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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

Volume 14, Number 4 Publisher: Willard J. De Filipps, C.P.A. December 2007

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. IRS EMPLOYEES CONTINUE TO COMPROMISE TAXPAYERS' CONFIDENTIAL INFORMATION. One really appalling piece of news about the IRS in late 2007 didn't get much publicity.

Did you know that over a recent 3½ year period, IRS employees reported the loss or theft of at least 490 computers and other sensitive data? This occurred in almost 400 separate incidents.

"Despite repeated warnings, IRS workers continue to show reckless disregard for computer security. Continued failure in this area is leaving millions of American taxpayers vulnerable to identity theft and other fraudulent schemes."

This is what Senate Finance Committee Chairman Max Baucus said in August in response to a report issued by TIGTA, the agency that reviews the adequacy and security of IRS technology.

Actually, several previous reports by TIGTA were also very critical of the lax IRS standards and practices that were uncovered. Summaries of three TIGTA 2007 reports are on pages 2-3 to give you an idea of just how deplorable the situation has become.

It is clear from these 2007 reports that many of these problems and security issues have plagued the IRS for years. However, the IRS has failed to, or has been unable to, take effective corrective action.

Could you run your business like this? Where's the IRS accountability for this? ... Where's the FTC and Gramm, Leach & Bliley, et al., when you need them? Or, is the problem so big that, like IRS "modernization," it has become another disturbing "fact of life" that's just gotten out of hand that we'll have to live with?

In light of this, maybe there are a few questions you should be asking an IRS auditor during an audit of your client about whether your client's data has been compromised. IRS agents won't tell you ... unless you ask.

#2. UPDATE ON SECTION 263A ... IRS GUIDANCE ON COST CAPITALIZATION FOR AUTO DEALERSHIPS. This quarter's "update" on TAM 200736026 is really brief.

IRS. There have been no new developments out of the IRS nor any published guidance.

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WATCHING OUT FOR

TIGTA Reports

IRS EMPLOYEES CONTINUE TO COMPROMISE TAXPAYERS' CONFIDENTIAL INFORMATION

Senator Baucus Response to TIGTA Reports ... August 3, 2007

COMMITTEE ON FINANCE
NEWS RELEASE

Max Baucus, Chairman
http://finance.senate.gov

MEMORANDUM

To: Reporters and Editors
From: Carol Guthrie for Senate Finance Committee Chairman Max Baucus (D-Mont.)
Re: Report of computer security violations at IRS

Senate Finance Committee Chairman Max Baucus (D-Mont.) commented today on a report that uncovered serious lapses in computer security at the Internal Revenue Service (IRS). The audit by the Office of the Treasury Inspector General for Tax Administration (TIGTA) discovered that IRS employees, including managers, are not complying with the basic computer security practice of protecting their passwords. TIGTA conducted a sting operation, convincing 61 out of 102 IRS employees contacted by telephone to disclose their usernames and temporarily change their passwords to ones TIGTA suggested. Applying TIGTA's "success" rate of 60 percent, almost 60,000 of the IRS's 100,000 employees and contractors are susceptible to computer hackers, putting untold amounts of personal taxpayer information at risk for unauthorized disclosure, theft and fraud.

From Chairman Baucus:

"Despite repeated warnings, IRS workers continue to show reckless disregard for computer security. Continued failure in this area is leaving millions of American taxpayers vulnerable to identity theft and other fraudulent schemes. Every IRS employee should take personal responsibility for protecting confidential taxpayer information. The IRS must take this problem more seriously and take aggressive steps to ensure that all employees understand and carry out security requirements."

The audit was initiated as part of TIGTA's statutory requirement to annually review the adequacy and security of IRS technology. The overall objective of the review was to evaluate the susceptibility of IRS employees to attempts by hackers to gain access to IRS systems. The full report, "Employees Continue To Be Susceptible To Social Engineering Attempts That Could Be Used By Hackers," number 2007-20-107, is available online at http://www.treas.gov/tigta/auditreports/2007reports/200720107fr.pdf.

3 TIGTA Reports in 2007 on IRS Security Lapses

- March 23, 2007 .... *The Internal Revenue Service Is Not Adequately Protecting Taxpayer Data on Laptop Computers and Other Portable Electronic Media Devices*
- July 20, 2007 .... *Employees Continue to Be Susceptible to Social Engineering Attempts that Could Be Used by Hackers*
- August 13, 2007 .... *Efforts Have Been Made, But Manager and Employee Noncompliance with Security Policies and Procedures Puts Personally Identifiable Information at Risk*

Treasury Inspector General for Tax Administration

THE INTERNAL REVENUE SERVICE IS NOT ADEQUATELY PROTECTING TAXPAYER DATA ON LAPTOP COMPUTERS AND OTHER PORTABLE ELECTRONIC MEDIA DEVICES

Issued on March 23, 2007

Highlights

Highlights of Report Number: 2007-20-048 to the Internal Revenue Service Chief Information Officer and Chief, Mission Assurance and Security Services.

IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) annually processes more than 220 million tax returns containing personal financial information and personally identifiable information, such as Social Security Numbers. If lost or stolen, taxpayer data can be used for identify theft and/or other fraudulent purposes. The risk of loss is particularly high because IRS employees are allowed to take electronic taxpayer data outside of the office for business purposes and the IRS has over 47,000 portable laptop computers assigned to its employees.

WHY TIGTA DID THE AUDIT

This audit was initiated as part of the Fiscal Year 2006 Annual Audit Plan and followed up on our findings from previous years that addressed noncompliance with procedures for safeguarding taxpayer data.

TIGTA conducted the review to determine whether the IRS is adequately protecting sensitive data on laptop computers and portable electronic media devices. The audit focused on identifying the number of lost laptop computers, determining whether data on those computers were encrypted, and determining whether laptop computer access controls were adequate. TIGTA also determined whether data on backup tapes stored at non-IRS offsite locations were encrypted and adequately secured.

WHAT TIGTA FOUND

IRS employees reported the loss or theft of at least 490 computers and other sensitive data in 387 separate incidents between January 2, 2003, and June 13, 2006. During this period, the IRS computer security organization was made aware of only 91 (24 percent) of the 387 incidents.

TIGTA determined 176 incidents likely did not involve any loss of taxpayer data, but 126 incidents involved the loss of personal information for at least 2,359 individuals. TIGTA was unable to determine the effect on taxpayers for 85 incidents due to a lack of details in the incident documentation.

A separate test of 100 laptop computers currently in use by employees determined 44 laptop computers contained unencrypted sensitive data, including taxpayer data and employee personnel data. In addition, 15 of the 44 laptop computers had incorrect settings that would allow anyone to bypass the password controls and access the contents on the laptop computer. Consequently, it is very likely that a large number of the lost or stolen IRS computers contained unencrypted data that could be easily accessed and read by persons gaining possession of the computers. Also, backup tapes were not encrypted and adequately protected at non-IRS offsite locations reviewed.

WHAT TIGTA RECOMMENDED

TIGTA recommended the Chief, Mission Assurance and Security Services, refine incident response procedures to ensure sufficient details are gathered regarding taxpayers potentially affected by a loss, periodically remind employees of their responsibilities for protecting computer devices along with the disciplinary actions for noncompliance of these responsibilities, and purchase cable locks as an extra layer of security for employees to protect their laptop computers.

TIGTA also recommended the Chief Information Officer include a reminder about encrypting sensitive information in the employees' annual certification of security awareness, consider implementing a systemic disk encryption solution on laptop computers that does not rely on employees' discretion for determining what data to encrypt, require system administrators to check security configurations when servicing computers, implement procedures to encrypt backup data sent to non-IRS offsite facilities, and conduct an annual inventory validation of backup media and a physical security check of the offsite facility used to store the media.

In their response to the report, IRS officials agreed with our findings and have taken or planned appropriate corrective actions to our recommendations. For two of the recommendations, the IRS offered alternative corrective actions that adequately addressed our findings. As such, TIGTA concurred with the planned corrective actions.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2007reports/200720048fr.pdf.

Email Address: Bonnie.Heald@tigta.treas.gov
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Treasury Inspector General for Tax Administration

EMPLOYEES CONTINUE TO BE SUSCEPTIBLE TO SOCIAL ENGINEERING ATTEMPTS THAT COULD BE USED BY HACKERS

Issued on July 20, 2007

Highlights

Highlights of Report Number: 2007-20-107 to the Internal Revenue Service Chief, Mission Assurance and Security Services.

IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) has nearly 100,000 employees and contractors who have access to tax return information processed on approximately 240 computer systems and over 1,500 databases. Using social engineering tactics, TIGTA determined IRS employees, including managers, are not complying with the rudimentary computer security practices of protecting their passwords. As a result, the IRS is at risk of providing unauthorized persons access to taxpayer data that could be used for identity theft and other fraudulent schemes.

WHY TIGTA DID THE AUDIT

This audit was initiated as part of our statutory requirements to annually review the adequacy and security of IRS technology. The overall objective of this review was to evaluate the susceptibility of IRS employees to social engineering attempts that could be used by hackers to gain access to IRS systems.

WHAT TIGTA FOUND

IRS employees continue to struggle with complying with the basic security requirements of protecting their passwords and reporting possible security incidents. TIGTA made 102 telephone calls to IRS employees, including managers and a contractor, and posed as a helpdesk representative seeking assistance to correct a network problem. Under this scenario, TIGTA asked the employee to provide his or her username and temporarily change his or her password to one TIGTA suggested. TIGTA was able to convince 61 (60 percent) of the 102 employees to comply with the request. Some of the notable reasons given were that the employee thought the scenario sounded legitimate and believable, did not think changing his or her password was the same as disclosing the password, or had experienced past computer problems.

TIGTA had conducted similar social engineering test telephone calls in August 2001 and December 2004, which yielded 71 percent and 35 percent noncompliance rates, respectively. In response to the two audits, the IRS took corrective actions to raise awareness over password protection requirements and social engineering attempts. However, the correction actions have not been effective. Based on the results of this audit, TIGTA concluded employees either do not fully understand security requirements or do not place a sufficiently high priority on protecting taxpayer data in their day-to-day work.

In addition, only 8 of the 102 employees contacted the TIGTA Office of Investigations or the IRS computer security organization to validate whether the test was an official TIGTA audit.

WHAT TIGTA RECOMMENDED

TIGTA recommended the Chief, Mission Assurance and Security Services, continue security awareness activities to remind employees of the potential for social engineering attempts and the need to report these incidents to the IRS computer security organization, conduct internal social engineering tests on a periodic basis to increase employees' security awareness and the need to protect usernames and passwords, and coordinate with business units to emphasize the need to discipline employees for security violations resulting from negligence or carelessness.

In their response to the report, IRS officials stated the Mission Assurance and Security Services organization plans to continue to deliver social engineering messages and use results from a social engineering survey to remind employees of the potential for social engineering attempts and the need to report these incidents to the IRS Computer Security Incident Response Center. The IRS plans to conduct at least one internal social engineering test during Fiscal Year 2008 to increase employees' security awareness and the need to protect usernames and passwords. The test will be robust and statistically diverse, surveying thousands of IRS employees. The IRS plans to communicate the test results to business units to increase awareness. Additionally, a revised Penalty Guide has been developed and is currently being negotiated with the National Treasury Employees Union. When the Guide is published, the IRS plans to emphasize to the business units the need to implement the new guidance.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2007reports/200720107fr.pdf.

Email Address: Bonnie.Heald@tigta.treas.gov
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Treasury Inspector General for Tax Administration

EFFORTS HAVE BEEN MADE, BUT MANAGER AND EMPLOYEE NONCOMPLIANCE WITH SECURITY POLICIES AND PROCEDURES PUTS PERSONALLY IDENTIFIABLE INFORMATION AT RISK

Issued on August 13, 2007

Highlights

Highlights of Report Number: 2007-20-117 to the Internal Revenue Service Chief Information Officer.

IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) processes and maintains personally identifiable information for more than 130 million taxpayers who file their income tax returns with the IRS. While the IRS has accomplished several noteworthy actions to protect this information, managers and employees have not complied with established security procedures. As a result, personally identifiable information is being unnecessarily exposed to unauthorized access and potential identity theft.

WHY TIGTA DID THE AUDIT

This audit was initiated as part of a statute that requires each agency's Inspector General to review the policies and procedures related to personally identifiable information and conduct reviews at least every 2 years to ensure it is adequately protected. The overall objective of this review was to determine the progress the IRS has made in ensuring the security and privacy of personally identifiable information it maintains.

WHAT TIGTA FOUND

The IRS has taken several noteworthy actions to protect taxpayer data in its possession. For example, it has established a Security Services and Privacy Executive Steering Committee to serve as the primary governance body for all matters relating to security and privacy issues in the IRS. In addition, it has made steady progress each year in complying with the requirements of the Federal Information Security Management Act.

However, TIGTA reviews during Fiscal Years 2003 to 2007 have identified persistent computer security weaknesses that jeopardize the security of personally identifiable information. TIGTA continues to find that employees are not aware of the security risks inherent in their positions. For example, TIGTA reviews found that employees did not sufficiently safeguard laptop computers and did not encrypt data on the computers; were susceptible to social engineering techniques that hackers could use to gain access to their systems; and ignored IRS policies on the use of email, which increased security vulnerabilities.

Even employees with key security responsibilities continue to ignore standard security configurations, often for their own convenience. One TIGTA review found that managers provided employees access to systems and data the employees did not need and were not aware of the access capabilities of their employees. Other TIGTA reviews found that technical controls in modernized systems and the security infrastructure were inadequate. Although industry guidance recommends that security controls be designed into new systems early in the development process, security has not been at the forefront when new systems are developed in the IRS. Waiting until systems are implemented to address security controls will most likely cost significantly more than if security controls were considered during the development of the systems.

It is clear that some IRS executives are not holding managers and employees accountable for carrying out their responsibilities and for ensuring managers and employees are aware of the security risks associated with their positions. For the IRS to make greater strides in improving computer security and protecting personally identifiable information, managers and employees must be aware of the security risks inherent to their positions and consider security implications in their day-to-day activities. Executives must clearly communicate expectations that procedures will be followed and take appropriate actions when procedures are not followed.

WHAT TIGTA RECOMMENDED

Because TIGTA had already made recommendations related to the aforementioned issues in prior audit reports, no additional recommendations were made. TIGTA will continue to monitor the IRS' overall strategy and ability to protect and secure personally identifiable information in future security-related reviews.

In their response to the report, IRS officials agreed that, while progress is being made, more needs to be done to ensure the privacy and security over personally identifiable information is a fundamental and top priority. The IRS plans to continue to update its systems, processes, and training so employees are aware of the steps they must take to prevent taxpayer information from being compromised.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

http://www.treas.gov/tigta/auditreports/2007reports/200720117fr.pdf.

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NADA. NADA has been very active on several fronts. This includes trying to convince the IRS to expand the UNICAP guidance that it said it would issue on the "producer issue" to cover more broadly many of the other non-producer cost cap issues affecting dealerships.

NADA is also trying very hard to persuade the IRS to "stand down" on cost cap audits involving non-producer issues, many of which surfaced in TAM 200736026.

Finally, because of the significance of the IRS' position that dealership leasing sales are "off-site" (i.e., they are not on-site) sales, NADA is attempting to garner support from a number of trade associations, including the Association of Consumer Vehicle Lessors which represents the major captive and independent leasing companies.

AICPA 2007 Auto Dealership Conference. The discussion of this TAM by the IRS Motor Vehicle Technical Advisor in Orlando is summarized on page 9. Ms. Harris really didn't add anything new to what we have already covered at length in previous issues of the *Dealer Tax Watch*. However, she was absolutely right in saying, "Stay tuned ... It's a bit of a hornet's nest."

Regrettably, there was no discussion of this TAM by anyone on the "Practitioners Tax Panel" at the Conference ... In my opinion, an inexcusable lapse.

So, we're all waiting for the next shoe to drop. Undoubtedly, we'll have more to report on this in 2008.

#3. DE FILIPPS' YEAR-END DEALER TAX UPDATE SEMINARS. In recent months, I've presented several dealer year-end update seminars, including one for CCH on December 13, 2007. This was a 2-hour audio presentation with an off-site moderator, and the audience consisted of CPA firms (many of them listening in their conference rooms) and other tax consultants around the country.

The outline of the topics that I covered in this seminar is below. This presentation is available from CCH in a CD format (CCH event ID #13342). The Mixed-Mode audio CD includes an audio recording of the event and all of my handout materials in PDF format.

During 2007, I also presented 4 other audio seminars for CCH covering various aspects of the LIFO inventory method and its application to various businesses, including auto dealerships.

To order presentation recordings, just follow the links on our web site (www.defilipps.com) to CCH's site or go directly to CCH's audio seminar page (http://tax.cchgroup.com/AudioSeminars/Default.htm) and follow the links to its Audio Seminar Archive Library.

#4. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. The AICPA's 13th Annual National Auto Dealership Conference was held October 25-26, 2007 at Disney's Contemporary Resort in Orlando. The broad range of subjects and speakers was intended to attract individuals from dealerships and CPAs with auto dealership practices.

→

De Filipps Year-End Update	*YEAR-END 2007 DEALER TAX UPDATE TAX STRATEGIES & IRS ACTIVITIES*
Recent Developments & Issues	• *Electronic recordkeeping requirements ... Revenue Procedure 98-25* • *Revenue Ruling 2007-37 ... May 23, 2007 ... 2007-24 IRB 1* • *IRS activities ... Audit & otherwise* ◆ *Three coordinated issues for audit dealerships* ◆ *Cash reporting & Form 8300 developments* ◆ *Tool reimbursement plans for service technicians under Section 62(c) ... ILM 200745018* • *Section 263A cost capitalization for dealerships ... TAM 200736026 (Sept. 7, 2007)*
LIFO Inventory Matters	• *New Vehicles - Alternative LIFO Method (Rev. Proc. 97-36, formerly Rev. Proc. 92-79)* • *The IPIC LIFO Method is not beneficial for auto dealerships* • *"Crossover" vehicles ... How should they be treated (pooled) for LIFO purposes?* • *Huffman, et al., v. Comm. (126 T.C. No. 17)* • *Will Use of the LIFO Inventory Method Be Legislated Out of Existence?*
Other Dealer Issues & Topics	• *Major tax planning opportunity is still available to dealers and dealerships under the Tax Increase Prevention & Reconciliation Act of 2006 (TIPRA)* ◆ *Lower tax rates on qualified dividend income and long-term capital gains* • *Tax return preparers ... Higher standard for avoidance of penalties ... Section 6694* • *FIN 48 ... Accounting for Uncertainty in Income Taxes & Uncertain Tax Positions*
Topics covered during an Audio Seminar presented on Dec. 13, 2007 by W. J. De Filipps for CCH, a Wolters Kluwer business.	

