, and parts sales. NADA's members include over 1,200 franchised dealers who sell only medium- and/or heavy-duty trucks. Our members collectively employ well in excess of 1 million people nationwide and a significant number are small businesses as defined by the Small Business Administration.

[2] The IRS Office of Chief Counsel announced in Notice CC-2006-013 (May 5, 2006) the creation of the GLAM process to provide "authoritative legal opinions on certain matters, such as industry-wide issues."

[3] To be sure, the matters under consideration in the GLAM involve significantly more than the producer issue. Nevertheless, the other issues stem from this critical classification.

tax consultant.[4] We also encourage you to review our recent submissions to the IRS Industry Director, Heavy Manufacturing and Transportation, for a more comprehensive treatment of the UNICAP issues affecting our members.

- The UNICAP rules have existed since section 263A was added to the Code in 1986. Among other things, section 263A and its implementing regulations require taxpayers with production activities to capitalize certain costs associated with their inventories.

- Congress added this provision to ensure that producers, who already were required to capitalize hard costs associated with their inventories, also capitalize associated indirect costs.

- Prior to the recent audits giving rise to the forthcoming GLAM, we were not aware of a single instance where the Service classified a dealer as a *producer*, despite completing thousands of dealer audits since the inception of the UNICAP rules. In fact, the Service has approved hundreds of dealer applications for a change in accounting method (IRS Form 3115) authorizing dealers to be treated as retailers who can utilize special allocation and *de minimis* rules that do not require the capitalization of these costs.

- Against this backdrop, IRS field examiners nonetheless have begun classifying dealers as producers. They have latched on to the inclusion of the term "install" in the Code's definition of "produce" to expand the producers' provision to retail businesses that perform service work involving parts in their inventory. Given the intent of section 263A and the Service's historic treatment of automobile dealerships as resellers without production activities, this has caught the industry completely by surprise.[5]

- In response to this alarming development, NADA requested early last year that the Service review its field examiners' approach as part of the Industry Issue Resolution Program or through another appropriate forum. In July, the IRS Industry Director, Heavy Manufacturing and Transportation, informed NADA that the issue would be considered by the IRS Office of Chief Counsel as part of the Generic Legal Advice process and that the Service would "stand down" on the producer issue until the GLAM is issued.[6] The Industry Director received from NADA written and verbal comments on the matter and, we have been informed, formally submitted the issue to the Office of Chief Counsel on December 15, 2006. Assuming the Office of Chief Counsel issues the guidance in the

[4] Former IRS Motor Vehicle Industry Specialist Robert C. Zwiers, Sr., currently with Crowe Chizek and Company, LLC.

[5] See IRS Motor Vehicle Technical Advisor Alert entitled IRC §263A: Auto Dealership Questions & Answers (January 2007)["MVTA Alert"]("The Producer Issue has not been previously considered an issue at dealerships by the IRS and there is no specific guidance....").

[6] See MVTA Alert ("Since the Producer Issue is new and conceivably could have an adverse affect on this industry, the Service has agreed to stand down on the Producer Issue only pending the decision reached in the GLA. During the stand down period, the Service has committed to the NADA that agents generally will not raise the producer issue....").

180-day benchmark period specified in Notice CC-2006-013, the GLAM will be issued by June 15, 2007.[7]

- It would be difficult to overstate the detrimental economic impact that this change may cause for dealers and other industries. As noted above, if the Office of Chief Counsel sustains the field examiners' current position, it could subject an average size franchised automobile dealer to an additional tax assessment that constitutes approximately 41% of its after-tax net annual profit.[8] For the thousands of franchised dealers whose brands are struggling and for whom the tax assessment could represent an even greater portion of their net annual profit, this unanticipated assessment could be devastating.

- Similarly alarming are the macro considerations. Because inventory and service operations are common to all franchised automobile dealers and each would have to seek a change in accounting method and pay the corresponding adjustment, the collective amount the anticipated GLAM could lead franchised dealers to pay is enormous. When the dealers' collective tax liability is coupled with that of retailers in other industries that perform similar operations, the total economic impact could be staggering.[9]

Clearly, such a dramatic and far-reaching policy shift should be thoroughly examined by senior policy officials before it is initiated. We urge Treasury to review this matter expeditiously, and we would welcome the opportunity to offer any additional input into the process that may be of assistance.

Thank you for your prompt attention to these concerns.

Sincerely,

Andrew D. Koblenz
Vice President and General Counsel

Enclosure

Cc: SBA Office of Advocacy

[7] The Office of Chief Counsel is considering this issue alongside a Technical Advice Memorandum involving a Massachusetts dealer.

[8] Our outside tax consultant has computed this figure by analyzing the field examiners' approach against average dealership profile information from the financial statements of 2,700 new car and light duty truck dealers.

[9] Even if the GLAM only partially validates the approach taken by the field examiners, the financial consequences still could be quite severe.

IRS

IRC §263A Auto Dealership Questions & Answers

Automotive Alert

Motor Vehicle Technical Advisor

January 2007

Introduction:

Internal Revenue Code (IRC) Section 263A (§263A) has been the topic of considerable discussion among auto dealership owners and their CPAs of late §263A is a complex provision for which the regulations provide simplifying elections to assist taxpayers in its application and is an issue that dealers and CPAs have been considering when filing tax returns for many years.

§263A's recently elevated profile is likely due to a number of factors including an increase in dealership examinations. In addition, in a very limited number of examinations, some examiners have considered whether the operations in an auto dealership's body shop and service department cause the dealership to be a "reseller with production activities" (Producer Issue). If a dealership is to be considered a reseller with production activities, it would require a significant amount of additional work for the dealership/CPA and could result in additional tax due for the dealership.

The Producer Issue has not been previously considered an issue at dealerships by the IRS and there is no specific guidance. In order to clarify the issue and to provide guidance to the industry, we have requested a Generic Legal Advice Memorandum (GLA). In addition to the Producer Issue, we have asked for industry specific guidance on several other §263A issues. Although normally the GLA process does not contemplate involvement from external customers, in this case NADA was invited to submit a white paper expressing the industry view of the issues.

Since the Producer Issue is new and conceivably could have an adverse affect on this industry, the Service has agreed to stand down on the Producer Issue only pending the decision reached in the GLA. During the stand down period, the Service has committed to the NADA that agents generally will not raise the producer issue. The stand down does not affect and agents will continue to consider other appropriate §263A issues.

In an effort to clarify some of the basic questions related to auto dealership §263A, we have developed the following questions and answers. The following consists of an *overview* of the application of IRC §263A to auto dealerships and *is not intended to be a comprehensive discussion* of the IRC §263A concepts.

If you have any questions or would like to discuss these issues you many contact the Motor Vehicle Technical Advisor team.

It should be noted that this document is not an official Service pronouncement and may not be cited as authority

IRC 263A
Auto Dealership Questions and Answers
Motor Vehicle Technical Advisor 1-9-07

NOTE: The following questions and answers consist of an overview of the application of IRC 263A to auto dealerships and a not intended to be a comprehensive discussion of the IRC 263A concepts.

	Question	Answer
1.	**What property is subject to IRC 263A?**	IRC §263A applies to : - Real and tangible personal property produced by a taxpayer - Real or personal property acquired by a taxpayer for resale.
2.	**Are any dealers exempt from the uniform capitalization rules?**	The uniform capitalization rules do not apply to personal property acquired for resale by an auto dealer whose average annual gross receipts for the three previous tax years do not exceed $10 million. Auto dealers in this capacity are referred to as small resellers §1.263A-3(a)(1)). Gross receipts are the total amount derived from all of the auto dealer's trades or businesses (Reg. §1.263A-3(b)(2). A controlled group of businesses is considered as one entity and the gross receipts of each member of such group are aggregated for purposes of applying this test (Reg. §1.263A-3(b)(3)).
3.	**What types of costs are capitalized under 263A?**	Section 263A costs for auto dealers include section 471 inventory costs and additional section 263A costs. Generally, §l.263A-1(e) describes the types of costs that must be capitalized by taxpayers. Dealers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A-1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by auto dealers are purchasing, handling, and off-site storage costs and generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits), occupancy expenses including rent, excess of book over tax depreciation, insurance, security, taxes, utilities and maintenance, materials and supplies; depreciation, insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities (Reg. § 1.263A-3(c)(2)).
4.	**What costs are included in the definition of purchasing costs?**	Purchasing costs include personnel costs relating to: -the selection of merchandise; -the maintenance of stock assortment and volume; -the placement of purchase orders; -the establishment and maintenance of vendor contracts; -the comparison and testing of merchandise. The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. If a person performs both purchasing and non-purchasing activities, the dealer must reasonably allocate the worker's labor costs between these activities. A dealer may elect the 1/3-2/3 rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the dealer must allocate the labor costs of all such persons using the 1/3-2/3 rule.

It should be noted that this document is not an official Service pronouncement and may not be cited as authority

		Under this rule: -if less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing; -if more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and -in all other cases, the dealer must reasonably allocate labor costs between purchasing and non-purchasing activities (Reg. § 1.263A-3(c)(3)).
5.	**What costs are included in the definition of handling costs?**	Handling costs include costs attributable to loading and unloading, processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale. Generally, transportation costs required to be capitalized include costs incurred in transporting property- -from the vendor to the dealer, -from one of the dealer's storage facilities to another of its storage facilities; -from the dealer's storage facility to its retail sales facility -from the dealer's retail sales facility to its storage facility; -from one of the dealer's retail sales facilities to another of its retail sales facilities (Reg. § 1.263A3(c)(4)).
6.	**Which storage costs must be capitalized?**	Storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing. Storage costs attributable to the operation of an on-site storage facility are not required to be capitalized under section 263A. Storage costs attributable to a dual function storage facility must be capitalized to the extent that the facility's costs are allocable to offsite storage (Reg. §1.263A-3(c)(5)(i)).
7.	**What is the definition of an offsite storage facility?**	An off-site storage facility is defined as a facility that is not an on-site storage facility. An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility (Reg. §1.263 A-3 (c)(5)(ii)(A)). A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility (Reg. §1.263A3(c)(5)(ii)(C)). A retail sales facility is defined as a facility where a dealer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes only those portions of any specific retail site- - which are customarily associated with and are an integral part of the operations of that retail site; - which are generally open each business day exclusively to retail customers; - in which retail customers normally and routinely shop to select specific items of merchandise; - which are adjacent to or in immediate proximity to other portions of the specific retail site (Reg. §1.263A-3(c)(5)(ii)(B)(1)). - Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire (Reg. §1.263A3(c)(5)(ii)(B)(2)).

		In contrast, a dealer may operate a wholesale warehouse where wholesale sales are made to customers physically present at the facility. The wholesale customers resell the goods they purchase to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to the wholesale warehouse must be capitalized (Reg. §1.263A-3(c) (5)(v)).
8.	**What is a dual-function storage facility?**	A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. Dual-function storage facilities could be utilized by new or used auto dealerships ranging in size from a small dealership with limited space to a mega-dealer to an auto mall where several dealers share the facility. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to retail customers in sales that are not on-site sales., or other customers (Reg. §1.263A-3(c)(5)(ii)(G)).
9.	**How are storage costs associated with a dual-function storage facility allocated between the off-site storage function and the on-site storage function?**	Storage costs associated with a dual-function storage facility are allocated between the off-site storage function and the on-site storage function using the ratio of gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person) to the total gross sales of the facility (Reg. §1.263A-3(c)(5)(iii)(B)). If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility (Reg. §1.263A-3(c)(5)(iii)(C)).
10.	**What types of costs are included as general and administrative (G&A) costs?**	G&A costs (capitalizable service costs) that directly benefit or are incurred by reason of the dealer's production or resale activities are included as §263A costs. Mixed service costs are G&A costs that are partially allocable as capitalizable service costs and partially deductible as non-production or non-resale activity costs. If G&A costs benefit only an inventory function, the costs should be allocated totally to that function. Types of capitalizable service costs include: - The administration and coordination of production or resale activities (wherever performed in the business organization of the dealer); - Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees; - Purchasing operations, including purchasing materials, vehicles, parts, equipment, etc., scheduling and coordinating delivery from the manufacturer or suppliers, expediting and follow-up; - Materials handling, warehousing and storage functions; and - Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions. For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a dealer may elect not to allocate any portion of the service department's costs as additional §263A costs. This election applies to all of the dealer's mixed service departments and constitutes the adoption of (or a change in) method of accounting. Under this election, if 90 percent or more of a mixed service department's costs are capitalizable service costs, the dealer must allocate 100 percent of the department's costs as additional §263A costs (Reg. §1.263Al(g)(4)(ii)).
11.	**What allocation methods can a dealer use to allocate its mixed service costs?**	A dealer may use a direct allocation method (which generally allocates mixed service costs to departments engaged in production or resale activities), the simplified service cost method (Reg. §1.263A-1(h)), or any other allocation method based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. An allocation method is deemed reasonable if it is used consistently, is not an attempt to circumvent the requirements or principles of §263A, and the total costs actually

		capitalized do not differ significantly from those that would be using another permissible method (Reg. §1.263A-l(f)(4)). Under the simplified service cost method, a dealer computes its capitalizable mixed service costs using the formula: Allocation ratio x Total mixed service costs.
12.	**How does the simplified resale method work?**	The simplified resale method is applied as follows: The combined absorption ratio is multiplied by the §471 costs remaining on hand at the end of each taxable year in which the simplified resale method is applied. The resulting product is the additional §263A costs that are added to the dealer's ending §471 costs to determine the section 263A costs that are capitalized (Reg. 1.263A-3(d)(3)). The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio and the purchasing costs absorption ratio (Reg. §1.263A-3(d)(3)(C)(1)). Section 471 costs remaining on hand at year end are generally costs that the dealer incurs during its current taxable year, which remain in its ending inventory at year end. (Reg. §1.263A3(d)(3)(C)(2)). The storage and handling costs absorption ratio is determined as follows: Current year's storage and handling costs divided by beginning inventory plus current year's purchases. Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the dealer's property acquired for resale and other eligible property. . Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the §471 costs of any property acquired for resale or other eligible property held by the dealer as of the beginning of the taxable year. Current year's purchases generally mean the dealer's §471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. The purchasing costs absorption ratio is determined as follows: Current year's purchasing costs divided by Current year's purchases. Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the dealer's property acquired for resale and other eligible property. Purchasing costs must include the amount of allocable mixed service costs. Current year's purchases generally are the dealer's §471 costs incurred with respect to purchases of property acquired for resale during the current taxable year (Reg. §1.263A3(d)(3)(E)(2)).
13.	**What is the Historic Absorption Ratio Election and how does it work?**	Reg. §1.263A-3(d)(4)(i) permits dealers using the simplified resale method to elect to use a historic absorption ratio in determining additional §263A costs allocable to eligible property remaining on hand at the close of their taxable years. A dealer's historic ratio is based on the percentage of additional §263A costs capitalized by the dealer during a three-year test period. Therefore, a dealer may only make a historic absorption ratio election if they have used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election and have capitalized additional §263A costs using an actual absorption ratio for their three most recent consecutive taxable years.

It should be noted that this document is not an official Service pronouncement and may not be cited as authority

TREATMENT OF PAYMENTS RECEIVED BY DEALERSHIPS FOR THE CANCELLATION OF DISTRIBUTOR AGREEMENTS

Revenue Ruling 2007-37, issued on May 23, 2007, addresses the tax treatment of any gain realized in connection with the receipt of payments for the cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products.

Dealers generally would prefer to treat any gain inherent in the payment as long-term capital gain, rather than as ordinary income. However, as this Ruling illustrates, this result may be difficult to obtain because of the operation of several Code sections which could treat portions of that gain as ordinary income.

In reading this Ruling, the words "auto dealer" or "retailer" or "auto dealership" may be substituted for the words "distributor" and "distributorship." And, clearly, this Ruling should be read in connection with Private Letter Ruling 200218034. This PLR was analyzed in the March 2002 *Dealer Tax Watch* after the IRS partially addressed this subject in connection with General Motors' termination of its Oldsmobile franchises.

This new Revenue Ruling has precedential value - as long as a taxpayer's facts are identical to the facts in the Ruling. This precedential value removes the concern we had expressed in analyzing the Private Letter Ruling that the PLR was applicable only to the one dealership that had requested the PLR.

Key issue. What PLR 200218034 did not discuss - and what Rev. Rul. 2007-37 discusses in detail - is the ***possibility that a significant amount of the gain that would otherwise be treated as long-term capital gain may be treated instead (either entirely or partially) as ordinary income.***

This can happen as a result of the explicit "recapture" provisions found in Section 1245 of the Code. Or, this could happen as a result of applying the "recharacterization provisions" in Section 1231(c) which would treat net long-term capital gain as ordinary income if there are any prior-year nonrecaptured Section 1231 losses within the past 5 years.

Two further points for CPAs advising dealerships in these situations.