This year's Conference included more presentations addressing dealership operations, industry status and "soft topics" ... and, it seems, fewer presentations geared to the CPA wanting more in-depth, hands-on technical information.

There was more *overview coverage* and less *in-depth, technical information.* For some, this makes the Conference only marginally attractive when balanced against its rather high cost.

Following the summary of the Conference on page 7, you'll find summaries of the presentations made by Terri Harris, the IRS Motor Vehicle Technical Advisor (on pages 8-9) and by the Tax Practitioners Panel (on pages 10-11). A more detailed report of Richard Sox's update on dealer legal/franchise issues begins on page 12.

#5. IRS CONCERN OVER POSSIBLE ABUSE OF CAPITAL CONTRIBUTION PROVISION. On October 5, 2007, the IRS Large and Mid-Size Business (LMSB) Division issued an Industry Directive (LMSB-04-1007-069) in which it noted that some taxpayers and practitioners were misinterpreting and/or misapplying Section 118.

The concern expressed by the IRS was that in many situations, taxpayers were treating certain payments received from nonshareholders as reductions of basis in property, rather than treating those payments as taxable income to be recognized immediately.

This Directive has a number of possible applications including the treatment by dealers/dealerships of incentive monies they receive from manufacturers in connection with certain facility and/or image upgrade programs.

This could also have an impact on your consideration of the new, higher standards for the avoidance of return preparer penalties, as discussed below.

#6. HIGHER STANDARDS FOR AVOIDANCE OF PENALTIES BY TAX RETURN PREPARERS. How does it feel, dear Reader, to have been recently deputized by Congress to be an IRS agent?

I'm sure you know what I am referring to by this obnoxious question ... Simply stated, it is the significantly more uncomfortable position that tax return preparers have been put in as a result of the increased preparer penalty standards.

These new standards are summarized on pages 24-25, and we've included two examples of situations where real conflict could easily arise between a CPA/return preparer and his/her dealer or dealership/taxpayer client.

Mercifully, on December 31, 2007, the IRS issued Notices 2008-11, -12 and -13 which provided some clarification and interim guidance. Notice 2008-13 is especially important, and it contains 12 examples illustrating the provisions involved.

Clearly, in the filing season now upon us, we will all have to give more thought and attention to thoroughly researching tough tax questions and to deciding whether various disclosures are advisable or required with the tax returns we are preparing.

My advice ... Don't sign any tax returns until you have read (at a minimum) Notice 2008-13 and all of the examples it contains. Also, for tough issues, think about preparing the memorandum I suggest on page 24.

#7. FIN 48 EFFECTIVE DATE POSTPONED FOR APPLICATION TO NON-PUBLICLY HELD BUSINESSES. Closely related to the new problems facing CPAs in connection with preparing dealership tax returns is the impact that FIN 48 will have once it becomes effective for the financial statements of non-publicly-held entities.

Some dealership CPAs were expecting the worst case scenario that FIN 48 would be effective for calendar year 2007 financial statements. Fortunately, the effective date for the application of FIN 48 to the financial statements of non-publicly-held entities has been postponed for (at least) 1 year.

So, you can breathe a sigh of relief ... at least for the time being ... until you start to work on your clients' 2008 financial statements.

#8. WILL THE USE OF THE LIFO METHOD BE REPEALED? Perhaps the last topic listed under LIFO issues my the year-end *Dealer Tax Update* outline (on page 4) caught your eye ... ***Will Use of the LIFO Method Be Legislated Out of Existence?***

H.R. 3970, introduced October 26, 2007, included proposed legislation that would repeal the use of the Last-In, First-Out (LIFO) inventory valuation method. This was proposed by Rep. Rangel (D, NY), Chairman of the House Ways and Means Committee, and it is estimated to raise $106 billion over 10 years.

Under the bill, the LIFO reserve income would be recognized (i.e., taken into income) over an 8-year spread period. Also included in Rep. Rangel's bill is a provision to repeal the use of the Lower-of-Cost-or-Market Method for valuing inventories.

We don't expect much to happen on this for a year or two ... until sometime in 2009, after the elections later this year. What is important is that the discussion of the repeal of LIFO has finally made it to the top of the list of the revenue-raisers that would be on the

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radar screen for the next Congress when it sets about to make major tax reforms and needs to find ways to pay for other tax cuts.

#9. DEALERSHIPS MUST PROMPTLY REMIT SECTION 401(k) PLAN CONTRIBUTIONS WITHHELD FROM EMPLOYEES. Failure by a dealership to promptly remit Section 401(k) plan contributions withheld from employees can be costly and very messy.

Department of Labor. Recently, the Department of Labor (DOL) showed signs of selective enforcement action against dealerships that were not promptly remitting Section 401(k) plan contributions to the designated depositories.

A recent DOL letter to a dealership (pages 26-28) shows just how important and far-reaching the ramifications can be for dealers (or any other employers, for that matter) if they are not promptly remitting withheld employees' contributions.

IRS. Of course, the DOL and the IRS share information on matters like this. Accordingly, we've expanded our discussion on this subject to present some of the other IRS repercussions of late remittances. These include (1) significant prohibited transaction penalty implications under Section 4975, (2) Form 5330 filing requirements and assorted penalties for late filings, and (3) "lost interest" computations ... all of which appear on pages 29-33.

#10. TECHNICIANS' ACCOUNTABLE TOOL PLANS - UPDATE. In the IRS Motor Vehicle Technical Advisor's comments at the 2007 AICPA National Dealership Conference, she emphasized the heavy IRS enforcement and policing in this area, especially by the Employment Tax branch.

Our last update on this topic (in the June 2007 issue, pages 20-21) included a discussion on one pending controversy which has serious "tax promoter" overtones attached to it.

Two developments (one in 2006 and one in 2007) shed more light on how the IRS is approaching reimbursement plans that it considers to be abusive in structure and in operation.

The more important development is Internal Revenue Service Legal Memorandum (ILM) 200745018 which was released on November 19, 2007. This ILM seems to set the background for the pending controversy with the ominous "promoter" overtones that we discussed in the June 2007 update on tool plans.

This ILM held that the plan for technicians did not qualify for Section 62(c) benefits. This ILM seems to summarize just about everything the IRS can throw up against a tool plan in the way of legal argument and precedent. It is extremely important, and our discussion of it begins on page 34.

The 2006 development is the issuance of Revenue Ruling 2006-56 which involves per diem allowances and reimbursement plans used by employers in the trucking industry.

This Revenue Ruling is notable because the IRS held that the failure of the arrangement in question to treat the excess allowances as wages for employment tax purposes caused ***all payments*** made under the arrangement (not just the excess amounts) to be treated as payments made under a nonaccountable plan.

We have included, as supplementary information, the comprehensive discussion of law in the ILM (beginning on page 46) and a summary of Rev. Rul. 2006-56 on pages 51-52.

#11. ARE ESOPs VIABLE TOOLS FOR ESTATE PLANNING FOR AN AUTO DEALER? Consider this a request or invitation for a guest author to discuss the application of ESOPs to auto dealerships.

Over the years, speakers at various AICPA and NADA conferences have suggested that employee stock ownership plans (ESOPs) could be very useful in the estate planning for an automobile dealer and his/her dealership. In the few instances where I've been directly involved with dealerships that were considering using ESOPs, the notion of using an ESOP has become less attractive as our discussions expanded to include the need for involvement with, and concurrence or permission by, the manufacturers/Factories. Hence the question ... Are ESOPs really viable tools for estate planning for an auto dealer?

For quite some time, I've been on the lookout for a good article that addresses this subject in a comprehensive way. However, so far, I haven't come across even one in my own (limited) research.

If you have experience with working with ESOPs for auto dealerships that you are willing to share and/or would like to write an article on the subject, I would be most happy to publish it in the *Dealer Tax Watch*. Alternatively, if you've run across a good article or two, I'd appreciate your letting me know where I can find them.

AICPA 13th ANNUAL NATIONAL AUTO DEALERSHIP CONFERENCE

The AICPA's Annual National Auto Dealership Conference was held October 25-26, 2007 at Disney's Contemporary Resort in Orlando.

This year's Conference included many presentations addressing dealership operations, industry status and "soft topics." There seemed to be fewer presentations geared to the CPA wanting more in-depth, hands-on technical information. In other words, there was more *overview coverage* and less *in-depth, technical information.*

Scant coverage on the cost capitalization TAM that has (or should have) all dealers shaking in their boots. As you know, the last few issues of the *Dealer Tax Watch* have concentrated heavily on analyzing the nature of the "industry dispute" with the IRS over the application of Section 263A to auto dealerships. After the IRS issued TAM 200736026, we devoted an entire issue (Sept. 2007) to that TAM.

I was looking forward to getting great insights and well-rounded discussion at this AICPA Conference ... but, I came away disappointed.

Although Terri Harris did discuss the TAM briefly, the special Practitioner Tax Panel just deferred to what Terri had said and offered no comments, criticisms or insights of its own.

The few discussions concerning the TAM that I was aware of during "networking breaks" or around the meal tables indicated that some attendees were very much aware of the importance of this TAM and (like myself) were very much surprised that this AICPA National Conference, specifically targeted to auto dealerships and dealership CPA practitioners, almost totally ignored it by giving it so little attention.

"State of the Industry." Jim Ziegler, the first morning keynote speaker, was on the cutting-edge and, as always, *Ziegleresque*. He made sure that everyone was awake by reminding all in attendance that "not all dealerships in the room will survive."

Mr. Ziegler also emphasized to the CPAs in the room that they need to get their processes and procedures in place because most of the new dealership business they will be getting in the next year will undoubtedly come by taking that business away from another CPA firm. Not a very pleasant thought for many of us.

IRS Activities Update by Terri Harris. One of the highlights of the Conference for many years has been the annual update presented by the IRS Motor Vehicle Technical Advisor. Ms. Terri Harris has done an excellent job in making this presentation for several years. This year, her Update agenda consisted of 7 major topics backed up by 42 PowerPoint slides.

The Dealer Tax Watch has thoroughly discussed most of the topics that Ms. Harris covered in her presentation. (About the only exception would be the subject of Alternative Motor Vehicle Credits which she covered in considerable detail.) As a result, rather than reproducing all of Ms. Harris' slides, they are summarized, with some observations, on the following pages.

You can contact Ms. Harris directly at Terri.S.Harris@irs.gov for a printout of all of her PowerPoint slides ... especially if you are interested in a lot of detail explaining the Alternative Motor Vehicle Credits.

Technicians' tool reimbursement plans. Ms. Harris gave this subject considerable attention, and the text of her slides is reproduced on page 35 as part of our separate Update coverage on tool plans.

Electronic recordkeeping requirements. This year, the subject of electronic recordkeeping requirements did not receive significant time or attention in Ms. Harris' Update. In fact, coverage of Rev. Proc. 98-25 was relegated to one slide included under the broad heading of "Other Items of Interest."

Practitioners Tax Panel discussion. On the second day of the Conference, one of the concurrent sessions was a 75 minute tax panel presentation. A summary of the topics and comments of this year's Panel presentation appears on pages 10-11.

Dealer/legal/franchise issues update by Richard Sox. Again this year, Richard Sox, of Myers & Fuller, P.A., gave an outstanding presentation. His presentation was entitled, *What Are the Manufacturers Really Up To? ... A Linemake-by-Linemake Analysis.* Mr. Sox approached this update on a manufacturer-by-manufacturer basis, rather than on a topic-by-topic basis as he did last year. Coverage of his presentation begins on page 12.

Conference audio available. Audio multimedia recordings of all the presentations are available through Conference Copy on the web at www.conferencemediagroup.com (Meeting No. A10710).

IRS Update 2007	*NEWS FROM THE IRS - WHAT YOU SHOULD KNOW* *BY TERRI S. HARRIS ... IRS MOTOR VEHICLE TECHNICAL ADVISOR* *SUMMARY OF PRESENTATION SLIDES* Page 1 of 2
Ms. Harris' Agenda	• Ms. Harris's agenda consisted of 7 major topics (below) covered in 42 slides. • See page 35 for Ms. Harris' slides dealing with technicians' tool reimbursement plans.
LIFO Pooling & IIR Process (Slides #1-8)	• Industry Issue Resolution (IIR) process was described and discussed. • Discussion of the current IRS IIR initiative to determine/decide what should be the proper treatment for LIFO pooling purposes of crossover vehicles (i.e., vehicles which have characteristics of both cars and trucks). • Only previous source for guidance on pooling is in the *Fox Chevrolet* case and in a footnote Rev. Proc. 2001-23 (which prescribes the treatment for Alternative LIFO Method for Used Vehicles). • What are some of the obstacles? ... ◆ Different governmental agencies use different definitions for cars and trucks. ◆ LIFO is a complex computation, and any changes may result in some additional complexity. ◆ What kind of transitional rules should be provided for any change in treatment ... cut-off method, Section 481(a) computations, etc. ◆ What would the effect of a change in treatment in this industry have on other industries? • Possibilities include ... single pool for all used vehicles or 2, 3 or 4 pools.
Cost Segregation (Slides #9-11)	• Many manufacturers are asking dealerships to expend significant amounts for new and/or upgraded facilities, signage, service department operations, etc. • The IRS is working with Cost Segregation Technical Advisor and engineers to evaluate specific dealership construction/facility applications. • Current IRS *Cost Segregation Audit Technique Guide* does not have a specific chapter or section devoted to automobile dealerships. ◆ If the IRS adds a chapter to the *Cost Segregation Audit Technique Guide* that would address specific auto dealership applications, it will probably contain a matrix that will address many of the special types of adjustments made to dealership facilities, based on IRS engineer feedback from various audit experiences.
Slides #12-16	• Section 263A cost capitalization ... See facing page.
Employee Tool & Equipment Plans (Slides #17-25)	• This controversial issue and area was given considerable attention by Ms. Harris. • The Service continues to have significant concerns with tool plans under the accountable plan rules. ◆ The IRS now has a cross divisional team in place to combat these plans. • The broader title or heading for this topic indicates that the IRS is looking at plans well beyond the dealership industry. "Tool plans" are proliferating in other industries, and they are coming back to the dealership industry. • Taxpayers and practitioners are encouraged to take a cautious approach to tool plans. ◆ Statements by third-party administrators and/or promoters that their tool reimbursement plans are "IRS-approved" should not be accepted at face value. • Ms. Harris said that she still has not seen a plan that completely complies with Section 62(c). All of them seem to fail the "wage recharacterization" test or requirement. Some plans, she acknowledged, were trying to comply ... they just hadn't succeeded. • The Service is reviewing the Coordinated Issue Paper that is issued in the year 2000, and it plans to update it to address the latest derivations of the tool plans. • The IRS currently has two types of enforcement activity going on ... ◆ Promoter investigations ... using summons enforcement to obtain customer lists, etc. ◆ Employer audits ... the regular type of audit. • Ms. Harris made no mention of either Revenue Ruling 2006-56 or ILM 200745018 in her presentation.
Alternative Motor Vehicle Credits (Slides #26-36)	• Thorough discussion of all four credits found in Code Section 30B. ◆ Hybrid vehicles ... Notice 2006-9 and Notice 2007-46 ◆ Alternative fuel (QAFMV) vehicles ... Notice 2006-54 ◆ Fuel cell vehicles ... Notice pending ◆ Advance lean burn vehicles ... Notice 2006-9 • Discussed various limitations on the credits, the Acknowledgment Process established in connection with these credits and what a dealership should know about these credits.
Source	• *IRS Update* by Terri S. Harris. Oct. 25, 2007. AICPA National Auto Dealership Conference (Orlando).