First, in a situation where the receipt of the cancellation payments may be spread over more than one year (and thus, may be subject to reporting on the installment method), the ordinary income portion of the gain is first reported in full or 100%, before any of the long-term capital gain portion is reported. In other words, all ordinary income is recaptured first, before any of the gain is reported as long-term capital gain.

Second, if an individual/taxpayer is operating his/her dealership as a "C" Corporation, then that individual/taxpayer would not be receiving any payments for the surrender of his/her capital investment in the distributorship/dealership. In other words, the payments would be received by the corporation, and not by the individual/taxpayer.

Recall that in our earlier analysis, we referred to the holding in *W. R. Matthews v. U.S.* (36 AFTR 2d 75-5974, 75-2 USTC Para. 9738, U.S. District Court, District of S. Car., Columbia Div.).

This case emphasized that the dealership corporation (controlled by the dealer) owned/***held*** the distributor agreement ... and that the individual dealer did not. The Court said that "a shareholder is not the owner of his corporation's assets; the corporation's separate legal status - including ownership of assets - must be respected for tax purposes barring sham or the like." As a result, the dealership was entitled to the long-term capital gain treatment under Section 1241 ... but, the individual dealer was not because the dealership corporation - and not the dealer individually - was the owner of the distributorship agreement.

"S" Corporations, however, pass through to their shareholders the nature of gains realized (i.e., ordinary vs. long-term capital gain).

Holdings in PLR 200218034. In this 2002 PLR, the IRS held that ...

1. The transition/termination payments received by the dealer are considered amounts received in exchange for the cancellation of its distributor agreement pursuant to Section 1241.

2. The gain calculated upon the exchange will be considered as long-term capital gain to the taxpayer within the meaning of Sections 1221 or 1231. (There was no mention of potential ordinary income recapture in the PLR.)

3. The taxpayer is eligible to report the gain from the exchange on the installment method pursuant to Section 453, because at least one transition payment will be received by the taxpayer after the year of disposition.

The facts in the Oldsmobile dealer's PLR are on page 19, and a detailed analysis of Revenue Ruling 2007-37 appears on pages 14-18.

Rev. Rul. 2007-37

Treatment of Payments Received for the Cancellation of a Distributor Agreement

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Overview

- Revenue Ruling 2007-37 addresses the tax treatment of the resulting gain in connection with the receipt of a payment (or payments) for the cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products.
  - Generally, when a dealer receives a cancellation payment from the distributor, the dealer would prefer to treat the gain inherent in the payment as long-term capital gain, rather than as ordinary income.
  - This Ruling shows that various sections of the Code could operate to treat portions of that gain as ordinary income.
- The Ruling does not state whether the distributor ("A") is operating as a C Corp. or an S Corp.
- The words "auto dealer" or "retailer" or "auto dealership" may be substituted for the words "distributor" and "distributorship" in the Ruling.
- The holding of the Ruling would clearly apply to situations such as those created when General Motors decided it would no longer produce Oldsmobiles.
  - Five years ago, at NADA's request, the IRS partially addressed this subject by issuing Private Letter Ruling 200218034. In this PLR/LTR, the taxpayer/dealer was an S Corporation. See *Dealer Tax Watch*, March 2002, pages 12-21.

IRS Conclusions

- The cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products is a sale or exchange of property ... ***if*** the distributor has made a substantial capital investment in the distributorship ***and*** the investment is reflected in physical assets (i.e., such as inventory).
- Any resulting gain to the distributor is capital gain ... ***if*** the agreement is a capital asset.
  - The gain is Section 1231 gain and may be treated as capital gain if the agreement is property of a character subject to the allowance for depreciation under Section 167.
  - For this purpose, property is treated as being of such a character if it is amortizable under Section 197 or Section 1253.
  - The Section 1231 gain may be subject to recapture under Section 1245.

Facts

- X manufactures automobile brand N.
  - X sells N through a network of automobile distributors with which X enters into distributor agreements.
  - The distributor agreements generally provide that a distributor may sell N within a prescribed geographic area and may renew the agreement as long as the distributor performs according to the agreement.
- In 1994, A (an automobile distributor) entered into a distributor agreement with X to sell brand N automobiles. As noted above, the Ruling does not state whether the distributor ("A") is operating as a C Corp. or an S Corp.
  - The amount of A's payment to X for the agreement is not contingent on the productivity, use, or disposition of the right to sell N, but rather is a fixed sum.
  - Since 1994, A has been continuously engaged in the trade or business of selling N.
  - A makes a substantial capital investment in its distributorship as reflected in the cost of its inventory of N automobiles.
- X plans to discontinue production of N in 2007, and offers payments to distributors to cancel their N distributor agreements.
  - In 2007, A (the distributor) accepts X's (the manufacturer's) payment of $40x in cancellation of its N distributor agreement with X.
  - A's basis in the distributor agreement is $10x.
  - A has no Section 1231 losses.

Relevant Code Sections

- Applicable Code Sections discussed in this Ruling are 197, 1221, 1231, 1241, 1245 and 1253.
- The Ruling also subdivides the discussion of the treatment of payments depending on whether the franchise was acquired ...
  - ***After*** August 11, 1993 (the effective date of Sec. 197).
  - ***After*** January 1, 1970 (the effective date of Sec. 1253) and ***before*** August 1993.
  - ***Before*** January 1, 1970.
- See pages 3, 4 & 5 for more detailed discussions of these Code Sections.

Analysis … Sec. 1241 Applies

- In the present case, A's distributor agreement with X is for the marketing of goods.
- In addition, A has made a substantial investment of capital in the distributorship as reflected in A's inventory value.
- The cancellation of the distributor agreement did not occur by reason of the expiration of the agreement in accordance with its terms, ***and*** the cancellation terminates all of A's rights to sell product N.
  - ◆ Therefore, Section 1241 applies to the cancellation of the agreement and X's payment to A in cancellation of A's distributor agreement is treated as an amount received in exchange for the agreement.

Analysis … A's Gain Is Not All LTCG

- A's distributor agreement gives A the right to sell N within a specific geographic area.
  - ◆ Therefore, the agreement is a franchise under Section 1253(b)(1).
- A entered into the distributor agreement after August 10, 1993, and A holds its distributorship agreement in connection with the conduct of a trade or business.
  - ◆ Therefore, the distributor agreement is an "***amortizable*** Section 197 intangible," and it is property of a character subject to the allowance for ***depreciation*** provided in Section 167.
    - ▪ As a consequence, the distributor agreement is ***not*** treated as a capital asset.
- A's gain of $30x (from the receipt of the $40x payment for the cancellation of the distributor agreement) qualifies under Section 1231 as long-term capital gain, but it is subject to …
  - ◆ Recapture (as ordinary income) under Section 1245 and
  - ◆ Recharacterization under Section 1231(c).

Analysis … Same Result for Agreements 1970 - Aug. 1993

- If A had entered into the distributor agreement with X after 1969, but before August 10, 1993 (the effective date of Section 197), then A's gain from the cancellation of the agreement would similarly qualify for Section 1231 treatment.
- Because A had paid a fixed amount to X in order to obtain the distributorship agreement, the agreement would be amortizable under Section 1253.
  - ◆ As a result, the agreement would be property of a character that is subject to an allowance for ***depreciation*** under Section 167.
- A's gain of $30x (from the receipt of the $40x payment for the cancellation of the distributor agreement) qualifies under Section 1231 as long-term capital gain, but it is also subject to …
  - ◆ Recapture (as ordinary income) under Section 1245 and
  - ◆ Recharacterization under Section 1231(c).

Analysis … Pre-1970 Agreements

- If A had entered into the distributor agreement with X before 1970
  - ◆ The agreement would be a capital asset, and
  - ◆ The $30x gain from the cancellation would be capital gain.

The Result … Step-by-Step

- Here's an analysis of the gain computation, assuming no further "recharacterization" is required by Section 1231(c) …
  - ◆ Step 1 … Compute gain

Proceeds received	$ 40x
Less: Adjusted tax basis (see Step 2)	(10x)*
Gain	$ 30x

  - ◆ Step 2 … Analyze adjusted tax basis

Cost (assumed)	$ 22x
Less: Amortization/Depreciation subject to recapture	(12x)
Adjusted tax basis (above)	$ 10x *

  - ◆ Step 3 … Divide gain into its 2 elements

Ordinary income … Recapture of amortization/depreciation (above)	$ 12x
Long-term capital gain ($30x total gain - 12x)	18x
Total gain	$ 30x

Citation

- Revenue Ruling 2007-37 … May 23, 2007 … 2007-24 IRB 1

Rev. Rul 2007-37

CODE SECTION DETAIL ANALYSIS ... SECTIONS 1221 & 1231

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Section 1221

- Section 1221 defines "capital asset" as property held by the taxpayer, whether or not it is connected with the taxpayer's trade or business.
  - Exception: Property used in a taxpayer's trade or business and of a character that is subject to the allowance for depreciation provided in Sec. 167 is not a capital asset. [Sec. 1221(a)(2)]

Section 1231 In General

- Under Section 1231, gain from the sale or exchange of property that is not a capital asset may be treated as capital gain if the property meets or satisfies three conditions. It is ...
  - Used in the trade or business,
  - Held for more than one year, ***and***
  - Of a character subject to the allowance for depreciation under Sec. 167.
- If a taxpayer has a net gain for a taxable year from sales or exchanges of property used in the trade or business (as defined in Sec. 1231(b)), each gain or loss from such sales or exchanges is treated (under Sec. 1231(a)(1)) as a long-term capital gain or loss.
- If a net loss results, each gain or loss is treated (under Sec. 1231(a)(2)) as ***not*** arising from the sale or exchange of a capital asset.
- The general rule is that the result of the operation of Sec. 1231 is to allow the taxpayer to receive the favorable benefits of
  - Long-term capital gains treatment on net gains, and
  - Ordinary loss (deduction) treatment on net losses.
  - However, see Recharacterization exception discussed below.

Section 1231 Recapture Complications

- Since Section 1231 gain includes gain from the sale or exchange ***of property of a character subject to an allowance for depreciation under Section 167***, Section 1231 gain may be subject to recapture under Sec. 1245.
  - Section 1245 provides for recapture of depreciation and amortization if the property sold or exchanged is Section 1245 property.
  - Section 1245 property includes any personal property, including intangible personal property, of a character subject to the allowance for depreciation under Section 167.
  - See Section 1245(a)(3)(A) and Reg. Sec. 1.1245-3(b)(2).
- "Recapture" means, of course, recapture as ***ordinary income*** to the extent of deductions allowed or allowable for depreciation and/or amortization.

Section 1231 Recharacterization Complications

- As stated above, the general rule is that the result of the operation of Sec. 1231 is to give the taxpayer the benefit of long-term capital gains treatment on net gains and ordinary loss (deduction) treatment on net losses.
- However, this general rule is subject to what is referred to as the "recharacterization" exception. (Section 1231(c))
- The net Section 1231 gain for any taxable year will be treated as ordinary income to the extent that the taxpayer has any non-recaptured net Section 1231 losses for the five most recent preceding taxable years.
  - If Section 1231 gains exceed losses, the net Section 1231 gain is taxed as long-term capital gain only if there are no nonrecaptured Section 1231 losses from the prior 5 years.
  - If there are nonrecaptured prior year Section 1231 losses, then the current-year's Section 1231 net gains are taxed as ordinary income to the extent of those unexpired prior-year nonrecaptured Section 1231 losses.
    - Five-year carryforward tracking, on a FIFO basis.
    - The intention behind the "recharacterization" rule is to prevent taxpayers from deliberately arranging the timing of their transactions over a period of years by separating their transactions so they fall in different years in order to obtain only the better tax results (i.e., long-term capital treatment for gains in some years and ordinary deduction/loss treatment for losses in other years).

Rev. Rul 2007-37

CODE SECTION DETAIL ANALYSIS ...
SECTIONS 1241, 1245 & 1253

Section 1241

- Section 1241 applies to a distributor agreement only if
  - ◆ The distributor agreement is for marketing or marketing and servicing of goods,
  - ◆ The distributor has made a substantial capital investment in the distributorship, ***and***
  - ◆ The capital investment is reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property.
- An investment is not considered "substantial" for purposes of Section 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing or otherwise dealing with the goods distributed ... or consists of a substantial inventory of such goods.
  - ◆ Section 1241 does not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time ***before*** the cancellation of the distributorship agreement.
- ***It is immaterial whether the distributor is a retailer,*** wholesaler, jobber or other type of distributor. (Reg. Sec. 1241-1(c))
- Section 1241 provides that amounts received by a distributor of goods for the cancellation of a distributor agreement in which the distributor has a substantial capital investment are amounts received in exchange for the agreement.
- "Cancellation" (of a distributor agreement) refers to the termination of all the contractual rights of a distributor with respect to a particular distributorship, other than by the expiration of the agreement in accordance with its terms.

Section 1245

Ordinary Income Recapture

- In general, an amortizable Section 197 intangible is Section 1245 property and is treated for purposes of Section 1245 as property of a character subject to the allowance for depreciation under Section 167.
  - ◆ Accordingly, any Section 1231 gain from the sale or exchange of an amortizable Section 197 intangible may be subject to recapture as ordinary income under Section 1245.
- Other provisions are important where franchises were acquired after Jan. 1, 1970 and before Aug. 11, 1993.
- In general, if the taxpayer claimed amortization deductions for these intangibles, then even though amortization were claimed under Section 1253(d)(2) or (d)(3), that amortization would be considered to have been claimed in connection with Sec. 1245 property.

Section 1253

- In general, intangible assets acquired ***before*** the effective date of Section 197 could be amortized only if they had a limited useful life, the length of which could be estimated with reasonable accuracy. (Reg. Sec. 1.167(a)-3)
- Although franchises in many cases have indefinite useful lives, Section 1253 allowed the cost of franchises in which the transferor retained any significant power, right, or continuing interest to be either (1) deducted in the taxable year paid or (2) amortized over a specified period of time.
- Section 1253(d)(1) provides that a purchaser of a franchise may deduct certain contingent payments under Section 162(a).
- Section 1253(d)(2) provides that payments not deductible under Section 1253(d)(1) were recoverable over a period of time that depended on whether the payments were made (1) in a lump sum, (2) in approximately equal installments over a specified period, or (3) under some other payment arrangement.
  - ◆ For transfers after October 2, 1989, Section 1253(d)(2) did not apply if the transfer of the franchise involved principal payments in excess of $100,000,
  - ◆ However, the taxpayer could make an election to recover the cost of the franchise ratably over a 25-year period beginning with the taxable year of the transfer. This election could be made under Section 1253(d)(3).
- ***Summary*** ... Although Sec. 1253 did not explicitly provide that a franchise was treated as property of a character subject to the allowance for depreciation, it did permit acquisition costs to be amortized as if the franchise had a limited useful life.

Rev. Rul 2007-37

CODE SECTION ANALYSIS ... SECTION 197
TREATMENT DEPENDING ON DATE FRANCHISE AGREEMENT WAS ACQUIRED

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Section 197 Effective Date

- Generally, the effective date of Section 197 will be August 11, 1993.
- However, under certain circumstances, a taxpayer could make a valid retroactive election that would move the effective date of Section 197 back to July 26, 1991.

Section 197

Franchises Acquired After August 11, 1993

- Under Section 197(f)(7), property that is an "amortizable Section 197 intangible" is treated as property of a character subject to the allowance for depreciation under Section 167.
- An "amortizable Section 197 intangible" is any Section 197 intangible that is acquired by the taxpayer on or after the effective date of Section 197 ... and is held in connection with the conduct of a trade or business.
- A "Section 197 intangible" includes any franchise, trademark, or trade name. (Sec. 197(d)(1)(F))
- The term "franchise" includes an agreement that gives the right to sell goods within a specified area. (Section 197(f)(4), and defined by reference to Section 1253(b)(1).)
- Since an amortizable Section 197 intangible (including a franchise) is property of a character subject to an allowance for depreciation under Section 167, it is not a capital asset for purposes of Section 1221.
- However, if an amortizable Section 197 intangible is used in a trade or business and held for more than one year, gain or loss on its sale or exchange generally qualifies as a Section 1231 gain or loss.
  - Similarly, an amortizable Section 197 intangible is Section 1245 property and any Section 1231 gain from the sale or exchange of an amortizable Section 197 intangible may be subject to recapture under Section 1245.