NEWS FROM THE IRS - WHAT YOU SHOULD KNOW
BY TERRI S. HARRIS ... IRS MOTOR VEHICLE TECHNICAL ADVISOR
SUMMARY OF PRESENTATION SLIDES

Section 263A Cost Capitalization (Slides #12-16)	• Right now, IRS audits addressing dealership compliance with Section 263A are not widespread ... but, there are pockets of highly visible activity in certain parts of the country. • Discussion of "producer" issue and status of guidance in the form of Generic Legal Advice. • Discussion of IRS examinations "stand down" on the "producer" issue only. However, other questions relating to the application of Section 263A to dealerships may be raised by agents during current audits. • TAM 200736026 was discussed in general. Key questions now include... ◆ How should various sales be categorized in terms of "on-site" or "off-site" status? ◆ Should lease "sales" be treated as on-site or off-site? (The TAM concludes they are "off-site" sales.) ◆ How should dealer trades be treated? (The TAM concludes they are "off-site" sales.) ◆ Does the dealer have off-site storage? ◆ Does the dealer have dual-function storage facilities? ◆ How should handling costs be treated? • Resolution of how lease "sales" should be treated is extremely important because if leases are treated as off-site sales, then the dealership's main showroom will be a dual function facility. ◆ Right now, all we have is this TAM ... and the TAM says that the facility of the dealership in question was a dual-function facility. • In view of these and other issues included in the TAM, it appears that the IRS may give a higher profile to the guidance that will ultimately be issued ... possibly elevating this guidance to a Revenue Ruling or a Revenue Procedure. • Although TAM 200736026 (like all other TAMs) "has not precedential value," everyone (IRS agents inside the IRS as well as practitioners outside the IRS) is using the TAM as a point of reference. ◆ IRS agents are trained to know that a Technical Advice Memorandum is not precedent. ◆ However, it is reasonable to expect that Revenue agents will take the dealership they are auditing and line up the "facts" concerning how that dealership operates with the "facts" in the TAM ... and take it from there. • Ms. Harris acknowledged that if dealerships are treated as producers or, through other interpretations, are required to use the Simplified Production Method, there will be huge potential adjustments based on what agents have been reporting from the field. ◆ One troublesome (but probably accurate) generalization is that, based on this TAM, there is probably not a single franchised new car dealership in the country that is compliant with Section 263A. ◆ The IRS National Office could have quite a problem on its hands if 20,000 dealerships filed Forms 3115 reflecting the holdings in the TAM as indicating how they should be capitalizing costs. • Only the "producer" issue is on the IRS Priority Guidance Plan ... Many of the other issues raised in / by TAM 200736026 are not. [Note: NADA is currently attempting to persuade the IRS to take a broader approach in issuing forthcoming guidance by including many of these other issues.] • Hopefully, guidance at a higher level (than a TAM or GLAM) will be forthcoming.
	Issues & Topics Included on Slides Not Covered in Presentation
Form 8300 Cash Reporting (Slides #37-40)	• Basic coverage ... Who must file Form 8300? ... What is cash? • What is the penalty for not filing Form 8300? ◆ Service is aware of inconsistent application of penalties. ◆ A team has been assembled to consider options and possibility of field guidance. ◆ Any guidance would involve a test period and evaluation. ◆ Form 8300 resources including Form, Instructions and MVTA *Automotive Alert*.
Other Items of Interest (Slides #41-42)	• PORC ... Pricing case recently docketed in Tax Court. • Revenue Ruling 2007-37 ... Cancellation of Distributor Agreement. • TAM 200732015 ... Manufactured vehicles are subject to excise tax. • LTR 200711006 ... Power units installed on tractors are subject to excise tax. • Dealership electronic recordkeeping requirements ... ◆ Activity progressing under Rev. Proc. 98-25. ◆ Data archiving systems may or may not be in compliance. ◆ Dealers & CPA should also retain tax preparation software and data.

Tax Panel 2007	***DEALERSHIP PLANNING AREAS & ISSUES HIGHLIGHTED BY PRACTITIONERS TAX PANEL*** Page 1 of 2
Intro	• The 2007 Practitioners Tax Panel consisted of ... Rebecca Dunsworth (Crowe Chizek & Co., LLC), Greg Humphries (Shutts & Bowen, LLP), Diane Wells (Plante & Moran, PLLC), and moderator Sid Tobiason (Moss Adams, LLP). • No outline was available in connection with the Tax Panel presentation. The only material was a chart (matrix) showing various attributes and results for different entity choices. • An audio CD of this presentation (Meeting #A10710 - Session 18) is available from Conference Copy (www.conferencemediagroup.com).
Service Technicians' Tool Reimbursement Plans *(Dunsworth)*	• Discussion of this topic was limited, and it emphasized that the issue of "recharacterization of income" presents a formidable barrier to the ability of a service technician tool reimbursement plan to comply with the requirements of Section 62(c). ◆ The Panel deferred to what Terri Harris (the IRS Motor Vehicle Technical Advisor) had said about tool plans on the previous day. • The lead presenter and the other Panel members said that, in their opinions, the IRS has pretty much shut the door on tool plans. ◆ To the Panel members, this seems "pretty cut and dried," and they "don't know why anybody would do that." ◆ In effect, the Panel's guidance was to ... "stay clear of them."
Inventory Issues & Cost Cap *(Wells)*	• Coverage of various inventory issues was limited to generalizations, including the topics of ◆ LIFO vs. FIFO [(sic) Specific Identification] for new vehicles ◆ Trade discounts ... Floorplan credits ◆ Advertising credits ◆ IPIC method for new vehicle LIFO reflecting deflationary indexes over recent years • ***Cost capitalization.*** There was no real discussion at all ... The Panelists just referred to what Terri Harris had said on this subject the day before ... There was no elaboration on the TAM, or the many aspects of the TAM that Terri Harris had not addressed in her remarks.
Reaction to Cost Cap TAM 200736026 *(Q & A)*	• In the absence of not knowing what the do this year (i.e., in connection with dealership tax returns to be filed for tax years ending Dec. 31, 2007), the Panelists indicated that they probably will do what was done last year (...whatever that was). • Given the magnitude of the possible IRS adjustments that are likely to hit at some point in the future, the Panelists advised practitioners to be very clear with their dealership clients about exposure that they might face in the future if the IRS prevails in its positions on how the cost cap rules should be applied to dealerships. • It is a very long TAM ... and it raises many more questions than answers. ◆ FIN 48 implications (with respect to Section 263A issues) will have to be considered in the future.
Should Real Estate Used by a Dealership Be Held in a Separate Entity? *(Q & A)*	• The question asked was: Should dealership real estate be protected by putting it in a separate entity? • Considerations include ... ◆ Some states have a sales tax on lease payments, so having the real estate in a separate entity could trigger a liability for sales tax on the rental payments. ◆ Particularly when buying older dealership facilities, it may be desirable to set up a separate entity to make the acquisition in order to contain any potential liability that might arise from environmental impact issues that might be associated with the property being acquired. • If there are continuing losses where rental property transactions are occurring between related parties, these losses should raise the question of whether the amount of rent being charged is a fair market rental value. ◆ Perhaps an exception to this might be where depreciation deductions under a cost segregation study result in significant front-end deductions (i.e., significantly larger amounts in the early years).
Recent IRS Audit Issues *(Q & A)*	• Usual areas of inquiry ... Entertainment, travel expenses, possible personal expenses, who is on the payroll (family members, children in college) • Outside services • Company credit cards • Internal controls over cash

DEALERSHIP PLANNING AREAS & ISSUES HIGHLIGHTED BY PRACTITIONERS TAX PANEL

Choice of Entity

(Humphries)

- In connection with this discussion, a two page handout, "Choice of Entity from a Taxation Perspective" was distributed.
- Although fewer C corporations are being set up now, there are still many C corps. that are still around.
  - The big disadvantage of the C corp. set up is the double taxation upon liquidation.
  - If you still have a C corp., it is probably advisable to stop putting new franchises or other asset acquisitions into that C corp. ...
    - Rather, it may be desirable to set up new entities for new acquisitions, and very likely the choice for the new entity form would be an LLC (or some entity structure similar to that).
- ***The S corporation entity choice is no longer as attractive as it once was.***
  - Inside vs. outside basis adjustments can be a problem.
  - In some dealerships, different classes of ownership, from a management standpoint, may be desirable. However, this is difficult to achieve because of the "one class of stock" requirement.
  - Limitations on ownership (i.e., who can be owners).
  - Restrictions on transferability of shares.
- For some dealers in heavier metropolitan areas, there may be opportunities to enter into economic incentive or revenue sharing agreements with a municipality.
  - Section 118 allows dealerships operating as C corporations to treat payments made by the municipality as paid in capital by a non-shareholder.
    - It was emphasized that Section 118 interacts with Section 362 and this Code Section (i.e., Section 362) is found in the part of the Revenue Code (Subchapter C) that deals with C corporations (not S corporations).
  - In order to qualify for that deferral and to apply those proceeds that the dealership receives against the cost of the land and/or building, the dealership must be operating in corporate form.
    - This is one of the few instances where, at least in terms of real estate, a S corporation-type of relationship should be carefully considered.

  [Note: In this connection with Section 118, see Tax Watch Out comment #5 (on page 5) ... "IRS Expresses Concern Over Possible Abuse of Capital Contribution Provision" ... IRS Large and Mid-Size Business (LMSB) Division Industry Directive 04-1007-069 ... October 5, 2007.]
- In the Panel's experience, almost all new dealership entities are now being set up as limited liability companies (LLCs) because LLCs afford comparatively more flexibility and savings (than C or S corporate arrangements) ...
  - Enhanced limited liability protection
  - Partnership tax treatment (if that is elected)
  - Confidentiality protection
  - Multiple classes of ownership interest are possible
  - Different entities can be members of an LLC
- Some manufacturers may be uncomfortable with LLC arrangements (due to lack of familiarity with them). As a result, in some situations where an LLC arrangement is desirable ...
  - Before approving the dealer, some manufacturers may require that the distribution section of an operating agreement has to have a restriction that says that the dealership will never distribute money that would result in an impact on the working capital (the manufacturers minimum mandated working capital requirement).
    - Such a restriction may not always be in the dealership's best interests.
  - Some manufacturers prohibit against the pledge of the ownership interests in the company. In an S corp., that can be a problem if it is necessary to borrow money at the shareholder level.
    - If this prohibition exists, then at a later date, a shareholder may find that he or she is prohibited from pledging his or her interest in the dealership to the lending entity.
  - Some manufacturers may want to impose a condition that there will be no change in ownership without the manufacturer's approval.
  - Another limitation could be that the activities of the entity will be limited to those which are consistent with the operation of a motor vehicle dealership.

DEALER - FRANCHISE ISSUES UPDATE MANUFACTURER-BY-MANUFACTURER

At the 2006 AICPA National Auto Dealership Conference, Mr. Richard Sox, Esq., a partner with Myers & Fuller, P.A., provided an outstanding discussion of "Emerging Manufacturer Initiatives Impacting Automobile Dealerships." That presentation was reported on pages 24-40 of the December 2006 *Dealer Tax Watch.* At this year's AICPA Conference, Mr. Sox returned to provide an update on various manufacturer programs and initiatives that are creating "problems" for dealers.

In this year's presentation, Mr. Sox approached his update on a manufacturer-by manufacturer or linemake-by-linemake basis. In some instances, he combined two manufacturers in his discussion. Mr. Sox also answered many questions, and where the question(s) involved a specific manufacturer, it has been included with his remarks concerning that manufacturer.

GENERAL MOTORS

GM's channel strategy is its latest marketing approach which has been around for the several years. In this approach, GM encourages dealers to combine certain linemakes with other linemakes in the same dealership. The linemakes that Myers & Fuller (M & F) works with the most is the Pontiac-Buick-GMC channeling, which is where GM is pushing dealers to combine those linemakes in a given market.

Buick, in particular, is not doing well. So, what's going to happen if a dealer gets pushed into buying a Buick franchise? For example, GM is offering money to assist dealers in purchasing these franchises and getting them in the right combinations. But, in these cases, the dealer is being asked to put some of his or her own money into the deal/rearrangement.

"Exclusive use" & "performance" agreements. Along with that money comes what is known as the

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2007 Update

What Are the Manufacturers Really Up To? A Linemake-by-Linemake Analysis
By Richard Sox, Esq. (Myers & Fuller, P.A.)

An audio CD of Mr. Sox's 2007 AICPA presentation (Meeting #A10710 - Session 14) is available from Conference Copy (at www.conferencemediagroup.com).

"exclusive use agreement." This is an agreement where General Motors requires the dealer to maintain those franchises, and only those franchises, at that dealership site.

For several years now, M & F has had concern with those agreements, and Buick illustrates this concern. If a dealer signed an exclusive use agreement several years ago (before things went down hill) ... what happened was the dealer ended up with a lot of capacity in the dealership and was not selling enough cars of these linemakes to make the mortgage payment.

The problem is that an exclusive use agreement will more than likely be enforced by a judge who would say to say a dealer, in effect, "Sorry, you knew what you were agreeing to, and you can't bring in Kia, Hyundai or any other linemake or any of the Chinese linemakes or Mahindra. You're not going to be able to bring in any one of these linemakes into your dealership if you have signed an exclusive use agreement."

So Myers & Fuller recommends that dealers think very carefully before signing an exclusive agreement.

The most recent development with GM and the exclusive use agreement is something they've deemed a ***"performance agreement."***

This performance agreement is the "next generation of the exclusive use agreement," when dealers push back and push back against GM on the exclusive use issue, and dealers decide that it is not worth it to them because they don't really want that (i.e., a Buick) franchise to go along with their Pontiac-GMC. If the dealer resists, GM will soon present the dealer with a performance agreement which doesn't mandate that the dealer maintain only GM linemakes at the dealership site.

However, these performance agreements do impose specific performance requirements on the dealer. The dealer has to meet a certain retail sales index percentage over the next three years after the dealer has signed the agreement. If the dealer fails to meet these targets, then the dealer will have to return 1/3 of the money that GM contributed to the dealership for each of those years. That can be very onerous.

There is more to be said about these types of performance requirements and the issues that M & F has with these. They're not always fair. They're based on an average, which (by definition) creates problems for some dealers.

VOLKSWAGEN & AUDI

It is amazing how many manufacturers have an existing margin incentive program in place where the manufacturers are taking margin away from dealers and paying them only when they meet performance and/or facility requirements. As an alternative to these programs, other manufacturers have created incentive programs to push sales.

In the case of VW and Audi, they've created the 1% holdback program which is holding back 1% of the margin to meet "the Big 3" performance requirements ... which are (1) sales performance requirements, (2) service performance and/or customer satisfaction requirements and (3) facility requirements.

Price discrimination considerations. The question becomes ... "Are these programs equivalent to price discrimination?" This was discussed last year, but a review is valuable because there are many new programs of this kind, just in the last 12 months.

When dealers call Myers & Fuller about a new holdback program and state that they can't comply despite knowing that the repercussions for noncompliance will be severe (i.e., "I'm going to get murdered under this program ... the guy down the street is going to be able to comply, and I'm not"), the first question M & F addresses is ... Why can't the dealer/dealership comply? What are the reasons?

If it's a sales component ... Is there a reason that is outside the control of the dealer so that the sales requirement can't be met? ... If there is an outside reason, then that program is potentially discriminatory as it applies to the dealer.

Similarly, with facilities ... many dealers have been spending money regularly on their facilities (especially with annually emerging programs requiring changes). M & F looks at the law to determine if it is practical or economically viable for the dealer to meet that facility requirement. If it is not, then that program is potentially illegal as applied to that dealer.

M & F first looks to see if there are any franchise protections available for the dealer under state law. There are some state laws that very specifically say that, regardless of who the manufacturer is, or regardless of whether there is another dealer down the street receiving the incentive (while another dealer is not), the only question (under these state franchise laws) is whether the net price that the dealer pays for the vehicle after incentives and bonuses is the same price for everybody. If it's not the same price, then it's a prohibited program. There are states like Texas that have regularly knocked these programs out using that prohibition.

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Most states don't have that kind of franchise protection. If the state doesn't, then M & F turns its attention to the Federal price discrimination laws. Those get a little bit more detailed and get into the issue of whether the incentive program is practically or functionally available to the dealer.

The question to ask, as you see these programs, is, "Is this just something we don't like, or is it something that truly, that even if we wanted to, we could not comply with?" That's the test on price discrimination.

New model program (Audi R8). Several months ago, Audi came out with a new model - the R8 - that all the dealers were all very excited about. Audi sent out correspondence to all of their dealers saying that if they wanted to participate in receiving this model, they needed to send Audi a check for $100,000 and do a few certain things. Some state dealer associations called M & F to ask if Audi could legally make these demands.

The answer is, "No," Audi cannot do that.

If it is a model within the franchise in which the dealer already has a franchise agreement, the dealer has to be able to receive that model. The only things the dealer is required to pay for in order to receive that new model are (1) special tools, (2) training materials and (3) any upgrades to the service facility that need to be made for that vehicle. The dealer doesn't have to pay money in return for the right to sell the new model.

In this case, Myers & Fuller wrote some letters to Audi on behalf of the dealer associations that were sent to Audi. To Audi's credit, Audi agreed that M & F was right, and Audi reduced the dealer's payment amount to about $25,000 which paid for training materials, some special tools and the things that are reasonable to have to pay for in order for a dealer to get a new model.

Audi's new program pushing for exclusive dealership facilities. Unlike the VW 1% holdback program, Audi has come out with a slightly different program. Audi is not going to hold any money back. Instead, Audi is going to pay additional monies for meeting certain requirements. Audi's big push (like so many of the other manufacturers') is for exclusive facilities.

But, the same test applies here ... and, even though Audi is not holding back money that the dealer used to receive as part of their margin, the same test for price discrimination applies even though this is new money being paid to certain dealers that meet the exclusive dealership requirements as compared to a dealer who has a dual facility.

To be clear, the question the dealer has to ask/ answer in connection with this program is, "Is it practical for the dealer to provide an exclusive facility under its circumstances?" If it is not, then it needs to be looked at further to see whether that program is being applied to that dealer in a legal manner.

NISSAN

Nothing much has changed over the past year with regard to Nissan. (This is almost the same slide as last year.) Nissan continues to push very hard for its NREDI dealership facilities program. Like all of the others, Nissan's program is very expensive and very large.

If a dealer doesn't comply with this program, the next thing that this dealer can expect if it is not performing up to the regional average is to receive a default letter from Nissan. This letter warns the dealer that the dealership is not in compliance with the dealer agreement, and it could be terminated. Then the negotiations start... That's what Nissan puts in writing.

However, in its verbal discussions with a dealer, Nissan tells the dealer that it (i.e., Nissan) is not really going to terminate the dealer. Instead Nissan tries to convince the dealer that its performance will improve (and Nissan will back off) if the dealer just builds one of these new facilities. The decision is up to the dealer, but Myers & Fuller always advises the dealer that this has to be a business decision. A manufacturer can't "bully" a dealer into a new image program. There is no requirement in the dealer agreement that the dealer must maintain a certain image at the facility.

The law always says (in order to protect dealers) that a dealer has to meet minimum and reasonable guidelines, which usually have to do with the (1) amount of square footage provided, (2) number of parking spaces provided and (3) number of service bays provided, etc.

The image is a whole separate, other issue. Dealers have to keep this in mind. And, often the dealers just have to withstand the pressure because Nissan just keeps applying the pressure.