Section 197

Franchises Acquired After January 1, 1970 & Before August 11, 1993

- Whether a franchise acquired during this time period* is a capital asset under Section 1221 or Section 1231(b) property depends on (1) whether the franchise is amortizable under Section 1253 and (2) whether, because of such amortization, it is property of a character subject to the allowance for depreciation under Section 167.
  - * The franchise acquisition time period referred to here is ... "on or after January 1, 1970 (the effective date of Section 1253), and before the effective date of Section 197."
- For this purpose, the relevant provisions of Section 1253 are those in effect before Sec. 1253 was amended in 1993.
- Property amortizable under provisions of the Code other than Section 167 has been held to be "property of a character which is subject to the allowance for depreciation under Section 167" and Section 1231(b) property. [... citations omitted]
  - Therefore, property that was amortizable under Section 1253 is properly treated as property of a character subject to the allowance for depreciation under Section 167 and as Section 1231(b) property rather than a capital asset.
- The amortizable character of franchises transferred during the period between 1969 and August 11, 1993 also determines their proper treatment for purposes of Section 1245.
  - As noted elsewhere, under the prior law, taxpayers may have claimed amortization deductions for the cost of a franchise.
  - Any franchise the cost of which was amortized under Section 1245(d)(2) is properly treated for purposes of Section 1245 as property of a character subject to the allowance for depreciation under Section 167.
  - Accordingly, such a franchise is Section 1245 property.
- ***Conclusion...*** A distributor agreement acquired after 1969 and before the effective date of Section 197, for a fixed payment (including a fixed sum payable in a series of approximately equal payments), is amortizable under Section 1253 and is treated as property of a character subject to the allowance for depreciation in Section 167.
  - Because it is property of a character subject to the allowance for depreciation, it is not a capital asset; however, gain from the sale or exchange of such property may be treated as capital gain under Section 1231 and may be subject to ordinary income recapture under Section 1245.

Franchises Acquired Before 1970

- A distributor agreement entered into before January 1, 1970 (the effective date of Sec. 1253), (1) is not amortizable, (2) is not property of a character subject to the allowance for depreciation in Section 167, and (3) is a capital asset under Section 1221.
  - See Rev. Rul. 55-374, 1955-1 C.B. 370; Rev. Rul. 88-24, 1988-1 C.B. 306.

Facts in Oldsmobile Dealer's Private Letter Ruling from the IRS PLR 200218034 ... February 2002

"The Taxpayer is an S corporation engaged in the business of selling and servicing Product A and Product B. The Taxpayer's annual accounting period is the calendar year and it reports income and expenses using the accrual method of accounting.

Distributorship Agreement

"The Taxpayer and Corporation entered into a distributorship's agreement that provided that the Taxpayer with the right to sell and market Product A within a prescribed geographic area (Distributor Agreement). The Distributor Agreement provides that it may not be assigned to a third party. If a distributor sells its business (assets or stock), the selling distributor voluntarily terminates its distributor agreement with Corporation and Corporation subsequently approves the buyer under a new distributor agreement. The Taxpayer had the right to continually renew the Distributor Agreement as long as the Taxpayer performed according to the terms of the Distributor Agreement. In addition to being part of the Distributor Agreement, the renewal right was provided to the Taxpayer pursuant to State (of ___) law. The Taxpayer and Corporation last extended the Distributor Agreement on _______ (date deleted).

"Under the Distributor Agreement, the Taxpayer is obligated to maintain at least $_______ of net working capital at all times for the Product A and the Product B lines during its business operation and maintain the Image of Corporation consistently with other distributors of Product A. The Distributor Agreement requires the Taxpayer to maintain and manage its distributorship so that it can effectively sell and service Product A. To do so, the Taxpayer is required to purchase and use Corporation designed equipment as necessary. The Taxpayer must service customers and maintain customer satisfaction. In addition, the Distributor Agreement requires that the Taxpayer must maintain a sufficient level of inventory to allow customers a variety of Product A. The Taxpayer's sales performance is monitored at least yearly and Corporation has the right to terminate the Distributor Agreement with the Taxpayer if it determines that the Taxpayer's sales performance is inadequate.

Manufacturer's Notice of Termination

"In ________ (date deleted), Corporation notified the Taxpayer and other Product A distributors of its intention to discontinue the Product A line. As part of this announcement, Corporation offered to provide transition payments to distributors who agreed to cancel their distributor agreements with Corporation. The calculations of the transition payments are based upon a number of factors including the number of Product A sold by the distributor over a three-year period and the percentage of Product A sold out of total sales by the distributor. The cancellation would also entail a release of Corporation from any future claim brought under a distributor agreement.

Transition and Release Agreement (TRA)

"On ________ (date deleted), the Taxpayer and Corporation agreed to cancel the Distributor Agreement and executed a Transition and Release Agreement (TRA) setting forth the terms of the cancellation. The TRA provided for ___ percent of the transition payment amount of $________ (amount deleted) to be paid to the Taxpayer upon the execution of the TRA and the remaining amount upon the earliest of three dates;

(1) ________ number of days after the Taxpayer provides notice to Corporation of its intention to no longer sell and market Product A;

(2) ________ number of months after Corporation provides notice to the Taxpayer of its intention to eliminate the Taxpayer's ability to sell, market and service Product A; or

(3) ____________ (specific date, date deleted).

"Under the terms of the TRA, the Taxpayer may continue to sell and market Product A until the earliest of the three dates. One or more of the transition payments will be received by the Taxpayer after the close of the taxable year in which the disposition occurs. As of ________ (date deleted), the Taxpayer had an inventory of approximately $________ (amount deleted) relating to the Product A line and gross revenue in _____ (year deleted) of approximately $_________ (amount deleted) relating to the Product A line."

SEC. 62(c) ACCOUNTABLE PLANS FOR TECHNICIANS' TOOL REIMBURSEMENTS

In December 2006, we reported that the IRS Motor Vehicle Technical Advisor, Ms. Terri Harris, had emphasized three points to the attendees at the AICPA National Auto Dealership Conference ... (1) "the IRS is taking these programs very seriously," (2) the compliance level of many programs with Section 62(c) is "problematic" and (3) in general, the Service has "grave concerns" about such plans in this area.

Our update now provides further reinforcement concerning the IRS' skeptical, negative attitude towards these plans.

COMMENTS BY IRS CHIEF OF EMPLOYMENT TAX

An article in *Tax Notes* (April 2, 2007) reported various remarks by Mr. John Tuzynski, IRS chief of employment tax, on various payroll and other employment tax issues. These remarks were made in March at a recent American Payroll Association Summit in Washington, DC, and, they highlighted several "issues in the employment tax arena that will see increased enforcement activity in the coming months."

Mr. Tuzynski said, "There's no shortage of abuse or fraud in the area of employment taxes."

Tax Notes reported that the IRS is focusing on tool allowances, in which an employee (traditionally in the auto repair industry) receives an hourly stipend to own and maintain tools as a condition of employment. Mr. Tuzynski had reminded the audience that allowance plans designated as "nonaccountable" will be subject to employment tax as wages.

"We're seeing these plans creep into other industries," he said. "We're going to start a lot of audit activity in this area in the next few months."

COMMENTS BY IRS MVTA AT RECENT CONFERENCES

At the May NABD-BHPH Conference, Ms. Terri Harris did not discuss these plans in her remarks to the attendees. However, she did include, as one of her PowerPoint slides in the Conference manual, a slide which states that the IRS is taking a tough stance on Section 62(c) plans.

Perhaps the reason that these plans weren't discussed at the NABD-BHPH Conference was either because of time limitations or because the use of these plans is less likely to be encountered in BHPH dealership situations.

However, in the following month, Ms. Harris was at the National Independent Automobile Dealers Association Convention in Nashville. At this Convention, it was reported in the *Used Car News* (July 2, 2007) that Ms. Harris had talked about these plans in some detail and repeated her now oft-quoted remark that she has yet to see one of these plans that actually passes muster with the IRS.

In the article in *Used Car News*, Ms. Harris is quoted as saying ... "The IRS takes these wage recharacterizations very seriously because it reduces the amount of income tax and Social Security tax paid. ... It also reduces the technician's Social Security wage base, so he's losing out. ... We have a team in place to look at these plans."

It appears that Mr. Tuzynski and Ms. Harris are singing from the same page and are on the same line in the same IRS hymnal.

Could it be that the IRS is just biding its time, waiting to find another *Shotgun Delivery* situation with very bad facts so that it can add a new face to the Section 62(c) wanted poster?

RECENT DEVELOPMENTS IN ONE PENDING CONTROVERSY

In the September 2006 *DTW*, we commented on an article that appeared in *Tax Notes* (August 7, 2006) in which Steven J. Mopsick had said, "Tool plan administrators all across the country are receiving Section 6700 tax shelter investigation letters."

In his article, *"IRS Abuse of Anti-Tax-Shelter Tools,"* he stated, "The IRS is using one of its biggest anti-tax-shelter weapons ... IRC Section 6700 ... to 'shoot first and aim later' by accusing legitimate businesses of fraud before their first meeting with a revenue agent." In advancing his argument that the use of Section 6700 should not be a substitute for normal audit procedures, Mr. Mopsick discussed much of the recent IRS activity from the 2000 Coordinated Issue Paper through its issuance of Rev. Rul. 2005-52.