Nissan will, unfortunately, proceed with some terminations. M & F has been involved in more than a handful in the past 2 or 3 years with Nissan. Some terminations came out of an argument over whether the dealer would build the big NREDI facility or not. Some terminations were straight-up performance issues.

Non-viable points issues. Lastly (and M & F thought this problem had gone away), 2 or 3 years

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ago, Nissan sent out letters to dealers in small markets stating that Nissan's research showed that the dealers' points was no longer viable points. Thus, while Nissan would continue to service them as dealers, if the dealers ever decided to sell or transfer their dealerships, then Nissan wouldn't entertain those requests... These dealers would then be asked to turn in their franchises voluntarily for no money. At that time, M & F told dealers who called that this was something that Nissan couldn't do.

All the franchise laws in every state provide some minimum protection to the dealers where the manufacturers have certain criteria that they are required to look at, and are limited in looking at, as it relates to a transfer. These criteria usually include (1) good moral character, (2) enough capital to make the deal happen and (3) past business experience in the automotive industry.

These criteria are what the manufacturers are limited to looking at in evaluating whether to turn down a dealer's transfer request. The manufacturers can't add on to this list of criteria the further condition of "whether or not the manufacturer deems the point viable."

In these cases, M & F wrote letters to Nissan objecting to what Nissan was trying to do (i.e., telling Nissan it couldn't do this). But, Nissan ignored them. M & F now has a dealer in Kansas who is ready to transfer majority ownership of this franchise to the General Manager. The dealership sent in the normal paperwork to Nissan. Nissan sent back a letter referring the dealer back to its original letter from 3 years ago which stated that Nissan wouldn't entertain this (transfer) request. M & F was shocked because this course taken by Nissan is so fundamentally against the franchise laws of which Nissan is well aware.

Currently, M & F is involved in this dealer's dispute with Nissan ... trying to get Nissan's attention, to convince Nissan that it really doesn't want this issue to result in Court action. It doesn't make sense for Nissan to do so. Incidentally, the dealer has said that he might be willing to consider going out of business if Nissan were willing to pay him ... but the dealer won't just turn in his franchise for no money and walk away.

HONDA

All of a sudden, Honda dealers are getting pushed to sell a lot more cars. This is something that Honda dealers are not used to. Honda dealers have always had a great relationship with the manufacturer. There was never a lot of tension or pushing to sell additional volume. Now that is happening.

Honda is now sending letters pushing its dealers to keep up with the Toyota dealers in their markets. Of course, that is difficult for Honda dealers to do without the same array of product that Toyota dealers have.

So, Myers & Fuller recommends that when a dealer receives these types of letters, the dealer should respond in writing and create a paper trail to point out in a polite, but business-like, way that Honda can't be comparing its dealers just to one other manufacturer (i.e., Toyota).

Honda dealers should point out that this (i.e., another manufacturer) is not what the dealer agreement says Honda is going to compare the dealer to when it comes to sales. Such a comparison is not practical. Honda dealers should be compared to other Honda dealers, if anything else, and not to Toyota dealers. M & F has written a lot of these letters lately to help Honda dealers to hopefully push back Honda and keep it at bay.

Add points. Next, unfortunately, the other shoe that's going to drop for Honda dealers will be add points ... That push has already begun. Honda is now on a kick to add points (new dealerships), and it has set this up by sending letters telling dealers that they are not selling enough cars ... that they're not keeping up with the other dealers in their markets.

When those letters arrive, dealers are going to have to look at their franchise laws to see if there is a way to protest those add points, and hopefully they will succeed at that. This hasn't happened yet, but M & F expects that it's right around the corner.

Question: Are you seeing more litigation by Honda dealers when Honda is adding points in an area that touches their markets?

Mr. Sox's Answer: Yes. As I said, for the longest time, we never heard from a Honda dealer because they were happy - selling lots of cars and the manufacturers weren't putting a lot of demands on them that were unreasonable in their minds. There wasn't a problem there until recently when things have just taken a turn all of a sudden, as far as the pressure that Honda wants to put on its dealers. The result of that is the dealers saying, "OK, we're going to step up and enforce our rights and try to protest another point from going in down the road."

TOYOTA

Toyota facilities. With regard to Toyota, the big issue involves dealership facilities. Dealers have told Myers & Fuller that this program is beyond anything they've ever seen. Toyota is projecting numbers out to the year 2012 based on units in operation. M & F has had Toyota dealers call saying that they're happy,

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loyal Toyota dealers who thought they'd never have to call M & F about anything, but this push by Toyota is just unreasonable and "beyond the pale."

Toyota wants a dealer to spend millions of dollars to meet square footage requirements that the dealer can't meet at his/her current facilities on his/her current property. For example, for a dealer in Long Island, NY, there may not a 20 acre parcel available to be purchased anywhere ... at any price. In this case, what would that dealer do?

So far, Toyota doesn't want to hear any of those excuses. Toyota is diligent in pressing forward in its requests that dealers meet the Image II program. M & F recommends that the dealers articulate their reasons clearly for not being able to comply. It's not a matter of "I don't want to." A dealer doesn't even have to go there, if he or she can explain (in a letter) that there are reasons why he or she cannot comply. In these cases, M & F eventually finds that Toyota will make some adjustments on the requirements or that Toyota will give some relief as far as time pressures are concerned.

It is important for a dealer to maintain his/her good relationship with the manufacturer on these image programs by writing such a letter. That letter will be in the dealer's file to represent the dealer's good-faith effort to find land, and to establish that additional land is not available at a reasonable price. This letter puts the ball back into the manufacturer's court.

One of the things that M & F has done in its letters to Toyota is to ask the question ... "How did you arrive at these targets based on units in operation in 2012?" So far, M & F hasn't received any clear answers back from Toyota. According to Mr. Sox, Toyota doesn't like to answer these kinds of questions, and it's not used to having to do so. He said that Toyota is putting itself in a position where it's rapidly getting cross-wise with its dealers who are generally happy to be Toyota dealers.

KIA & HYUNDAI

It's appropriate that Kia and Hyundai be lumped together because, for years now, both have steadily been adding new dealerships. But, in the last 18 months, there appears to be a relationship between who is getting these new dealerships.

Kia dealership clients are calling Myers & Fuller to report that they are in the running for a Hyundai dealership while Hyundai clients are calling the firm to report their bid for a Kia dealership in their market. There appears to be some relationship now (more than there used to be) in the minds of the Kia and Hyundai executives as to who is going to receive the new points.

When it comes to new points, M & F always recommends that dealers contact an experienced franchise lawyer or someone who understands the state laws to see if there are protest rights ... Most states have a radius around the dealership, so that if a new point comes in, the existing dealer has the right to attempt to stop that addition. That attempt involves showing that due to market events, it's not justified to add another dealership because it's just going to "split up a piece of the pie that everybody is already feeding from."

Mr. Sox noted that he is aware of a Kia point that is coming in Ohio where demographics for the population are flat, at best, across almost the entire state. So, there are good arguments in a state like that (and in markets like that) that it is not appropriate to add another point.

Of course, Kia is demanding stand-alone facilities, just like the other manufacturers, and in this case, the same advice applies ... Dealers should make a business decision and not be pushed into it. If the dealer decides that it is not economically viable, he/she should make sure everything is put into writing and sent to the manufacturer.

Tiered price incentive programs. Lastly, Kia's tiered price incentive program is no longer in place. However, Mr. Sox reported that his firm has represented a dealer who is involved a lawsuit against Kia over its (old) tiered price program.

Recently, Kia called asking what M & F would consider a "legal" incentive program to be. M & F explained its understanding of the law, and to its credit, Kia's attorneys said they would like to contact M & F's client/dealer directly to see if a new incentive program could be put in place that would satisfy the client/dealer going forward. This happened, and the new incentive program was satisfactory because it was based on that particular dealer's potential in its market.

Mr. Sox cautioned that other manufacturers will try this type of program - that they keep recycling these old tiered price incentive programs that are based on arbitrarily set targets.

For example, if a dealer sold 15 vehicles in a month, it would receive $500 per vehicle, retroactive to the first car sold in the month. If a dealer sold 30 vehicles, it would receive $750 per vehicle sold in the month. If 45 vehicles were sold, then the dealer would receive $1,000 per vehicle sold in the month, etc. This

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program was employed with no recognition towards any particular dealer's potential in their market.

With respect to the Kia dealership that M & F is representing in the lawsuit, that dealer's own planning volume as Kia prescribed it was to sell no more than 15 vehicles a month. Yet, that dealer was competing against a Kia dealer in a larger, neighboring market who regularly hit that top 45 vehicles sold and above. The dealer client was placed at a major competitive disadvantage.

M & F contends that, as a result of what was happening in that market, that was a violation of the Federal Price Discrimination laws. Mr. Sox reports that, "So far, so good." The case is moving, and the Judge has agreed with the dealer that it has a valid claim, so they are in the process of proving this now. He believes that his firm's efforts had an impact on getting that incentive program changed.

Question: For a Hyundai dealer, even though the incentive program has changed and the target is supposedly geared towards that dealer's potential, what do you do if that target still seems to be off the charts and unobtainable as compared to other similarly sized dealerships in similar markets?

Mr. Sox's Answer: The first action that we take is to write a letter on behalf of the dealer, and say, "Please explain in detail how you arrived at my objective." Then, we can take it from there and start to break it down to see if there are any flaws in the reply. I still think that the manufacturer uses some computer program to generate these targets and that computer program, by definition, is not going to take into account something unusual about what is going on in that dealer's market.

Also, the dealer should make sure to explain that its inability to meet the manufacturer's target impacts the dealership financially in a big way. It is helpful to be able to quantify that because, that tends to get their attention. Sometimes if the manufacturers think, "Oh, there's an attorney in the background setting this thing up for a lawsuit," ... Sometimes it's not a bad thing for them to be thinking that way. That's going to get their attention, and they may provide the dealer with some useful information.

M & F uses a couple of different experts around the country that have all kinds of market data from all over the country that they use to run tests on a dealer's census track data. As lawyers, our job is to ask the questions to get some information which we can look at. Sometimes, it's really obvious that something is not right, and then we send it on to our experts and let them do the detail analysis.

CHRYSLER

There has been a lot of activity with Chrysler which has led to a series of problems for the dealers.

Incentives to order. First, the dealers had a glut of inventory that Chrysler was "cramming down dealers' throats." Dealers were unsure whether they had to take the inventory because they were offering money (i.e., $1,000 "on the hood") of each vehicle. According to Mr. Sox, the dealers didn't have to take the inventory. That should be a business decision for the dealer to make. The dealers only have to take what they order. Every franchise law gives the dealers that protection.

The problem arose because Chrysler was so desperate to get rid of that volume that they started cutting deals with some of their larger dealers who could take on larger volume ... and Chrysler was giving these larger volume dealers maybe $2,000 per vehicle. This creates a competitive disadvantage and a potential violation of the law.

Default letters. In July of 2007, Chrysler sent out a letter to roughly 200 dealers stating that the dealers were below 85% of their sales requirement, and therefore, in default of their dealer agreement. These letters gave the dealers 180 days to "cure the problem." The 180-day period hasn't run out yet, so according to Mr. Sox, the other shoe hasn't dropped. He said that this is part of Chrysler's efforts to consolidate its dealer body.

As dealer advocates and lawyers, Myers & Fuller understands that there is a business reality for the manufacturers that, in many places, they do need to consolidate the market. However, M & F feels that there is a "right" way to do that, and running dealers out of business without paying them the value of their franchises is not how to do it. That's what it seems Chrysler is doing with these default letters.

MSRs, census tracks & sales targets. So, on behalf of these dealers whom Chrysler alleges are performing below sales requirements, M & F responded in writing (with the dealer's signature), helping the dealers explain what is going on in their market, why it is that they are performing below their targets ... assuming that Chrysler's MSR (minimum sales responsibility) is accurate (which is a big assumption) for that dealer ... the dealer still has to explain in the letter what is going on in his/her market that might explain something out of the dealer's control as to why the dealership is performing below 85%.

An example of this would be a Chrysler dealer in Spartanburg, South Carolina. There's a BMW plant

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in Spartanburg which might explain why, compared to other dealers in his state or in his region, he is performing less than 100% of an average. The key is that the reason for this below-average performance is completely out of the dealer's control.

M & F often finds that, when dealers start to think about this and to put it in writing, they can start to identify some very good reasons why they're not meeting their sales requirements.

Also, with regard to sales performance responses, M & F questions the target itself that has been given to a particular dealer. Those targets are usually based on an area of land - in technical terms, "census tracks." They get assigned to the dealer and that dealer is judged on the number of sales that he or she makes in that area.

Many times, M & F finds that the manufacturer's computer programs do not assign a census track correctly. In a multi-dealer market, that computer program tends to assign a census track based on the dealer who is physically closet to the center of that census track... as the crow files.

When you overlay a road system or natural barriers like a river on those census tracks, M & F has repeatedly found that those census tracks are assigned to a dealer across the river where the customers who live in the census track have to drive 10 miles up the side of the river to the first bridge that gets them across the river and then down 12 miles to get them to the dealership. So, even though, as the crow files, those people are closer to that dealership, there has not been a fair assignment of territory.

The same thing goes for when you put the road system over census tracks without natural barriers. Sometimes, a census track can be several miles further from another dealer, but if an Interstate runs right through there that drives a customer right past another dealer, then drive time becomes a critical analysis. And, if there is a big difference between your dealership and another dealership in drive time, then there is a good argument to be made that that census track should be assigned to another dealership. So, M & F looks at these considerations and others and includes them in the response letters.

Fortunately, the VPA incentive money program is going away as of January 1, 2008. Mr. Sox described this as a "terrible" program that was different from the Kia program because Chrysler could never tell its dealers how it is that they arrived at any given sales targets for the incentive.

Dealers asked Chrysler repeatedly how it (Chrysler) arrived at its target numbers, and Chrysler could never show a formula that got them there. This, of course, made M & F very suspicious that Chrysler assigned those targets on a (somewhat) arbitrary basis. As soon as the element of someone getting to decide the target for one dealership versus another, then the potential for price discrimination arises.

This VPA program is being replaced with a straight-up, price-per-car incentive program which M & F perceives to be a fair incentive program. So, if you're a larger volume or exceptional dealer, you're going to benefit ... You're going to get $400 a car for every car you sell above where the average dealer is. But, if you're not, and you have other circumstances keeping you from selling a lot of cars, you're still going to get the same amount per car. That's a fair and legal program, according to M & F's way of thinking.

Question: Can you comment on a new Chrysler program that would penalize Chrysler dealers if they do not floorplan with Chrysler?

Mr. Sox's Answer: Chrysler recently has come out with a new program, as I understand it, that in essence says, "If you don't floorplan with us, the way we're going to finance your customers is going to be less advantageous to you." I haven't seen any detail on the program yet.

Generally speaking, the franchise laws over time have started to address this issue. These laws say a couple different things, depending on what state you're in. A captive finance source will be treated, for all intents and purposes, as if it were the manufacturer. Therefore, anything that a state's franchise laws would prohibit a manufacturer from doing, a captive would also be prohibited from doing. If the manufacturer can't do it, then neither can the captive.

Some other franchise laws have gone into more detail and said, "You can't use your captive to coerce the dealer to do something as it relates to financing (whether is floorplanning, customer financing, etc.) that you would not otherwise do, or that would not otherwise be your first choice."

For Chrysler dealers, after M & F sees the details of the program, the first question is going to be "What does your state's franchise law say about this?" And then, "Is this going to impact you enough to justify starting to write the letter to see if you can get it changed?"

[Note: In the first question related to Ford (discussed below), Mr. Sox compared Chrysler with Ford in certain respects ... See that question also.]

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FORD

Ford is very active in the market with its consolidations. Calls concerning Ford's activities are probably the saddest calls that Myers & Fuller gets from dealers because Ford is not doing anything wrong or anything illegal, per se. It's just that things are so bad out there for Ford and Lincoln-Mercury dealers.

M & F is simply assisting Ford dealers in trying to get the most value for their dealerships, if they are the ones in their market who have been targeted to sell out. Ford will go to the other dealers in the market to see if they will contribute to the buy-out of the (target) dealership. Sometimes, M & F will represent the dealers who are being asked to contribute to the buy-out of another dealer. Sometimes M & F will represent the dealer who is being bought out.

In the case of the dealer being bought out, M & F tries to maximize the amount that Ford kicks in to the pot. The only complaint that Mr. Sox has heard from the Ford dealers who have been part of the consolidation process is that Ford is trying to put a large financial burden on the other Ford dealers who will remain to pony-up substantial amounts of money to buy out the other target dealer.

The problem with this is that often, none of the Ford dealers in that market area are doing very well, per se, and so for them to come up with $250,000 or $300,000 is difficult. Yet, Ford tries to put the burden on these other dealership to do so. It's important to know that all of this is negotiable.

Question: Do you consider Ford's consolidation in some markets to be unfair to other Ford dealers who won't have the opportunity to have the Lincoln-Mercury franchises and the full compliment of vehicles?

Mr. Sox's Answer: Unfortunately, the way the franchise laws are written, the only legal action that can be taken would be on behalf of another Lincoln-Mercury dealer who is having that other Lincoln-Mercury franchise brought closer to their franchise as it is being merged with an existing Ford dealer. There is not any franchise protection per se for the other Ford dealers that won't have the opportunity to sell Lincoln-Mercury.

That said, M & F would always recommend the same thing ... Writing a letter to Ford saying "We're happy for Joe Smith Ford down the road that he's getting Lincoln-Mercury, but we're sitting here suffering, too, and we'd like to be appointed a Lincoln-Mercury dealer." If Ford really wanted to do it right, they'd come in and work these things out with all of the dealers.

M & F used to see Chrysler do that with its Alpha program. Chrysler would say to its dealers, "We want to put the Chrysler and the Dodge and the Jeep dealers together ... To avoid protests and problems, we're just going to give everybody all three of those. Whichever one you're missing, we're going to give you your missing franchise." That way, everybody is on a level playing field.