In March 2007, papers were filed in the U.S. District Court for the District of Colorado that are apparently related to one of the cases to which Mr. Mopsick was referring. Included in these papers were a copy of the Section 6700 tax shelter investigation letter and a copy of the Information Document Request (IDR Form 4564), summarized on the following page, that was issued to the taxpayer.

If this case moves forward in the courts, there may be more to report on this.

Tool Plans
Form 4564

INFORMATION DOCUMENT REQUEST

SENT BY LOCAL REVENUE AGENT
FROM THE SMALL BUSINESS/SELF-EMPLOYED DIVISION

Provide the Following Information for the Period January 1, 2002 to the Present (Feb. 2006):

A. All manuals, operations handbooks, prospectuses, offering documents, or other documents written by or provided by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***, which describe the plan, operations or structuring of any tool reimbursement plan strategies or other tax arrangement offered to investors or purchasers.

This includes all documents provided to clients by any employees, agents, or staff of ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***.

B. All documents describing the marketing activities and strategies of any tool reimbursement plans or other tax arrangements promoted or offered by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]*** or the employees, agents, or staff thereof including but not limited to:

(1) Any training manuals or other published material such as books, pamphlets, flyers or promotion packages.

(2) Any media, videotapes, audiotapes, compact discs, or computer discs used for training salespeople.

(3) Any media, videotapes, audiotapes, compact discs, or computer discs used in marketing any tool reimbursement plan positions or strategies or other tax arrangements.

(4) Promotional recordings such as radio shows, television shows or seminars.

C. Documents which identify names and addresses of all persons involved in the promotion or sale of any tool reimbursement plan positions, strategies, or other tax arrangements promoted or offered by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***, or by the employees, agents, or staff thereof.

These persons include, but are not limited to (1) attorneys, (2) Certified Public Accountants, (3) salespersons, and (4) other persons to whom commissions or finders fees were paid.

D. All legal, accounting, or other opinions used in drafting the brochures or web site information including, but not limited to ... ***[web sites of his (related) corporations or businesses]***.

E. All documents which identify names and addresses of any purchasers of any tool reimbursement plans or other tax arrangements promoted or offered by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***, or the employees, agents, or staff thereof.

F. All applications, contracts and invoices with respect to purchasers described in paragraph E. above.

G. All receipts for payment and a schedule of fees charged with respect to purchasers described in paragraph E. above.

H. All documents which suggest or propose entries on any tax or other tax arrangements promoted or offered by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]*** or by the employees, agents, or staff thereof.

I. Copies of all tool reimbursement plans prepared by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***, or by the agent(s) thereof for investors, purchasers, or clients.

J. All records of payments received from purchasers of tool reimbursement plans or other tax arrangements by ***[Mr. XYZ]*** or by ***[his (related) corporations or businesses]***, or by the agent(s) thereof including, but not limited to, general ledgers and cash receipts journals.

For Section 6700 Tax Shelter Investigation Letter sent to taxpayer, see page 28.

The National Buy-Here, Pay-Here Conference May 2007

BHPH INDUSTRY TRENDS & BENCHMARKS

The 9th annual National Buy-Here, Pay-Here (BHPH) Conference was held in Las Vegas on May 14-16, 2007. Over 1,800 attendees registered for this event where the emphasis was placed on "Leading & Learning."

In discussing various benchmarks and industry trends based on information complied by his firm, Kenneth Shilson, CPA (Shilson, Goldberg, Cheung & Associates, LLP, Houston, Tex.) identified three factors that were most detrimental for BHPH dealers. These factors are: (1) increases in vehicle acquisition costs, (2) increased bad debt losses and charge-offs and (3) higher operating expenses, most of which are attributable to unavoidable inflation.

Many BHPH dealers are encountering difficulty in finding vehicles that will meet their buying criteria for vehicle mileage and condition ... at the price the dealer is willing to pay. In many cases, older, more reliable vehicles are becoming more expensive for the BHPH dealer to purchase, and dealers are having to travel greater distances in order to find "acceptable" or desirable lower priced vehicles for their lots.

From a detailed analysis of a very large database of BHPH operators, here are some general trends over the last 3 years.

	2006	2005	2004
Revenue	100 %	100 %	100 %
Cost of vehicle sales			
Cost of vehicles	(55.26) %	(55.10) %	(53.94) %
Reconditioning costs	(5.38) %	(5.42) %	(5.50) %
Other (travel, transportation, etc.)	(2.86) %	(3.15) %	(2.16) %
Total cost of vehicle sales (rounded)	(64) %	(64) %	(62) %
Financing income	18 %	18 %	17 %
Bad debts expense	(20) %	(19) %	(17) %
Gross Profit	34 %	35 %	38
Average total ACV per vehicle sold (including recond.)	$ 4,949	$ 4,906	$ 4,395
Average case in dealer per unit sold	$ 4,480	$ 4,563	$ 3,825
Average customer down payment	$ 900	$ 837	$ 1,066
Average weekly payment amount	$ 79	$ 78	$ 76

This information shows that overall financing income was not sufficient to offset the significant rise in bad debt expense. Copies of all of these benchmarks can be downloaded at the NABD web site (www.bhphinfo.com) in the "News & Views" section.

THE IRS AT THE BUY-HERE, PAY-HERE CONFERENCE ... MAY 2007

The IRS Motor Vehicle Technical Advisor, Ms. Terri Harris, was one of the presenters at the BHPH Conference.

Every time Ms. Harris speaks, it's always a good opportunity to hear about what's going on currently at the IRS from a reliable source. Mrs. Harris' presentation was divided into three parts. In the first part, she discussed IRS resources that were available to BHPH dealers to assist them with both individual problems and questions, as well as (hopefully) the resolution of more "global" issues.

Ms. Harris referred to the second part of her presentation as "some food for thought." This was appropriate since her presentation came right before the cocktail/dinner break. In these comments, she emphasized some important tax considerations that BHPH dealers should be aware of and, if necessary, discuss further with their tax advisors.

The third part of her presentation was a Question & Answer session in which Ms. Harris fielded various and sundry questions from the attendees, with appropriate background commentary added by Ken Shilson.

Ms. Harris' comments are summarized on page 23. The PowerPoint slides for her presentation were fairly generic, and we have not reprinted them here. However, you can obtain a copy by e-mailing Ms. Harris at Terri.S.Harris@irs.gov, or just call or e-mail us, and we'll send them to you.

Presentation Comments	*The IRS at the Buy-Here, Pay-Here Conference ... May 2007*
Part I ... ***Resources***	• Pre-filing & technical guidance - LMSB • Technical Advisor program • Identification and resolution of global issues, including Industry Issue Resolution (IIR) programs • *Dealership Audit Technique Guide ... "New Vehicle ATG"* (Dec. 2004) ◆ Many chapters applicable to BHPH dealers • *Retail Audit Technique Guide* (August 2005) ◆ Chapter 3 in this *ATG* addresses independent used car dealers
Part I ... ***If You're Audited ...*** ***Issue Resolution Strategies***	• In general, IRS audits of dealerships ... both new and used ... are increasing in number. • Ms. Harris emphasized that ***BHPH dealers should be relying on CPAs who have meaningful experience with the industry***. ... ◆ This was vividly emphasized during the Q&A part by one attendee who prefaced his question by saying he was attending this year's Conference hoping to find a good, knowledgeable CPA who knew something about the BHPH industry, because for 3 years, the person preparing his tax returns had made glaring errors. • Strategies available to BHPH dealers when difficult audit issues arise. ◆ Ask for a conference with the examining agent's manager/supervisor. ◆ Request advice from National Office, possibly written advice in the form of a TAM (Technical Advice Memorandum). ◆ Request case-specific Field Advice. ◆ Request Appeals conference, if agreement cannot be reached at the examining agent level. ◆ Identify issues that may have a national (referred to as "global") implications and work through national industry associations to try to secure resolution.
Part II ... ***"Food for Thought"*** ***... Questions for Dealers (from the IRS)***	• Are you using the accrual method of accounting? ◆ BHPH dealers must use this method ... The installment method of reporting cannot be used. • When you purchase several vehicle at the same time at auction, how do you allocate the total cost among the vehicles that were purchased? • How do you book the inventory value of a trade-in? • At year-end, what method are you using for writing down vehicles in your inventory? ◆ Across the board, flat percentage write-downs (based on "experience") are not permitted. ◆ Assuming you're not using LIFO, have you properly elected to use the lower-of-cost-or-market method? • What kind of service contracts do you sell? Are you considered to be a dealer obligor on these? • Have you set up a related finance company (RFC) to whom you sell your customers' notes? ◆ Is the RFC really operated on an arm's-length basis? ... Or, is it a "drawer in a file case"? • When do you write off bad debts? When do your collection efforts stop and write-offs occur? ◆ BHPH dealers are not permitted to use a reserve account for bad debts for tax purposes.
Part II ... ***A Few Other Issues***	• Cash reporting and Form 8300 requirements * • Electronic recordkeeping requirements & electronic records retention * • Employee tool and equipment (Section 62(c)) plans * • Section 263A cost capitalization requirements * • Inventory ... Lower-of-cost-or-market (LCM) writedowns must be applied to each vehicle individually and supported by appropriate documentation. * *Comment...* These issue have been discussed at length in previous issues of the *Dealer Tax Watch*, and the IRS MVTA Office has issued an *Automotive Alert* addressing topics indicated by (*). You can request a copy of these *Automotive Alerts!* from Ms. Harris or find them in prior issues of the *Dealer Tax Watch*.
Part III ... ***Questions from Dealers (to the IRS)***	• During the Q & A session, questions asked by dealers generally related to two main areas... ◆ Filing requirements for Forms 1099-C (*Cancellation of Indebtedness*) ... Who is required to file? What events trigger the filing? What if money is collected later on the note? Etc. ◆ Use of the accrual method ... Prohibition against use of the Installment method ... Ability to offset the disadvantage of not being able to use the installment method by setting up a related finance company (RFC) to defer the tax until the money is collected from customers on their notes. • These subjects have been discussed at length in previous issues of the *Dealer Tax Watch*. See www.defilipps.com for complete index of articles from prior issues of the *DTW*.