That's a simplified version of what occurred because there was always somebody who was left out, and that person usually ended up in a lawsuit. But, Chrysler took care of most of the dealers that way. If Ford were to take that approach, I think it would save them a lot of problems and be a more fair way to do it.

Question: Will the lawsuit that Navistar has with Ford affect Ford Dealers, and if so, how?

Mr. Sox's Answer: Navistar is in a lawsuit with Ford. Some years ago, Navistar build a diesel engine for the Ford F-250 and above, and that engine had major problems. The Ford dealers did a tremendous amount of repair work on it, submitted millions of dollars in warranty reimbursements to Ford, which Ford paid.

Ford's agreement with Navistar (as the supplier of that engine) was that for certain repairs, Navistar would have to reimburse Ford for any money that Ford had to reimburse its dealers for warranty work on the Navistar engines.

However, when Ford made the request to Navistar for repayment, Navistar said, "No, we're not going to pay you ... We don't think there is/was anything wrong with our engines."

So, Ford sued Navistar. It's a very simple breach of contract claim. Navistar came back and said that the reason Navistar wasn't going to reimburse Ford was because Ford dealers, in essence, committed fraud in their warranty work. They did work that was unnecessary... they did the work incorrectly... and Navistar listed 3 or 4 other claims that all focused on the dealers being at fault. Note that no dealers are parties to this lawsuit.

Next, Navistar sent out about 90 subpoenas to the Ford dealers (not heavy duty truck dealers, but regular dealers) asking for years of warranty records on that engine. A Ford dealer client of M & F's in Florida called to ask about compliance with Navistar's subpoena. M & F found that Navistar's subpoena is asking for records and information that go way beyond what the franchise laws require the dealerships to maintain and to provide to Ford.

While Navistar is asking for the records, if the dealership produces those records and they are

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entered into the record of the court proceedings, then Ford will have access to the dealership's records that it (as manufacturer) otherwise would not have access to pursuant to the franchise laws.

Couple this with the possibility of an eventual decision by the judge that Navistar's claims are correct and that the Ford dealers were at fault ... What (do you think)Ford is going to do? ... They're going to turn around and charge back the dealers now going as far back as they have records ...We're talking hundreds of thousands of dollars in repairs. And, Ford would seem to be just in the kind of financial straits that it would do that, and put it on the backs of their dealers.

Our concern is that, in that lawsuit, the dealers really don't have any representation. No one is defending them. So, M & F has been in front of the judge explaining why the subpoenas are over-broad, why they need to be narrowed and why they need to be disclosed under strict confidentiality orders.

If there is another wave of subpoenas, and if you have a Ford dealer client who gets one, don't assume they're just innocuous. You need to take some action.

Follow-up Question: Are Navistar's claims of fraud against Ford dealers well-founded?

Mr. Sox's Answer: The dealers I've talked to have said that the (diesel) engine that Navistar built for Ford was a disaster. These dealers have told me, "That engine cost us a lot of time in warranty repairs, and it also cost us a lot of customer loyalty."

You're always going to have some errors in the warranty process ... "fraud" really isn't the right word. There is a reason that the statutes protect the dealers from the manufacturers going back only so far. And, a dealer doesn't want to open that door.

LINCOLN-MERCURY

Everyone asks what has been going on with Lincoln-Mercury. This linemake is struggling and there is very little product in the pipeline. So the question is ... "Is this another Oldsmobile?"

Myers & Fuller represented a lot of Oldsmobile dealers in lawsuits against General Motors in trying to obtain for those dealers the value of the franchise that had been discontinued. Mr. Sox believes that what is going to be different about the current Mercury situation is that it is going to be more like what happened when the Plymouth linemake was discontinued and the Plymouth dealer body had to be satisfied.

It appears that Ford may be going to take the Mercury models that are left and roll them over into Lincoln. If that happens ... most of those dealers who have Mercury also have Lincoln, and theoretically, there may not be as much damage done. M & F finds that those dealers usually just want to move on, and they do not want to pursue trying to obtain additional value for their Mercury franchise. Mr. Sox believes that this is the way Ford is headed with the Lincoln-Mercury issue.

With regard to Ford-Mercury stand-alone franchises (Mr. Sox is unaware of any Mercury stand-alones), there may be something these dealers want to do to try to get some money out of Ford if, in fact, Ford makes an announcement pretty soon that there is no new product coming, and they're going to wind the linemake down.

MERCEDES BENZ

Mercedes Benz has been unusually active in the last year, and this probably has a lot to do with the new president of Mercedes Benz. He wants to get a lot done, and he is doing the same things that the domestic manufacturers are doing. He said, "I want everyone to comply with the Autohaus facility image design," and he wants every dealer to meet their MSR sales responsibilities. He also wants their customer satisfaction scores to improve. So, Mercedes Benz has tackled these objectives in several ways.

Autohaus Design Program. Earlier this year, Mercedes Benz sent out 2-year term agreements to dealers whose dealer agreements had expired under their own terms as of the end of last year. As part of those term agreements, MB sent improvement addendums to any dealer that was not meeting their MSR or who had not committed to the Autohaus design.

In these improvement addendums, Mercedes Benz asked the dealer to sign the addendum that admitted, "I am not meeting my sales [and/or facility] obligations, and I agree that within 6 months I will have brought my sales to such and such level [and/or I will have met with the designer and have plans submitted to you for my Autohaus facility]."

Myers & Fuller advised dealers that they should not ever sign anything that admits in writing that they have not met their obligations under their franchise agreements. This would be the death knell because, in the future, if it ends up in a fight, a dealer wouldn't want that signed acknowledgement to surface.

Dealers questioned whether they had to sign these term agreements (and addendums) because their old agreements had expired. M & F advised that these dealers did not have to sign. The reason is because the franchise laws in every state give dealers the protection that says, in essence, that the franchise agreement is perpetual. That means that

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the dates put in these franchise agreements don't mean anything.

The only thing that a manufacturer can do is to give the dealer notice that it is going to terminate the dealership agreement or give the dealer written notice that it is not going to renew the agreement at its expiration.

Consistently, the manufacturers do not send notices of non-renewal. Instead, they're sending out improvement addendums and term agreements hoping to convince the dealers to agree to these various types of new conditions and in many cases, to give away their (the dealers') legal rights.

Dealers are giving away their legal rights when they sign term agreements and addendums. Here's why ... The franchise laws say that if a manufacturer tells a dealer that it is going to non-renew or terminate that dealer, then a whole series of tests come into play under the franchise laws.

These laws require the manufacturer to prove it has good cause to take that action (i.e., either to terminate or non-renew a dealer). And, a manufacturer usually does not want to "go there" (i.e., pursue this course). These test generally are difficult for a manufacturer to meet. And they have been made difficult to meet for a reason ... Franchise laws are in place to protect the dealers' investments.

Accordingly, M & F advises dealer clients not to worry that their dealer agreements have expired, and not to be convinced that they have to sign what the manufacturer has sent. Dealers should respond, in writing, saying (1) that they want to comply with this or that issue, but that the language which is included in the Addendum is unacceptable, and (2) that they would like a full-term dealer agreement.

After these two points are addressed, then the dealer can offer to look at the Autohaus design in another venue. But that should not be addressed within the dealer agreement because "that is a set-up." Mr. Sox reported that his firm has written a lot of those letters on behalf of Mercedes Benz dealers.

Margin holdback programs. The other way that Mercedes Benz is going about trying to get dealers to commit to the Autohaus design program and to sales performance requirements is through its new margin holdback program. This program is pretty simple ... It's 3% ... 1% goes towards the dealer if they've met the image facility program, 1% is for sales performance and 1% is for customer satisfaction. So, the same test applies.

In and of itself, this is not an illegal program. But, as it is applied to any given dealer, it is necessary to look at whether these requirements are practically doable and/or economically viable for the dealer. If they are not, then it is necessary to look further to see if there might be any price discrimination.

Regarding Mercedes Benz and its Autohaus design program, Mr. Sox noted that MB is pushing dealers hard to participate, and M & F is not necessarily happy with the way dealers are being pushed. However, once a dealer commits to participate in the program, there appear to be some pretty significant dollars as a reward on the back end to help the dealer pay for some of the costs ($400 a car). To be fair, Mr. Sox wanted to acknowledge that this seemed to be a pretty good incentive program.

Question(s): How recently did the Mercedes Benz term agreements come out? Do dealers still have an opportunity to avoid signing them?

Mr. Sox's Answer: I have found that dealers will let those kinds of things sit on their desks for months. So, these came out earlier in the year, but I don't think that's any reason to assume that dealers have already made a decision one way or the other.

If you have Mercedes Benz clients, you need to find out if they just put that on the corner of their desks. With everybody in the retail industry focused on trying to sell more cars, it's very hard for dealers to take the time to focus on agreements that are sent to them by the manufacturer.

And, this is part of the problem. If the dealer doesn't have time to do it, someone else should read that agreement all the way through ... from the front to the back. The reason is because about once a year M & F will see the same agreement, the same form, and then all of a sudden it will find some new provision in it that wasn't in there before, and that newly slipped in provision is usually a real negative for the dealer. That's why dealers have to read these agreements. They can't just stick their heads in the sand as much as they would like to as it relates to these things.

There is still enough time for Mercedes Benz dealers to claim that they don't want to agree that they are in violation of anything ... that if the manufacturer wants to pursue their sales performance record, there is room under the regular dealer agreement to do that - there is provision there that says that the dealer has to meet a certain sales responsibility.

If the manufacturer doesn't think the dealer has met that responsibility, then the manufacturer can take action under the dealer agreement, but it shouldn't ask a dealer to agree up front that he or she is not meeting his or her obligations.

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CHAMCO & CHINA CAR (CHINA)

First of all, Chery is not an opportunity for dealers anymore. Many questions were raised when dealers called Myers & Fuller to ask if they should contribute the $2 million or so for the that franchise. However, everything now seems to have fallen through.

China Car and Chamco are both there now as opportunities for dealers. M & F is advising dealers to obtain copies of the dealer agreement they're going to propose. Dealers should also obtain copies of the distribution agreement between the U.S. distributor and the foreign car maker. The reason for the latter is because the distribution agreement is really where the protections for the dealer ... if there are any ... are going to be found.

For a dealer to try to go after a foreign manufacturer in a country like China that doesn't operate under a free trade economy, it's going to be a hopeless cause. So, if something were to happen after a dealer has made an investment in a facility and dealership and the foreign manufacturer pulls the plug, the distributor needs to have some rights against that manufacturer on the dealer's behalf. If the distributor does not have any rights on the dealers behalf against that manufacturer, the dealer is not going to be able to do anything about recovering some of its investment.

M & F has dealers who are looking at Chamco and China Car, and M & F has seen those dealer agreements and distribution agreements. Mr. Sox noted these companies, through their U.S. distributors, are already acting like the other manufacturers. They have had dealers sign confidentiality agreements before they would allow M & F to look at their agreements for them. So, Mr. Sox was not allowed to tell the audience what was found in the agreements or what the concerns were.

Regardless, whatever franchise dealers are interested in, they should have an experienced franchise lawyer review these agreements on their behalf.

MAHINDRA (INDIA)

Mr. Sox noted that his firm is a little more comfortable with Mahindra, but only because of the economy and the free trade system in India and also because Mahindra has a track record. However, at the same time, there are risks.

Myers & Fuller is advising dealers to look at those agreements carefully and to know what they're getting themselves into. Dealers should also try to "slow walk" the requirements that Mahindra is putting into those agreements as it relates to giving them an exclusive facility within 6 to 8 months of a year from receiving the first cars.

This strikes M & F as awfully quick for a dealer to be spending that kind of money when no one really knows what is going to happen with the product and whether it's going to get a bad reputation because it has some flaw. So, Mr. Sox advice was to "slow walk those expenses."

Question: Do you have any more information on Mahindra?

Mr. Sox's Answer: I had the opportunity to review the distribution agreement with Mahindra under their confidentiality agreement. They didn't even want me to have a copy of it in my possession, so I flew up to Atlanta to their Alpharetta offices. I sat in their boardroom to review Mahindra's distribution agreement and met some of their executives.

I don't want anybody to take my advice on which of these manufacturers is the right one to hook up with; but, from what I could tell, their management has some real good car experience. I'll leave it at that.

Question: *Do you have any more information on Crosslander?*

Mr. Sox's Answer: A few years ago, some dealers bought Crosslander, and then they didn't get their money back when Crosslander didn't come through. My understanding is that so far, when dealers ask if they can apply the money that they paid years ago for Crosslander to any of the initial fees for a Mahindra franchise, they are being told that they cannot because Mahindra is a separate corporation. Unfortunately, we haven't seen any progress in that regard.

SELECTED QUESTIONS

#1. Can a manufacturer legally require a dealer to participate in its local marketing group (LMG)?

Mr. Sox's Answer: The answer is, "No." Manufacturers don't like that answer, but the answer is still, "No."

We have represented several dealers who have become fed up with contributing towards a local marketing group, and for whatever reason (they may be a fringe dealer in that market), they don't feel like they're getting the full benefit from all of the money they're putting into it.

What we have done is put the designated leader of the marketing group on notice that our client does not want to participate anymore. We'll ask for copies of the bylaws of the LMG, which will provide the exit for any dealer that doesn't want to participate in the LMG any more. If those procedures are followed, the dealer should be in the clear. →

As a practical matter, what has happened when we do that is the manufacturer comes knocking on the dealer's door and asks what the dealer is doing, saying, "We need to have full participation in this." This gives the dealer the opportunity to say ... "I'm a team player but, for the following reasons, I didn't think I was getting the benefit out of it." This should open the door for negotiations with the manufacturer to correct the problem.

Again, a dealer is not legally required to participate in a LMG.

#2. Question: How important are capital standards in dealership acquisitions?

Mr. Sox's Answer: That's usually one of the big 3 criteria that a manufacturer can focus on in order to turn a deal down. It doesn't happen very often, but we have had some dealers both on the selling side or on the buying side who say, "This capital requirement just doesn't seem to be right."

We recommended that the dealer have a discussion with its manufacturer to find out how the manufacturer arrived at the capital standard(s) it had set. Sometimes, the manufacturer will reconsider and say, "OK, we see where you're coming from," and they lower the capital requirement. They reach some kind of agreement. It is certainly something that is negotiable.

#3. Question: Has your firm been involved in any of the litigation involving how administration and/or doc fees were charged to the customer at closing?

Mr. Sox's Answer: Yes. We've brought in 3 attorneys that specialize in F & I compliance, and we've been involved in some of the class actions.

Many states are moving towards some kind of action - whether it be to put a cap on those fees, or to require specific disclosure language that needs to be included on the buyer's order as to what that fee represents. What M & F recommends is that dealers disclose them on a line separate from any other regulatory fees or taxes. The reason is because the first thing that the class action attorneys usually say is, "You have deceptively presented that fee as if it is non-negotiable, as if it is just another regulatory fee." That gets a lot of traction in court.

So, dealers want to make sure that these fees are set forth separately; and underneath, in parentheses and in lettering as big as you can make it, make some kind of disclosure that "This fee represents costs and profits to the dealership." This is the language that is required in Florida and it is what we recommend to dealers who don't have any kind of regulatory guide in their state.

#4. Question: Can you comment a recent change in Florida law that affects manufacturers' payments to dealers?

Mr. Sox's Answer: Florida passed a law that provides that dealers are now required to be paid their retail rate, not only for their labor but also for their parts. The manufacturers have responded to this very unhappily - challenging it as unconstitutional. They've said, "If you want your retail rate for your parts on our warranty work, then we're going to bring in audit teams to determine whether you're charging a reasonable retail rate."

At the next legislative session in Florida, M & F will attempt to define the formula that is going to be used by the dealers to compute the retail rate that the manufacturers will have to pay. There are only 5 states whose laws are so specific that they say, in effect, that the dealer submits 100 repair orders and takes an average mark-up of those repair orders, and that average percentage mark-up is what is applied going forward on all their warranty reimbursement requests. This approach strikes us as a pretty simple and good formula.

The manufacturers don't like the result, but that's where they forced the Florida dealers to go because they put up such a fight over the current law which doesn't have a specific formula in it. Certainly many dealers are counting on the additional money such a formula approach would provide to help with their bottom lines.

STRICTER STANDARDS FOR AVOIDANCE OF PREPARER PENALTIES REQUIRE MORE DUE DILIGENCE

EXECUTIVE SUMMARY

Recent changes make it easier for the IRS to assess penalties against tax return preparers. In the filing season now upon us, more thought and attention will have to be given to thoroughly researching tough tax questions and to determining whether various disclosures are required with the tax returns to avoid these penalties.

In light of the interim guidance in Notice 2008-13, a prudent course of action would be for tax return preparers to document their files by including a memorandum indicating the extent to which they were able to comply (i.e., satisfy themselves) with its guidelines.

CHANGES IN THE LAW

The *Small Business & Work Opportunity Act* of 2007 amended Section 6694 (1) to increase the first tier and the second tier penalty amounts and (2) to alter the standards of conduct to be complied with in order to avoid imposition of ***tax return preparer*** penalties in connection with positions taken on ***all*** tax returns.

These penalties have been extended to preparers of tax returns for estate, gift, employment, excise tax and exempt organizations. Although there is minor transitional relief, these changes apply to all tax returns ... not just to income tax returns ... prepared after May 25, 2007. They also apply to preparers of claims for refund.

"Unreasonable position." The penalty for filing a return that has a tax liability understatement due to an "unreasonable position" is now the ***greater*** of (1) $1,000 or (2) 50% of the income earned (whether or not collected) by the tax return preparer for preparing the tax return or the claim for refund.

"Willful or reckless conduct." The penalty for filing a return that has a tax liability understatement due to "willful or reckless conduct" is now the ***greater*** of (1) $5,000 or (2) 50% of the income earned (whether or not collected) by the tax return preparer for preparing the tax return or the claim for refund.