STATIC POOL ANALYSIS ... ONE OF THE KEYS TO GREATER BHPH PROFITABILITY

Again at this year's BHPH Conference, Mr. Shilson emphasized that the BHPH business is not about buying and selling cars; it is about managing risk. In this regard, dealers must gather more information at the point of sale and continue to try to place customers in vehicles that they can really afford.

In emphasizing this year's Conference theme, "Learn from Your Losses," Mr. Shilson suggested that there are 5 questions that every BHPH dealer should be able to answer about his/her loan portfolio. These are questions that CPAs should be discussing with their BHPH dealer clients...

5 QUESTIONS

- What is the rate of return on your investment?
- How much of your financing profit do you really collect?
- What portfolio losses can you expect in the future?
- How can you reduce your future losses?
- How does your portfolio performance compare with the rest of the industry?

Key factors. The answers to these questions can only be provided by analyzing in detail the loan portfolio performance and underwriting characteristics. This analysis requires the identification of key factors which directly affect performance such as ... sales price, down-payment amount, deal mark-up, amount financed, vehicle cost and other characteristics (including mileage, manufacturer, age, model, cars vs. trucks, etc.), payment amount, loan term and number of payments.

Questions & more questions. The more finely the data is sliced and diced, the greater the amount of useful information that it will yield. For example, here are five more detailed questions that could be answered if the information can be extracted from the data...

- ***How does vehicle performance affect repayment?*** Generally, when a vehicle stops running, the BHPH customer stops paying. It is possible to compare the overall default rate on vehicles in various mileage ranges based upon their mileage at the time of loan origination (120,000 to 130,000 miles vs. 130,000 to 140,000 miles, etc.).

- ***How does portfolio performance differ for cars versus (or compared to) trucks, vans and SUVs?*** Are the default rates about the same or are there significant differences in the default rates? Which group has the highest default rate? ... Which group has the lowest default rate?

- ***How does the cost of a vehicle affect the portfolio's default rates?*** What is the default rate based on vehicle cost ranges (vehicles costing under $2,500, or vehicles in the cost range of $2,500 to $4,000, $4,000 to $5,000, etc.)? It is important to match the right vehicle with the right customer so that the customer is being sold a vehicle that he/she can (realistically) afford. This will require considerable fine-tuning because results will vary by dealer, geographic region and by rural versus urban business models.

- ***How do down-payments (measured against vehicle cost) affect default rates?*** What is the default rate for various down-payment-as-a-percentage-of-cost ranges? And, how do these default rates compare to the overall default rate?

- ***What add-on product positively affects portfolio default rates?*** Is there a (significant) difference in the default rate for vehicles sold with service contracts compared to vehicles sold without service contracts? And, how do these default rates compare to the overall default rate?

These questions show how important it is for the BHPH dealer to have an accurate understanding of the nature of his/her loan portfolio and then to follow up by establishing procedures to constantly monitor subsequent transactions.

In this regard, static pool analysis/loss tracking is a valuable tool. Although this analysis can be done in-house, some dealers may find it more economical to outsource this analysis which involves recognizing and evaluating both "leading" and "lagging" indicators. "Leading" delinquency indicators are those which are computed before charge-off or before recognition of a loss. "Lagging" indicators are indicators which are computed after a loss has been incurred.

It is important for a BHPH dealer to be able to do this analysis and to answer these questions regardless of whether his/her business model is going to (1) "tote his/her own notes" (i.e., continue to hold the notes and try to collect them with or without the benefit of a related finance company structure) or (2) collect those notes and sell them to an unrelated financing source or lending company.

see **STATIC POOL ANALYSIS**, page 26

BHPH Dealers

PORTFOLIO ANALYSIS ... SELECTED LOSS RATES & LOSS FREQUENCY DATA

Presented at the 2007 BHPH Conference by Kenneth Shilson, CPA
Based on Information from Subprime Analytics (www.subanalytics.com)

	2006	2005
Loss Rates		
Average gross loss $ (before recoveries)	$ 6,025	$ 6,432
Average net loss $ (after recoveries)	$ 4,370	$ 4,952
Average default rate (% of loans written off)	26.2%	25.6%
Average gross dollar loss rate (% of principal)	36.72%	32.97%
Average net loss rate: (% of principal)	26.63%	25.15%
Average recovery as a % of principal charged-off (excluding repo expenses)	25.70%	23.30%
Loss Frequency		
Highest cumulative default month after origination	17th Month	15th Month
Highest frequency of default (expressed as month after origination)	5th Month	5th Month
Highest loss month (based upon originations)	February 2006	

Most Alarming Finding ... Over 50% of all BHPH installment contracts don't pay out.

This is because operators apparently decided not to pursue the last $1,000 or $1,500 of the deal.
In effect, many operators stopped monitoring these collections.
The moral: BHPH dealers need to collect their deals all the way out.

Supplementary Information

OTHER TERMS & MEASURES IN PORTFOLIO ANALYSIS & AUDIT ISSUE W/R/T VALUING LOAN PORTFOLIOS

Frequency of loss ... This is not a dollar amount, but rather it is a percentage or ratio computed by dividing the number of losses that are incurred in a given pool by the number of loan originations in that pool.

Severity of loss ... This is a percentage or ratio computed by dividing the average loss expressed in dollars by the average contract principal financed (i.e., $5,200 average loss / $10,000 average contract principal financed = 52%).

Percent delinquency ... As soon as the customer has not made a payment on his/her note, that note is considered delinquent in this calculation ... i.e., as little as 1 day late or $1 short.

Recency ... An expression of the number of days since the last payment was made by the customer.

Overall net-net-net loss rate ... Net of repossessions and recoveries.

Repo rate ... Frequency of repossession.

Liquidation rate ... Dollars extracted from the portfolio pool expressed as either (1) dollars collected as a percent of notes receivable (overall), or (2) dollars collected per account / note.

Audit Issue with Respect to Valuing Loan Portfolios ... Estimating Uncollectable Accounts

It's December 31, 20xx, and it's time to prepare the balance sheet for ABC, a BHPH dealership whose loan portfolio is $2,500,000 (or any other number you might imagine).

One major audit issue relates to determining the dollar amount that should be provided for the balance in the notes receivable account at the end of any given year. Should the amount of the estimated uncollectable accounts (i.e., bad debts) as of Dec. 31, 20xx be based upon ...

- An amount expected to become uncollectable within 120 or 150 days (say, 6% of the account balance), ***or***
- The overall anticipated delinquency that has been determined for that aggregate of notes receivable as a result of static pool analysis (which might be, perhaps, 28%)?

Although the percentages determined under each approach will vary according to circumstances, the spread between the percentages can be significant (it is in the range of 20 percentage points in this example). Accordingly, this can be a significant audit issue in connection with the valuation of the note receivable account.

(Continued from page 24)

Levels or phases of capital needs. Here is one generalization about BHPH dealers' capitalization needs. These needs fall into three categories or phases. Phase I needs range from $500,000 to $1,000,000, and these needs may be basically satisfied by money provided by the dealer, family members and friends. Phase II capital needs range from $1 million to $5 million, and these needs are usually handled by local banks. Phase III capital needs involve anything beyond $5 million, and often this level is one beyond which most local banks are either unwilling or unable to go with the dealer.

It would appear that some of the very largest BHPH dealers prefer to avoid financing with an unrelated source and, instead, continue operating with a related finance company (RFC) structure.

Shopping for capital... Monetizing a loan portfolio. Where a BHPH dealer's model involves the sale of customer notes to an unrelated financing source or company, these dealers need to recognize that these lending institutions tend to view comprehensive loan portfolio analysis in terms of potential loan collateral performance. This involves expressing portfolio performance in terms of collection trends, aging and delinquency trends and loss trends all generated from month-by-month analyses of the loan portfolio over a meaningful period of time.

Static pool analysis (SPA) is helpful here because it allows for a more accurate assessment of underwriting and collection efforts by involving the application of historical experience to assist in predicting future losses. It has been said by some that SPA shows with exact precision the historical percentage of loans booked that were collected, and, for this reason, most lending institutions require a considerable degree of sophistication in a BHPH dealer's overall customer note history database.

A *"pool"* is simply a group of loans that were all created during the same specific/defined timeframe. For example ... all loans originated during the month of March, 20xx or all loans originated during the quarter ending September, 20xx.

The portfolio analysis is referred to as *"static"* because the analysis is applied exhaustively to all of the loans that were originated during that specific/time-defined pool.

By looking at all of the loans that were originated in that pool, it is possible to track information relating to the collective performance of the notes in that pool. This would include all manner of (1) collection, (2) aging and (3) loss experience. And this can be refined further based upon the demographics of (1) the customer, (2) the vehicle and (3) the deal structure or characteristics.

Static pool analysis groups or sources all losses on customer notes back to the period of origination of the underlying notes, and it tracks both frequency and severity of loss, as well as overall loss percentages. The longer the period of consecutive months' activity reflected in the customer note history database and the greater the number of overall loan originations in that database, the greater (should be) the predictability of future losses assuming that historical results, trends and averages will be the same in the future.

A typical format for either internally analyzing a loan portfolio or presenting it in connection with a financing request is shown on the facing page, along with a few related comments.

It's somewhat more complicated than this, and further refinements abound, but that's the general or overall idea. These analyses are updated monthly and are watched very carefully by establishing reasonable and reliable practices to constantly monitor subsequent transactions.

If static pool analysis were to show that the overall default rate on a portfolio segment was computed to be 30%, that could mean that the bank, lender or purchaser could expect to be able to collect 70% on that portfolio segment. Following from this, if an additional 10% were factored in as a "cushion" or margin of error, then that portfolio segment should be worth 60% (i.e., it could be monetized for 60% of its total amount. Although the lending rates may vary based on differences in circumstances and/or locale, financing institutions may be willing to lend approximately 55% to 60% as an advance rate against the notes in better pool segments.

To recap... There is little doubt that BHPH dealers are in the financing business and that the sale of vehicles is simply a necessary ingredient in that activity. Understanding the nature of the losses likely to be incurred on customer notes and having some historical, performance-based means of predicting losses on these notes is critical.

This valuable information enables a BHPH dealer to have an accurate assessment of underwriting and collection efforts, and thus, to better manage and absorb future risk. In addition, this information permits a BHPH dealer to develop ways of grading or scoring customers according to basic common denominator characteristics.

Finally, as the BHPH operation grows, these analyses permit a dealer to approach lending institutions with greater confidence when, or if, it should become necessary to borrow money, or to sell, on the basis of his/her note portfolio.

Sample Formats

BHPH DEALER NOTE/LOAN PORTFOLIO PRESENTATION

		August 2006	September 2006	October 2006	November 2006	December 2006
Beginning of the month total portfolio principal	(A)	$ 7,700,000	$ 7,756,000	$ 7,803,000	$ 7,836,000	$ 7,858,000
New principal from sales during the month	(B)	501,000	502,000	503,000	502,000	501,000
Principal collected during the month	(C)	(315,000)	(325,000)	(340,000)	(350,000)	(367,000)
Principal charged-off during the month	(D)	(130,000)	(130,000)	(130,000)	(130,000)	(130,000)
Month-end total portfolio principal	(E)	$ 7,756,000	$ 7,803,000	$ 7,836,000	$ 7,858,000	$ 7,862,000
Principal collected during the month	(F)	$ (315,000)	$ (325,000)	$ (340,000)	$ (350,000)	$ (367,000)
Interest collected during the month	(G)	(168,000)	(168,000)	(170,000)	(171,000)	(172,000)
Recoveries on previous charge-offs	(H)	-	-	-	-	-
Total	(I)	$ (483,000)	$ (493,000)	$ (510,000)	$ (521,000)	$ (539,000)
Trend of Principal Collections						
Principal collected each month divided by the beginning total principal balance (F) / (A)		4.09%	4.19%	4.36%	4.47%	4.67%
Trend of Total Collections						
Principal & interest collected each month divided by the beginning total principal balance [(F)+(G)] / (A)		6.27%	6.36%	6.54%	6.65%	6.86%
Trend of Interest Earnings / Portfolio Yield						
Interest collected divided by beginning principal balance, annualized [(G) / (A)] x 12 ... monthly yield		26.18%	25.99%	26.14%	26.19%	26.27%

Aging Trends

By adding additional data showing how the end-of-the-month total portfolio principal (E) is aged, one can readily observe aging trends in the note portfolio.

(Note the problem in December ... big jump in over 90 days past due accounts.)

		October 2006	November 2006	December 2006
Current		$ 5,336,316	$ 5,437,736	$ 5,448,366
0 to 30 days past due		1,206,744	1,202,274	1,179,300
31 to 60 days past due		720,912	738,652	487,444
61 to 90 days past due		313,440	345,752	259,446
91 days or more past due		258,588	133,586	487,444
Total	(E)	**$ 7,836,000**	**$ 7,858,000**	**$ 7,862,000**
Current		68.1%	69.2%	69.3%
0 to 30 days past due		15.4%	15.3%	15.0%
31 to 60 days past due		9.2%	9.4%	6.2%
61 to 90 days past due		4.0%	4.4%	3.3%
91 days or more past due		3.3%	1.7%	6.2%
Total		**100.00%**	**100.00%**	**100.00%**

Comments ...

From data in this format, it is possible to compute many other important statistical measures and trends. The variations of further data analysis are almost endless.

The above display is for simple interest contracts. Pre-computed contracts would have different roll-forward line items as follows... Beginning Total of Payments ***plus*** New Total of Payments ***less*** Payments Collected ***less*** Charged-Off Principal ***less*** Rebated Unearned Finance Charges ***equaling*** Ending Total of Payments.

Sec. 62(c)
Update, Pg. 20

Section 6700 Tax Shelter Investigation Letter
Sent by Small Business/Self-Employed Division
Department of Treasury - IRS - Wash., D.C.

Dear Mr. XYZ: February ____, 2006

We have reviewed certain materials with respect to your tax shelter promotion. We are considering possible action under Sections 6700 and 7408 of the Internal Revenue Code relating to penalties and to an injunction action for promoting abusive tax shelters. In addition, we plan to consider issuing "pre-filing notification" letters to the investors who have invested in this promotion.

You are requested to meet with (Mr. ABC, IRS Examiner) on (date), at IRS Area Counsel's office located at .... If you have any questions, (Mr. ABC, IRS Examiner) can be reached at (phone no. ...). Enclosed is an Information Document Request listing documents, books and records that you should have available and questions that you should be prepared to reply to at that time. Please call to confirm this appointment by (date).

If we conclude that penalties, injunction, and/or "pre-filing notification" action is appropriate, you will be afforded an opportunity to present any facts or legal arguments which you feel indicate that action should not be taken.

Sincerely,
Mr. ABC, Revenue Agent, Small Business/Self-Employed Area ___

Service Technician's Tool Reimbursements Emerging Issue Team ... May 2007

- Service has grave concerns over this [Section 62(c)] issue
- Cross divisional team to address current guidance and potential for additional guidance
- Plan promoters are becoming more aggressive and plans [are becoming] more abusive
- Issue crosses industry lines not just automotive
- Plans are being formulated to initiate examinations on multiple participants in multiple industries.

Source: *Harris, T. IRS Motor Vehicle Technical Advisor. NABD 2007 National Buy-Here, Pay-Here Conference Manual, Las Vegas, May 2007. PowerPoint presentation.*

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