Under the ***new rules***, a penalty for an incorrect return position can be avoided only if there is a ***"reasonable belief"*** that the position taken will ***"more likely than not"*** be sustained on its merits ... That requires a ***greater than 50% ... an over 50% ... chance.***

Under prior law, a penalty for taking a tax return position could be avoided if there was a ***"realistic possibility" ... one-in-three or 33-1/3% ... chance*** that the position taken in the tax return could be sustained on its merits.

Under these new, higher standards, it is possible that a tax return preparer could be penalized ... if there is not a more than 50% chance (i.e., a more likely than not chance) of being right ... even though the taxpayer might be able to avoid a comparable penalty. The taxpayer is only required to have a more than one-third chance of being right (i.e., a realistic possibility that the position taken in the tax return could be successfully defended).

Should you attach Form 8275 to the tax return? Some tax questions require studying the Code and the Regulations and trying to understand what they say. Sometimes what they say is clear; however, despite this clarity, the taxpayer may still want to take a contrary position in filing the tax return. Also, some tax questions require a study of the case law involving similar situations with varying fact patterns, and from these cases, some judgment must be made as to where the case at hand falls on the spectrum of sustainable possibilities.

If, as the tax return preparer, you're not sure of the correct tax treatment for a transaction, should you attach Form 8275, *Disclosure Statement* to the tax return? Take a close look at this form and its companion Form 8275-R. You'll probably be needing them this year.

INTERIM GUIDANCE ... "REASONABLE BELIEF"

Mercifully, on December 31, 2007, the IRS issued 3 notices (Notice 2008-11, -12 and -13) providing some clarifications and interim guidance. Notice 2008-13 is especially important, and it contains 12 examples illustrating some of these new rules.

Notice 2008-13 provides the following interim guidance in connection with "reasonable belief that the tax treatment of the position would more likely than not be sustained on the merits."

"... ***[A] tax return preparer is considered reasonably to believe*** that the tax treatment of an item is more likely than not the proper tax treatment ... ***if (1) the tax return preparer analyzes*** the pertinent facts and authorities [in the manner described in Reg. Sec. 1.6662-4(d)(3)(ii)] ***and, (2) in reliance upon that analysis, reasonably concludes in good faith*** that there is a ***greater than fifty percent*** likelihood that the tax treatment of the item will be upheld if challenged by the IRS. .... [Emphasis added.]

"... [A] tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, as provided in Reg. Sec. 1.6694-1(e). →

"In addition, a tax return preparer may rely in good faith and without verification upon information furnished by another advisor, tax return preparer or other third party. Thus, a tax return preparer is not required to independently verify or review the items reported on tax returns, schedules or other third party documents to determine if the items meet the standard requiring a reasonable belief that the position would more likely than not be sustained on the merits.

"The tax return preparer, however, ***may not ignore the implications*** of information furnished to the tax return preparer or actually known to the tax return preparer.

"The tax return preparer also ***must make reasonable inquiries*** if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete."

CIRCULAR 230

Another consideration in these discussions is the fact that, in September 2007, the IRS issued proposed Regulations that would change Section 10.34(a) of Circular 230, which governs practice before the Treasury and the IRS.

This change provides that a practitioner can sign a tax return as preparer only if there is "a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on the merits." This change is intended to maintain some parity between the thresholds in Section 6694 and Circular 230.

TWO EXAMPLES OF NEW PENALTY TENSIONS

1. Taxability of manufacturer "reimbursements" to dealerships for consolidation and/or facilities & image upgrades. This is an issue that's a good example of the "rock-and-a-hard-place" dilemma that now confronts a CPA tax return preparer.

As discussed in the Dealer/Factory Issues Update (pages 12-23), many manufacturers have incentive or other programs which provide that a dealership will be "reimbursed" if it participates in certain consolidation and/or facility and image upgrade activities. Are such payments received by the dealership currently taxable? ... Or, can the basis of the assets or improvements be reduced by the amount of the manufacturer's "contribution" or "reimbursement?"

I'm not going to try to answer that tax question here. However, many CPAs with whom I have recently discussed this tax question have said that they believe that the manufacturer's reimbursement is not (immediately) taxable to the dealership. They have taken the position that the reimbursement received can be offset against the basis of the facility or improvement. Sometimes, they have cited Section 118 of the Code as the basis for their conclusion. (Frankly, I have my own doubts that this would be correct. Also in this regard, see the IRS recently issued Internal Directive cautioning against the misuse of this provision, as discussed in Update #5 in the "Tax Watch Out" section of this issue of the *DTW*.)

Certainly, one consideration bearing on how a dealership should treat these payments from the manufacturer lies in the wording of the contract or agreement between the manufacturer and the dealership. Are services being provided? Are there other conditions or requirements? etc.

Another consideration is what the Code (especially Section 118), Regulations and various pronouncements and cases have held on similar situations in the past.

What if, after all of your research, you conclude that it should be proper to reduce the basis of the improvements ...but you're not entirely sure? Well ... How sure are you ... on a scale of 1 to 100, where you have to get to at least 51 in order to avoid a tax return preparer penalty?

If the correct tax treatment is that the payment received from the manufacturer is taxable immediately as ordinary income (and the payment should not be treated as an offset against basis), then it is possible that the IRS could impose penalties on both the return preparer and the taxpayer if the tax return did not report the payment as income and no further disclosures were made in the tax return. Here's where completing Form 8275 and attaching it to the tax return becomes important.

The changes in the law have established a disparity in the now higher "greater than 50%" threshold at which penalties will be assessed against tax return preparers vis-à-vis taxpayers (who "can live with" a lower one-in-three threshold). This disparity is likely to necessitate some potentially unpleasant discussions with clients, especially if you are going to give your client a lecture explaining the differences between your respective, relative, tolerable degrees of (un)certainty. Things could get tense and touchy and conflicts of interest could arise.

2. Tool reimbursement plans. With the extension of Section 6694 penalties to preparers of employment tax returns, similar considerations arise for those preparing quarterly Forms 941 for employers who have (or believe they have) Section 62(c) accountable plans. Preparer liability is no longer limited to the preparation of income tax returns for those participating in these arrangements. In this regard, see our discussion on ILM 200745018.

Failure to Promptly Remit Section 401(k) Plan Contributions Withheld from Employees Causes Dealership Big Problems

U.S Department of Labor **Employee Benefits Security Administration**
Washington District Office
1335 East-West Highway, Suite 200
Silver Spring, MD 20910-3225

(301) 713-2000 Fax (301) 713-2008

SEP 19, 2007

Certified No: ... Return Receipt Requested

Dear *[Plan Trustee]*:

The Department of Labor (the "Department") has responsibility for administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Title I establishes standards governing the operation of employee benefit plans such as the [XYZ Dealership] Section 401(k) Plan and Trust (the "Plan").

ERISA Violations by Plan Administrator & by Plan Trustee

This office has concluded its investigation of the Plan, of the *[XYZ Dealership]* (the "Company") as Plan Administrator and of you as the Plan trustee. Based on the facts gathered during this investigation, it appears that, as Plan Administrator and Plan trustee, the Company and you, respectively, violated several provisions of ERISA. Accordingly, during the on-site investigation and by telephone, we apprised you of your specific actions, which we believe violated ERISA.

Facts

As we understand the facts, many of which were provided to this office by you during the course of our investigation, the Company's established practice from *[X date in calendar year 2002]* through *[X date in calendar year 2007]* was to remit employee contributions to *[ABC, Inc.]*(the "Principal") (the Plan's asset custodian) up to 66 days following the pay date on which contributions were withheld.

From 2002 through the present, the Company remitted employee contributions electronically. ... The shortest delay pursuant to the remittance of employee contributions was 2 days. Three Company dealerships participated in the Plan specifically, *[Dealership #1]*, *[Dealership #2]* and *[Dealership #3]*.

The Company took 34 days, 31 days and 27 days on average, per the three aforementioned dealerships, to remit employee contributions to the trust. During an on-site interview, you explained that the Company established a goal to remit contributions to the Plan by the 15th business day of the following month subsequent to the month in which the employee contributions were withheld from payroll. You also explained that the earliest point at which employee contributions could be reasonably segregated from the Company's general assets was on the pay date.

It Was Possible for the Dealership(s) to Remit Withheld Contributions Much Sooner

In an interview with Company personnel responsible for administering the day to day Plan operations, it was explained that if the Company had not established a goal to remit employee contributions to the Plan by the 15th business day of the following month, it would have been administratively feasible for the Company to have remitted employee contributions to the Plan on the pay date for which the contributions were withheld - specifically, each week on Friday.

Therefore, in consideration of the Company's administrative practice and procedures, the pay date for which the contributions were withheld was selected as the date for employee contributions to be reasonably segregated from the employer's general assets.

Lost Interest Is Due to the (Section 401(k)) Plan

Based upon this review of the Company's timeliness pursuant to the remittance of Plan employee contributions, the Department determined lost interest due to the Plan.

In the Department's lost interest calculations, the pay date (specifically, each week on Friday) was selected as the date for employee contributions to be reasonably segregated from the employer's general assets for the period from *[X date in calendar year 2002]* through *[X date in calendar year 2007]*.

Generally, the Payroll Pay Date Will Reflect the Date When Such Contributions Can Be Segregated and Become Plan Assets

Department of Labor Regulation 29 CFR 2510.3-102 specifies in part, that employee contributions to a plan become plan assets "...as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets...". Generally, the payroll pay date will reflect the date when such contributions can be segregated and become plan assets. At that time, the contributions are considered to be for the exclusive benefit of the participants.

Violation of ERISA Provisions

Your failure to collect and the Company's failure to forward employee contributions to the Plan in a timely manner is a violation of ERISA Sections 403(c)(1), 404(a)(1)(A) and -(B), 406(a)(1)(D), and 406(b)(1) and -(2).

403(c)(1) The assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

404(a)(1) A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and ...

-(A) For the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.

-(B) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

406(a)(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect ... (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan.

406(b)(1) A fiduciary with respect to a plan shall not deal with the assets of the plan in his own interest or for his own account.

406(b)(2) A fiduciary with respect to a plan shall not (in his individual or in any other capacity) act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.

Corrective Actions Taken

It is further my understanding that you have been verbally informed of the actions which we believe resulted in violations of ERISA. It is my understanding that corrective action has been taken, in that you have ...

- Deposited *[almost $70,000]* into the Plan, which represented restoration of lost opportunity costs for delinquent employee contributions, and ...
- Already changed your employee contributions remittance policy so that employee contributions will be remitted to the Plan's asset custodian on the pay date for which the contributions were withheld specifically, each week on Friday.

Because you have taken the corrective action described above, the *[Department of Labor]* will take no further action with respect to this matter.

Caveats ... Warnings

- You are cautioned, however, to refrain from such conduct in the future.
- You are further cautioned that this notice addresses only the Issues described above.
- You must understand that by agreeing to take no further act on with regard to this issue, the *[Department of Labor]* commits only itself and cannot in any way restrain any other individual or governmental agency from taking any further action it may deem appropriate with respect to either this or other matters.

Prohibited Transaction Conduct and Possible IRC Section 4975 Penalties

Further, as you may be aware, Congress, in enacting ERISA, added Section 4975 to the Internal Revenue Code of 1954. Section 4975 imposes an excise tax on disqualified persons (generally, the same as parties in interest under Title I of ERISA) who engage in prohibited transactions with employee retirement benefit plans.

In general, this excise tax, which is administered and enforced by the Internal Revenue Service, is applicable in two steps ...

- ***A first level tax equal to ... 15%*** for prohibited transactions (occurring on or after August 5, 1997) of the amount involved in the transaction for each taxable year during which the transaction is outstanding, and
- ***A second level tax equal to 100%*** of the amount involved if the transaction is not corrected.

The excise tax is paid concurrently with the filing of a Form 5330 (Form and Instructions enclosed).

Information Required to Be Shared Between Internal Revenue Service and Department of Labor

Please also be advised that pursuant to Section 3003(c) of ERISA, 29 U.S.C. Section 1203(c), the Secretary of Labor is required to transmit to the Secretary of the Treasury information indicating that a prohibited transaction has occurred. ***Accordingly, this matter will be referred to the Internal Revenue Service.***

Sincerely,

Regional Director, Washington District Office

Enclosures: 5330 Form and Instructions

Selected Comments on Form 5330 & Computation of Section 4975 Excise Taxes Where Employers Fail to Promptly Remit Sec. 401(k) Plan Contributions Withheld from Employees' Wages

- Form 5330 is required to be filed for each year or portion of a year. The due date for Form 5330, if it is being filed only for Section 4975 taxes, is the last day of the 7th month after the end of the tax year of the filer (i.e., the employer or other person who must file Form 5330).
- Form 5330 is a 5-page form (last revision March 2007). Only Pages 1, 3 and 4 appear on page 30.
- The Instructions cover 12 pages. Only selected portions of the Instructions relevant to the Section 4975 excise tax are reproduced here.
  - A Form 5330 and tax payment is required for ... "Each year (or part of a year) in the taxable period applicable to a prohibited transaction under Section 4975." (Instructions, Page 2)
  - When calculating the prohibited excise tax where there is a failure to transmit participant contributions (elective deferrals) ... or amounts that would have otherwise been payable to the participant in cash ... the *"amount involved"* is based on interest on those elective deferrals. See Revenue Ruling 2006-38. (Instructions, Pages 1 & 7)
  - If Form 5330 is filed late, interest in penalties for late filing and late payment will be billed separately (by the IRS) after the tax return has been filed. (Instructions, Page 3)
- In the dealership situation subject to the Department of Labor letter ...
  - It could be possible that as many as 18 Forms 5330 might have to be filed ... 3 dealerships x 6 years (2002-2003-2004-2005-2006-2007).
  - When a prohibited transaction spans multiple tax years, and where that interest is not repaid in (or by the end of) a given year, that interest is added to the principal amount in the subsequent year.
  - Revenue Ruling 2006-38 provides an example of the computation of the first tier of excise tax.
    - The interest rate provided for in Section 6621(a)(2) on the date of the prohibited transaction is an appropriate rate to calculate the "amount involved" if the Form 5330 is timely filed.
    - If Form 5330 is being filed late, a different interest rate could possibly be applied.
  - The second tier tax (under Section 4975), if the initial tax is not corrected within the taxable period, is an additional tax equal to 100% of the amount involved.
    - This tax is reported as an additional tax on Line 6b of Page 1, Part I.
    - If not all of the prohibited transactions have been corrected, it is necessary to complete Part V (Page 4) of Form 5330 in accordance with the Instructions on pages 8 and 9 (not reproduced).
  - Since the Forms 5330 are being filed late, the filers will also be subject to...
    - ***Interest*** charged on taxes not paid by the due date, even if an extension of time to file is granted.
    - ***Penalty for late filing of return****... multiple penalty amounts, depending on how many days after due date the tax return is filed.
    - ***Penalty for late payment of tax.****
      * These penalties may be waived by the IRS if the filer can prove reasonable cause.
- The Department of Labor has the authority to issue Regulations interpreting Section 4975(c)(1).
  - The Department of Labor has advised the Internal Revenue Service that the failure to remit employee contributions to an employee benefit plan may constitute a crime under 18 U.S.C. 664.
  - Accordingly, anyone who unlawfully and willfully converts to his or her own use or to the use of another, any of the moneys or funds, or other assets of any employee benefit plan could be subject to the fines and/or imprisonment as provided for under the provisions of Title 18.

Further Information

- Form 5330, Pages 1, 3 & 4 .... Pg. 30
- Instructions, selected portions .... Pg. 31
- Analysis of Revenue Ruling 2006-38 .... Pg. 32

Form **5330**
(Rev. March 2007)
Department of the Treasury
Internal Revenue Service

Return of Excise Taxes Related to Employee Benefit Plans

(Under sections 4965, 4971, 4972, 4973(a)(3), 4975, 4976, 4977, 4978, 4978A, 4979, 4979A, 4980, and 4980F of the Internal Revenue Code)

OMB No. 1545-0575

Filer tax year beginning , and ending ,

A Name of filer (see page 3 of the instructions)	B Filer's identifying number (see instructions) ☐ Employer identification number (EIN)
Number, street, and room or suite no. (If a P.O. box, see page 3 of the instructions)	☐ Social security number (SSN)
City or town, state, and ZIP code	
C Name and address of plan sponsor	E Plan sponsor's EIN
	F Plan year ending
D Name of plan	G Plan number

H Check here if this is an amended return . . . ▶ ☐

Part I Summary of Taxes Due

		FOR IRS USE ONLY		
1	Section 4972 tax on nondeductible contributions to qualified plans (from line 14l)	161	1	
2	Section 4973(a)(3) tax on excess contributions to section 403(b)(7)(A) custodial accounts (from line 24)	164	2	
3	Section 4976 tax on disqualified benefits for funded welfare plans (see instructions)	200	3	
4a	Section 4978 and 4978A tax on certain ESOP dispositions (see instructions)	209	4a	
b	The tax on line 4a is a result of the application of: ☐ Sec. 664(g) ☐ Sec. 1042 ☐ Sec. 4978A		4b	
5a	Section 4979A tax on certain prohibited allocations of qualified ESOP securities (see instructions)	203	5a	
b	Section 4965 tax on prohibited tax shelter transactions	237	5b	
6a	Section 4975(a) tax on prohibited transactions (from line 25c)	159	6a	
b	Section 4975(b) tax on failure to correct prohibited transactions (see Part IV instructions)	224	6b	
7a	Section 4971(a) tax on failure to meet minimum funding standards (see instructions)	163	7a	
b	Section 4971(b) tax on failure to correct minimum funding standards (see Part VI instructions)	225	7b	
8	Section 4977 tax on excess fringe benefits (from line 30d)	201	8	
9	Section 4979 tax on excess contributions to certain plans (see instructions)	205	9	
10	Section 4980 tax on reversion of qualified plan assets to an employer (from line 34)	204	10	
11	Section 4980F tax on failure to provide notice of significant reduction in future accruals (from line 41)	228	11	
12a	Section 4971(f)(1) tax on failure to pay liquidity shortfall (from line 45)	226	12a	
b	Section 4971(f)(2) additional tax on failure to correct liquidity shortfall (see Part XI instructions)	227	12b	
13a	**Total tax.** Add lines 1 through 12b (see page 5 of the instructions)		13a	
b	Enter amount of tax paid with Form 5558 or any other tax paid prior to filing this return		13b	
c	**Total tax due.** Subtract line 13b from line 13a. Attach check or money order payable to "United States Treasury." Write your name, identifying number, plan number, and "Form 5330, Section(s) " on your payment ▶		13c	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature ▶ ( ) Telephone number ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶ ▶ Date

Firm's name (or yours if self-employed) and address ▶

For Privacy Act and Paperwork Reduction Act Notice, see page 11 of the instructions. Cat. No. 11870M Form **5330** (Rev. 3-2007)

Form 5330 (Rev. 3-2007) Page **3**

DUE DATE: Section 4975 taxes are due by the last day of the 7th month after the end of the tax year of the filer.

Part IV Tax on Prohibited Transactions (Section 4975) (see instructions)

25a Is the excise tax a result of a prohibited transaction that was (check one or more):
☐ discrete ☐ other than discrete (a lease or a loan)

b Complete the table below to disclose the prohibited transactions and figure the initial tax (see instructions).

(a) Transaction number	(b) Date of transaction (see page 7 of the instructions)	(c) Description of prohibited transaction	(d) Amount involved in prohibited transaction (see page 7 of the instructions)	(e) Initial tax on prohibited transaction (multiply each transaction in column (c) by the appropriate rate (see page 7 of the instructions))
(i)				
(ii)				
(iii)				
(x)				

25c Add amounts in column (e). Enter here and on line 6a ▶

26 Have you corrected all of the prohibited transactions that you are reporting on this return? (See page 8 of the instructions) ☐ Yes ☐ No
If "Yes," complete Part V of this form. If "No," complete Part V of this form and see page 8 of the instructions.

Form **5330** (Rev. 3-2007)

Form 5330 (Rev. 3-2007) Page **4**

Part V Schedule of Other Participating Disqualified Persons and Description of Correction (see instructions)

27 Complete the schedule of other participating disqualified persons and description of correction (see instructions)

(a) Item no. from Part IV	(b) Name and address of disqualified person	(c) EIN or SSN	(d) Date of correction	(e) Description of correction

Form **5330** (Rev. 3-2007)

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

Instructions for Form 5330

(Rev. March 2007)

Department of the Treasury
Internal Revenue Service

Return of Excise Taxes Related to Employee Benefit Plans

Section 4975, Prohibited Transactions. Generally, for purposes of a prohibited transaction described in section 4975(c)(1)(A), (B), (C), or (D), if a disqualified person enters into a prohibited transaction in connection with the acquisition, holding, or disposition of certain securities, or commodities, and the transaction is corrected within the correction period, it will not be treated as a prohibited transaction and no tax will be assessed.

When calculating the prohibited transaction excise tax where there is a failure to transmit participant contributions (elective deferrals) or amounts that would have otherwise been payable to the participant in cash, the *amount involved* is based on interest on those elective deferrals. See Rev. Rul. 2006-38.

Interest and Penalties

Interest. Interest is charged on taxes not paid by the due date even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, gross valuation overstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Penalty for late filing of return. If you do not file a return by the due date, including extensions, you may have to pay a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if you can show that the failure to file on time was due to reasonable cause. If you file late, you must attach a statement to Form 5330 explaining the reasonable cause.

Penalty for late payment of tax. If you do not pay the tax when due, you may have to pay a penalty of 1/2 of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if you can show that the failure to pay on time was due to reasonable cause.

Interest and penalties for late filing and late payment will be billed separately after the return is filed.

Part IV (Section 4975)

Tax on Prohibited Transactions

Section 4975 imposes an excise tax on a disqualified person that engages in a prohibited transaction with the plan.

Line 25a. Check the box that best characterizes the prohibited transaction for which an excise tax is being paid. A prohibited transaction is discrete unless it is of an ongoing nature. Transactions involving the use of money (loans, etc.) or other property (rent, etc.) are of an ongoing nature and will be treated as a new prohibited transaction on the first day of each succeeding tax year or part of a tax year that is within the taxable period.

Line 25b, Column (b). List the date of all prohibited transactions that took place in connection with a particular plan during the current tax year. Also list the date of all prohibited transactions that took place in prior years unless either the transaction was corrected in a prior tax year or the section 4975(a) tax was assessed in the prior tax year. A disqualified person who engages in a prohibited transaction must file a separate Form 5330 to report the excise tax due under section 4975 for each tax year.

Line 25b, Columns (d) and (e). The *amount involved* in a prohibited transaction means the greater of the amount of money and the fair market value (FMV) of the other property given, or the amount of money and the FMV of the other property received. However, for services described in sections 4975(d)(2) and (10), the amount involved only applies to excess compensation. FMV must be determined as of the date on which the prohibited transaction occurs. If the use of money or other property is involved, the amount involved is the greater of the amount paid for the use or the FMV of the use for the period for which the money or other property is used. In addition, transactions involving the use of money or other property will be treated as giving rise to a prohibited transaction occurring on the date of the actual transaction plus a new prohibited transaction on the first day of each succeeding tax year or portion of a succeeding tax year which is within the taxable period. The *taxable period* is the period of time beginning with the date of the prohibited transaction and ending with the earliest of:

1. The date the correction is completed,
2. The date of the mailing of a notice of deficiency, or
3. The date on which the tax under section 4975(a) is assessed.

See the instructions for *Additional tax for failure to correct the prohibited transaction*, under Part IV for the definition of correction.

Failure to transmit participant contributions. For purposes of calculating the excise tax on a prohibited transaction where there is a failure to transmit participant contributions (elective deferrals) or amounts that would have otherwise been payable to the participant in cash, the amount involved is based on interest on those elective deferrals. See Rev. Rul. 2006-38.

Column (e). The initial tax on a prohibited transaction is 15% of the amount involved in each prohibited transaction for each year or part of a year in the taxable period. Multiply the amount in column (d) by 15%.

Additional tax for failure to correct the prohibited transaction (Section 4975(b)). To avoid liability for additional taxes and penalties, and in some cases further initial taxes, a correction must be made within the taxable period. The term *correction* is defined as undoing the prohibited transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

If the initial tax is not corrected within the taxable period, an additional tax equal to 100% of the amount involved will be imposed under section 4975(b). Any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such) must pay this tax imposed by section 4975(b). Report the additional tax on line 6b.

Line 26. If the "No" box is checked on line 26, there has not been a correction of all of the prohibited transactions by the end of the tax year for which this Form 5330 is being filed. Attach a statement indicating when the correction has been or will be made.

Part V

Schedule of Other Participating Disqualified Persons and Description of Correction

If more than one disqualified person participated in the same prohibited transaction, list on this schedule the name, address, and social security number or employer identification number of each disqualified person, other than the disqualified person who files this return.

Line 27. For all transactions complete columns (a), (b), and (c). If the transaction has been corrected, complete columns (a) through (e). If additional space is needed you may attach a statement fully explaining the correction and identifying persons involved in the prohibited transaction.

Correcting certain prohibited transactions. Generally, if a disqualified person enters into a direct or indirect prohibited transaction (listed in items 1 through 4 below) in connection with the acquisition, holding, or disposition of certain securities or commodities, and the transaction is corrected within the correction period, it will not be treated as a prohibited transaction and no tax will be assessed.

1. Sale or exchange, or leasing of any property between a plan and a disqualified person.
2. Lending of money or other extension of credit between a plan and a disqualified person.
3. Furnishing of goods, services, or facilities between a plan and a disqualified person.
4. Transfer to, or use by or for the benefit of, a disqualified person of income or assets of a plan.

However, if at the time the transaction was entered into, the disqualified person knew or had reason to know that the transaction was prohibited, the transaction would be subject to the tax on prohibited transactions.

For purposes of section 4975(d)(23) the term *correct* means to:

- Undo the transaction to the extent possible and in all cases to make good to the plan or affected account any losses resulting from the transaction, and
- Restore to the plan or affected account any profits made through the use of assets of the plan.

The *correction period* is the 14-day period beginning on the date on which the disqualified person discovers or reasonably should have discovered that the transaction constitutes a prohibited transaction.

Rev. Rul. 2006-38	COMPUTATION OF FIRST TIER (15%) PROHIBITED TRANSACTION EXCISE TAX WHEN PAYMENTS TO THE PLAN ARE NOT TIMELY REMITTED

Facts

- Employer X sponsors a calendar year profit-sharing plan that is qualified under Section 401(a) of the Internal Revenue Code and contains a qualified cash or deferred arrangement described in Section 401(k).
- Employees of Employer X are paid on a payment date following the close of each payroll period.
- Pursuant to the terms of the plan, during a specific payroll period, a portion of the pay of each employee was withheld from his or her pay in accordance with a cash or deferred election made by the employee.
- The aggregate amount withheld for all employees for that payroll period totaled $100,000.
- ***Failure spanned 2 years ... 2004-2005.*** Although Employer X could reasonably segregate this amount from its general assets and transmit it to the plan on Dec. 8, 2004, Employer X failed to do so, and it did not correct the failure until Dec. 30, 2005.
- The interest rate for underpayments under Section 6621(a)(2) was 5 percent on Dec. 8, 2004, and on Jan. 1, 2005.

Law & Analysis

Two Tier Excise Taxes	• Section 4975(a) imposes a 15% excise tax (the first tier excise tax) on a prohibited transaction. • In addition, Section 4975(b) imposes a 100% excise tax (the second tier excise tax) on a prohibited transaction if that prohibited transaction is not corrected during the taxable period. • The tax applies to any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such). • Under Sec. 4975, the applicable excise tax is applied to the ***amount involved*** in the prohibited transaction.
Prohibited Transactions	• A prohibited transaction includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. [Sec. 4975(c)(1)(D)] • A prohibited transaction also includes any act by a disqualified person who is a fiduciary whereby the fiduciary deals with the income or assets of a plan for his or her own interest or for his or her own account. [Sec. 4975(c)(1)(E)] ◆ The definition of a disqualified person includes an employer any of whose employees are covered by the plan. [Sec. 4975(e)(2)]
Definitions	• The term ***"amount involved"*** is defined generally, as the greater of (1) the amount of money and the fair market value of the other property given or (2) the amount of money and the fair market value of the other property received in such transaction. [Sec. 4975(f)(4)] • ***Fair market value.*** ◆ For purposes of the first tier excise tax, the fair market value is determined as of the date on which the prohibited transaction occurs. ◆ In contrast, for purposes of the second tier excise tax, the fair market value is the highest fair market value during the taxable period described in Sec. 4975(f)(2). • The term ***"taxable period"*** is defined as the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of ... ◆ The date of the mailing of a statutory notice of deficiency, ◆ The date on which the first tier excise tax is assessed, or ◆ The date on which correction of the prohibited transaction is completed. [Sec. 4975(f)(2)] • The term ***"correction"*** is defined as undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards. [Sec. 4975(f)(5)]
Other Considerations	• ***Use of money.*** Where the transaction involves the use of money or other property, the ***amount involved*** is the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used and the amount involved is determined for the entire period that the money or other property is used. [Reg. Sec. 53.4941(e)-1(b)(2)(ii)] • In addition, in the instance of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the use occurred. [Reg. Sec. 53.4941(e)-1(e)(1)] ◆ Where principal and interest already have been repaid, the amount involved is the principal times the percentage that constitutes the fair market value of the use of money on the date of the transaction for each year or partial year in the taxable period. [Reg. Sec. 53.4941(e)-1(b)(4), Example (2)] • ***Transactions spanning multiple taxable years.*** Where a prohibited transaction spans multiple taxable years, if interest is not repaid in a given year, that interest is added to the principal amount in (i.e., as of the beginning of) the subsequent year. [Rev. Rul. 2002-43, 2002-2 C.B. 85]

Rev. Rul. 2006-38	**COMPUTATION OF FIRST TIER (15%) PROHIBITED TRANSACTION EXCISE TAX WHEN PAYMENTS TO THE PLAN ARE NOT TIMELY REMITTED**

When Withheld Contributions Become Plan Assets	• Amounts withheld from a participant's wages for contributions to a plan become plan assets as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. [Section 2510.3-102 of the Department of Labor Regulations] • In the case of a Section 401(k) plan, in no event does the date on which such contributions become plan assets occur later than ... ◆ The 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash ... i***n the case of amounts withheld by an employer from a participant's wages***, or ◆ The 15th business day of the month immediately following the month in which the participant contributions are received by the employer ... in the case of amounts that a participant or beneficiary pays to an employer.

Calculation

- In the facts above, the failure to transmit the contribution until Dec. 30, 2005, constitutes a prohibited transaction for 2004 and a prohibited transaction for 2005 under Section 4975(c)(1).
  - For the 2004 prohibited transaction ...
    - The ***amount*** involved is interest on $100,000 from Dec. 8, 2004, to Dec. 31, 2004, and
    - The ***taxable period*** begins on Dec. 8, 2004 and ends on Dec. 30, 2005 (date of the correction).
  - For the 2005 prohibited transaction ...
    - The ***amount*** involved is interest on the new balance owed to the plan after increasing the principal as a result of there not being a correction of the 2004 prohibited transaction, and it is calculated from Jan. 1, 2005, to Dec. 30, 2005.
    - The ***taxable period*** begins on Jan. 1, 2005 and ends on Dec. 30, 2005 (date of the correction).
- For purposes of calculating the Section 4975 excise tax (on a timely filed Form 5330) for a failure to transmit participant contributions ..., the interest rate for underpayments described in Section 6621(a)(2) on the date of the prohibited transaction is an appropriate rate used to calculate the amount involved.

Calculation of the Amount Involved

- For this purpose, the amount involved if an employer does not timely pay the participant deferrals or contributions to a qualified plan is based on interest on those elective deferrals.
- The following illustrates the application of the 5% interest rate to the facts above (and taking into account only the first tier excise tax):

Date	Principal	Interest Rate	Time	Amount Involved
12/8/2004	$ 100,000	0.05	0.0628415	$ 314
1/1/2005	100,314	0.05	0.9972602	5,002

Calculation of the Section 4975 First Tier Excise Tax

Act #	Date of Prohibited Transaction	Taxable Period	2004 Taxable Year	2005 Taxable Year
1	12/8/2004	12/8/04 to 12/30/05	$ 314	$ 314
2	1/1/2005	1/1/05 to 12/30/05	-	5,002
			$ 314	$ 5,316
			x .15	x .15
			$ 47	$ 797

- The Section 4975(a) first tier excise tax totals $844 ($47 + $797).

Other Problems	• Note: This example does not address ... ◆ The computation of any interest or penalties for late filing or late payment of tax. ◆ The calculation, or applicability, if any, of the second tier excise tax.
Citation	• Revenue Ruling 2006-38 (2006-29 I.R.B. 80)

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

This topic and area of the law continues to be among the most significant that the IRS is pursuing in terms of its application to auto dealerships. But, auto dealerships are just one example out of a large class of businesses in our economy that would like to obtain the benefits under Section 62(c) of the payment of tax-free income to their employees.

Evidence of the IRS' tenacious concern over potential abuse in the application of Section 62(c) continues. Our 2007 year-end update considers three developments ... (1) recent remarks by the IRS MVTA at the 2007 AICPA auto dealership conference, (2) Revenue Ruling 2006-56 and, most importantly, (3) ILM 200745018.

1. REMARKS BY IRS MOTOR VEHICLE TECHNICAL ADVISOR AT 2007 AICPA NATIONAL AUTO DEALERSHIP CONFERENCE

Ms. Terri Harris' update comments at the 2007 AICPA National Dealership Conference clearly emphasized the IRS enforcement and policing in this area. The text of the slides that Ms. Harris used in her comments on tool plans appears on the facing page.

2. REVENUE RULING 2006-56

This Ruling was issued in late 2006 in the context of employer per diem allowances to employees in the trucking industry. This factual background, therefore, involves a situation where the law allows employees to receive fixed amount per diem allowances or minimums.

What is significant about Rev. Rul. 2006-56 is its holding that the failure of the arrangement to treat the excess allowances as wages for employment tax purposes causes ***all*** payments made under the arrangement to be treated as made under a nonaccountable plan.

In this Ruling, the employer's expense allowance arrangement had no mechanism or process to determine when an allowance paid to an employee exceeded the amount that could be deemed substantiated. In this case, the employer's arrangement routinely paid allowances to employees that were in excess of the amount that could be deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount.

The holding in Rev. Rul. 2006-56 should come as no surprise, especially in the context of the facts and holding in Revenue Ruling 2005-52 (analyzed in the September 2005 issue of the *Dealer Tax Watch*) which was addressed specifically to auto dealership technician tool plans.

Rev. Rul. 2006-56 is analyzed on pages 51-52.

3. ILM 200745018

More recently, in November 2007, the IRS released ILM 200745018 which was dated August 2, 2007. This ILM was authored by the Branch Chief, Employment Tax Branch 1 (Exempt Organizations/ Employment Tax/Government Entities ...TEGE).

The plan involved in this ILM was set up in the context of an employment situation where the employer's service technicians were required to provide their own tools as a condition of employment. The exact nature of the employer's business is not specified in the ILM. During the 4-year period (2003 through 2006) that the plan was under IRS audit, it underwent several modifications and facelifts.

The ILM's conclusion was that the employer's plan for technicians did not qualify for the tax-free benefits available under Section 62(c) for reimbursements under accountable plans. Therefore, all amounts paid to the employee technicians under the Employer's Tool Plan would have to be ... (1) included in the technician's gross income, (2) reported as wages or other compensation on the technician's Form W-2 and (3) subject to withholding and payment of employment taxes.

IMPORTANCE OF THIS ILM CANNOT BE OVERSTATED

This document provides a clear indication of the technical arguments available to the IRS. It contains perhaps the most complete statement, to date, of the position that the IRS is now taking - and can be expected to take - to challenge dealership technician tool plans. The ILM fully discusses the issue of "wage recharacterizations" as a recurrent theme. Furthermore, its analysis integrates both *Namyst* decisions (Tax Court and Appeals) and Revenue Ruling 2005-52 into the overall discussion.

The ILM differentiates the situation the IRS addressed in Rev. Rul. 2005-52 insofar as that Revenue Ruling did not discuss how an arrangement intending to reimburse tool expenses can satisfy the business connection requirement. In the ILM, the IRS stated, "... Accordingly, Rev. Rul. 2005-52 did not address the prohibition against wage recharacterization nor the level of detail necessary to establish the requisite connection between the expense and the employee's job. Such analysis was not necessary in light of the

see **SECTION 62(c)**, page 36

Section 62(c) Accountable Plans	***EMPLOYEE TOOL & EQUIPMENT PLANS*** ***PRESENTATION SLIDES*** ***BY TERRI S. HARRIS ... IRS MOTOR VEHICLE TECHNICAL ADVISOR***

What Is a Tool Plan?
(Slide #17)
	• A program intended to compensate technicians and trades people, who are required to provide their own tools, for both their labor and the use of their tools.
	• Technicians are provided with two checks…
	  ◆ Labor payments from the employer
	  ◆ Tools payment through plan providers
	• Programs purport to comply with the accountable plan rules of IRS 62(c).

Typical Programs (Slide #18)	• Characterize a portion of the technicians' compensation as reimbursement for tools rather than as wages. ◆ Avoiding both employment and income taxes on the tool payment amount. • Tool & equipment payments are paid based on an hourly rate. • Combination of tool rate and labor rate generally remains the same as prior rate after the implementation of the plan.
Wage Recharacterization Example (Slide #19)	• Employer S pays its engineers $200 a day. • On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer's travel expenses. • Because Employer S would pay en engineer $200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section (part of business connection). • No part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. • All payments under the arrangement ware treated as paid under a nonaccountable plan. • Employer S must report the entire $200 as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the entire $200 when paid.
Programs Are Currently Being Marketed to … (Slide #20)	• Auto and Truck Dealerships • Aviation techniques • Rig Welders • Construction Workers • Heavy Equipment and Farm Implement Dealers • Electrical, HVAC, plumbing contractors and repairmen

IRS Significant Concerns
(Slide #21)
	• The Service has significant concerns with tool plans under the accountable plan rules.
	  ◆ This concern focuses on that some/many of these plans may just be wage recharacterization plans.
	  ◆ The plans also may not meet the other accountable plan requirements.
	    ▪ Business connection
	    ▪ Substantiation
	    ▪ Return of excess

Revenue Ruling 2005-52
(Slide #22)
	• Rev. Rul. 2005-52 addressed plans as they existed at the time, but did not ultimately resolve all of the concerns.
	  ◆ Industry mistakenly thinks it doesn't apply.
	  ◆ Plans have adapted a bit to add substantiation-sounding concepts to plan.

Aggressive IRS Responses to Plans
(Slides #23-24)
	• The Service has established a cross divisional and cross functional team to address the issues.
	  ◆ The team includes members of Examination and Counsel functions of SBSE, TEGE, and LMSB as well as Chief Counsel in a coordinated process.
	• There are promoter exams underway and we are obtaining client lists using summons enforcement mechanisms if necessary.
	• Employer examinations are starting as a result of obtaining client lists.
	  ◆ To the extent plans do not meet the accountable plan rules, there will be assessments.

IRS Guidance (Slide #25)	• Taxpayers are encouraged to take a cautious approach to tool plans and not to take "IRS-approved" statements at face value. • The Service is reviewing the Coordinated Issue Paper last issued in 2000 and will update it to address the latest derivations of the tool plans.

(Continued from page 34)

tool allowance's failure to satisfy the equally fundamental requirements of substantiation and return of excess."

Well ... The ILM takes care of that ... thoroughly.

PLAN FAILED ALL 3 REQUIREMENTS

In the ILM, the IRS concludes that the tool plan fails each of the three requirements of business connection, substantiation and return of excess.

After analyzing only the first requirement for compliance with Sec. 62(c) ... business connection ... the ILM author(s) state, "...The failure to satisfy the business connection requirement is sufficient to disqualify the Tool Plan as an accountable plan and to require treatment of all payments made under the Tool Plan as taxable wages. ***However, for purposes of providing a complete legal analysis, we will also address whether the Tool Plan satisfied the substantiation and return of excess requirements.***" [emphasis added]

Because this ILM thoroughly analyzes all three requirements ... despite the fact that it could have stopped after analyzing the first requirement ... it provides great insights on many levels.

The ILM states that the tool plan under audit failed the business connection and return of excess requirements, both in design and operation. As to the substantiation requirement, the ILM holds that, though the tool plan (as outlined in the plan materials) may appear to contain elements that satisfy the substantiation requirement, it (i.e., the plan) was insufficient in both design and in operation, and therefore, the plan also failed the substantiation requirement.

PATTERN OF ABUSE ... CLEAR & CONSISTENT

Then, the ILM goes further and brings the "pattern of abuse" element into its analysis.

In discussing the "pattern of abuse," the ILM states, "We [the IRS] also note that, in addition to violating the basic requirements of an accountable plan, (namely substantiation, business connection, and return of excess), the plan as adopted by the employer and as administered by the promoter may also evidence a pattern of abuse under Reg. Sec. 1.62-2(k), requiring the treatment of payments made under the plan as made under a nonaccountable plan.

"***These violations were not isolated errors with regard to a particular technician or particular period of time or type of tool. They are routine and fundamental to the design of the tool plan, where the goal is to ensure that the gross pay of each technician never changes, by altering the compensation structure so that the amount of wages decreases by the same amount "reimbursed" in order to save on income and employment taxes that otherwise should be withheld and paid.***

"The accountable plan rules were not meant to allow taxpayers to avoid paying taxes on their wages, even if for a short period of time, in the guise of expense reimbursement."

An abuse of the accountable plan rules was evidenced by the plan's practices of (1) routine reimbursement of unsubstantiated expenses and (2) recharacterizing wages as reimbursement until expenses are reimbursed, only to reinstate the original compensation amount at that point.

ILM CONCLUSION

The ILM concludes that, in light of the plan's failure to satisfy any of the three requirements for an accountable plan ***and the pattern of abuse evidenced by its structure and operation***, the employer's reimbursements to its employee technicians did not satisfy the requirements of an accountable plan under Section 62(c). Therefore, these "reimbursements" were to be treated as paid under a nonaccountable plan.

FINAL THOUGHTS

One might infer that this ILM (which concludes that the plan was "abusive" and refers to some of those involved with its operations as "promoters") reflects the background for the controversy with the ominous "promoter" overtones that we discussed in our June 2007 *DTW* update on tool plans.

Interestingly, the ILM does not discuss the possibility of Section 6662 accuracy penalties nor does it discuss the possibility of (old) Section 6694 tax return preparer penalties.

Because of the overall significance of ILM 200745018, we have devoted a great deal of space and attention on the following pages to the facts in the case (pages 37-41) and to the IRS' analysis of those facts (pages 42-45). If you are already familiar with all of the legal citations, you can easily skip over the discussion of law (pages 46-50) which we have included as supplementary information, along with the discussion on pages 51-52 of Revenue Ruling 2006-56.

Facts	***ILM 200745018 … Tool Reimbursement Plan Is a Nonaccountable Plan*** ***Pattern of Abuse, Fully Taxable Payments, Promoter Involvement***
General	• The Employer's employee service technicians (Technicians) are required to provide their own tools as a condition of employment. The tools used may range from simple wrenches to sophisticated power tools and computer analysis equipment. ◆ Prior to the years at issue, Technicians had been compensated solely on an hourly wage basis, with no specific amount attributed to the provision of tools or other factors related to their employment qualifications. ◆ In late 2002, the Promoter approached the Employer regarding implementation of the Promoter's program (Tool Plan) as a tax savings opportunity related to the reimbursement of Technicians' tool expenses without requiring the Employer to pay to the Technicians any additional cash over their hourly wages.
Projected Tax Savings & Enrollment Forms	• The Employer completed a number of forms to permit the Promoter to determine projected tax savings and to enroll in the Tool Plan. ◆ As part of this enrollment process, Technicians were asked to estimate their tool inventory value. • From the estimates and other information provided by the Employer, such as the hourly wage rate of each eligible Technician, the Promoter then compiled a benefit analysis for Employer to determine projected the Employer savings. ◆ However, the Promoter increased each estimated inventory value by $2000 to reflect an estimate of the Promoter's administrative fee that would be charged to each Technician and treated as an expense covered by the Tool Plan. ◆ Once the Employer chose to implement the Tool Plan in early 2003, eligible Technicians could participate at their option by completing and signing an enrollment form.
Minimum Participation Level & Acceptance	• The plan materials state that to become a Tool Plan participant, a Technician must average a minimum of 20 hours of employment per week and have a minimum of $1,000 worth of "qualifying expenses." ◆ The Tool Plan materials state that the following may be claimed as employee business expenses … "all tools required as a condition of employment, all ordinary and necessary trade and business expenses incurred by the employee in furtherance of his employer's business, such as uniforms, safety clothing and gear, training and certification, travel and lodging to obtain training and certification, insurance on tools, and maintenance of tools, equipment, and uniforms, etc., interest paid on tools, personal property taxes paid on tools, and the replacement cost of tools lost, stolen, or damaged." ◆ We (i.e., the IRS technicians involved with writing the ILM) are not certain how these non-tool expenses were claimed by the Technician and incorporated into the Tool Plan. • After receiving a Technician's enrollment form, the Promoter notified the Technician of his acceptance as a plan participant and the amount of the Tool Benefit he would receive, if any. ◆ The Technician's Tool Benefit amount was based on the information provided on the enrollment form, as described further below.
Tool "Inventory" Lists	• The enrollment form (in the years 2003, 2004 and part of 2005) asked the Technician to list the tools the Technician was "required to provide, hold liability insurance for, keep, and maintain for purposes of [the Technician's] job" and to provide the cost of each category of tools. ◆ Technicians were asked to sign the form, which included a statement that "the information contained here is accurate to the best of my knowledge and, if required, full substantiation can be provided." ◆ Although the enrollment form asked the Technician to sign a statement that "I only use the above listed tools/equipment for my employer's business related activities," the Employer has not provided any evidence that it verified whether the tools listed by a Technician were actually required for or used in the Technician's employment with the Employer.

Facts	***ILM 200745018 … Tool Reimbursement Plan Is a Nonaccountable Plan Pattern of Abuse, Fully Taxable Payments, Promoter Involvement*** Page 2 of 5
No Date of Acquisition Or Other Information Follow-up	• The enrollment form did not ask for any information regarding date of acquisition of the tools in order to determine when the listed cost may have been paid. • The enrollment form asked the Technician for information regarding any depreciation taken by the Technician for the listed tools. • Other Tool Plan materials indicated that the Employer may have asked Technicians whether any prior reimbursements had been received for such tools. • However, the Employer has not provided any evidence that the Technician provided this information or that the Employer made any attempt to otherwise determine if Technician had recovered any tool cost through depreciation or previous reimbursement. ◆ The Promoter has stated that its procedure was to ask each Technician to either provide copies of the prior four year's tax returns or sign a Form 4506T which would allow the Promoter to access tax return information from the IRS to verify whether the Technician had previously claimed a tax deduction based on the tools listed on the Tool Inventory as either an itemized deduction on Form 1040, Schedule A, or as a business expense deduction on Schedule C. ◆ Neither the Employer nor the Promoter has provided any evidence that it obtained signed Forms 4506T or the tax return information.
Receipts, Records, (Lack of) Documentation	• The Promoter's materials stated that the Tool Plan asked for receipts or documentation related to the acquisition of the tools, if available, however, the Employer has not provided any evidence that it ever requested or obtained this documentation or otherwise determined if precise cost information was available. • The Promoter claims that it asked each Technician to fill out a form to permit the Promoter to access each Technician's tool purchase records, if any, from certain tool companies. ◆ For the 11 technicians involved with the plan in 2003 through 2005, only four of these forms were identified. • Therefore, the information provided by the Technician on the enrollment form appears to be the only documentation of the Technician's tool expenses. ◆ We (i.e., the IRS technicians involved with writing the ILM) understand that the Technicians may have submitted pictures of their tools to attempt to document their Tool Inventory estimates or subsequent lists of tools on enrollment forms. ◆ We (i.e., the IRS technicians involved with writing the ILM) do not know the relevance placed by the Employer or the Promoter on these pictures to establish the values or costs of Technicians' Tool Inventories. • The Promoter updated its records of the Technician's initial Tool Inventory estimate to reflect the tool costs listed on the form. ◆ However, we (i.e., the IRS technicians involved with writing the ILM) understand that for one or more Technicians enrolled in the Plan, the Employer has not provided any evidence that the Employer ever updated the Technician's initial estimate of tool inventory with tool cost information that would have been listed on an enrollment form if one was completed by the Technician.

Facts

ILM 200745018 … Tool Reimbursement Plan Is a Nonaccountable Plan Pattern of Abuse, Fully Taxable Payments, Promoter Involvement

Late 2005 Enrollment Form Changes

Extensive Lists

Out-of-Date Prices

- In late 2005 the enrollment form changed and was supplemented with an extensive tool inventory list with prices for each tool that could be purchased from certain specific tool companies.
  - The price lists were generally 3 years old.
  - The tool inventory list had another column for the Technician to list tools acquired from other companies.
- The Promoter instructed the Technician to go through the list and insert the number of each tool he had available for use at the place of employment at that time.
  - The Promoter multiplied the number of tools by the price on the list to estimate the cost of the Technician's Tool Inventory.
    - The Promoter's materials reference the Technician's ability to modify the price listed if necessary. Some of the Promoter's materials refer to information establishing the "value" of the Technician's tool inventory.
  - The Promoter then updated its records of the Technician's initial Tool Inventory estimate with the Tool Inventory as determined by the enrollment form and the tool inventory list the Technician had completed.
- As with the previously used enrollment form, the new enrollment form did not ask for any information regarding date of acquisition of the tools or previous cost recovery through depreciation or prior reimbursement.
  - The new enrollment form asked the Technician to sign only that "I will be asked to provide substantiation for *future* expenses on a quarterly basis, which will also be reimbursed through [the Promoter]." [Emphasis added by IRS in ILM text.]
  - Furthermore, while the Promoter's materials stated that the Tool Plan asked for receipts or documentation related to the acquisition of the tools, if available, the Employer has not provided any evidence that it ever requested or obtained any additional documentation for those expenses.
  - The prices listed on the tool inventory list were the only documentation of the Technician's tool expenses for any tools listed on the form.

Promoter Fees

- The Promoter charged a two-part fee for setting up and administering the Tool Plan.
- The Promoter charged the Employer a flat fee per Technician ($50 per Technician joining the Plan) when the Technician signed up.
- The Promoter also charged the Technician an administrative fee of 10% of the computed value of the Technician's Tool Inventory as derived from the enrollment form.
  - In states that do not have an income tax, the Promoter administrative fee was 8% of the computed value of Technician's tool inventory, to reflect the reduced tax savings for employees who enrolled in the Tool Plan in those states versus states that did have an income tax.
  - The 10% amount was added to the Technician's Tool Inventory to arrive at the Total Tool Dollar Amount.
  - By increasing the Technician's Tool Inventory by 10% and then calculating its 10% of the new Total Tool Dollar amount, the Promoter effectively receives a 11% fee of the Tool Inventory amount.

Tool "Benefit" & Tool Rate

- The Tool Plan then calculated the Technician's Tool Benefit based on the Total Tool Dollar amount (i.e., the Tool Inventory plus 10%).
  - The Tool Benefit was paid to the Technician as an hourly reimbursement rate (Tool Rate) over a determined number of reimbursement hours. As a formula, the computation was as follows:
    - (Tool Inventory + 10% fee) / Tool Rate = reimbursement hours
- The Tool Plan determined the Tool Rate as a fixed dollar amount per hour for each Technician.
  - The starting point was 35% of the Technician's current hourly wage, although under the Tool Plan the Tool Rate could not exceed $8.00 per hour, or an amount that [when recharacterized from the Technician's hourly wages] left an hourly wage below the legal minimum wage. For example, the Tool Rate for a Technician receiving compensation of $20 per hour would be 35% of $20, or $7.

| --- | --- |
| ***Technicians Received Two (2) Checks ...***

 But, the Two Checks Added up to the Same Total Hourly Pay as Before | • The number of reimbursement hours for which the Technician would receive the calculated Tool Rate was based on the formula above.
◆ The Technician received the Tool Rate for each hour worked until the reimbursement rate times such hours equaled the Technician's Tool Inventory plus the 10% fee, or the Total Dollar Amount.
• To pay the Tool Benefit, the Employer divided the Technician's compensation into two components ... (1) the hourly wage rate and (2) the hourly Tool Rate.
◆ The sum of the two components equaled the Technician's previous hourly wage.
◆ Once the Total Dollar Amount was paid via the Tool Rate over the number of reimbursement hours, the portion of the Technician's hourly wage that had been recharacterized as a Tool Rate immediately reverted back to part of the hourly wage, so that the Technician always received the same gross wages.
◆ The tax savings promoted by the Tool Plan resulted from treating the Tool Rate portion as nontaxable.
• More specifically, once a Technician enrolled in the Tool Plan, the Employer began making two payments at the end of each pay period.
◆ ***Check #1 ...*** The Employer issued one check to the Technician at the reduced hourly wage rate and treated this amount as wages and withheld income taxes and Federal Insurance Contributions Act (FICA) tax on the amount reported.
◆ ***Check #2 ...*** The Employer made the second payment each pay period to the Promoter based on the determined Tool Rate; the Employer treated this check as not subject to income tax withholding or FICA tax for the employer or the employee.
◆ The Promoter took its fee of 10% of the Total Dollar Amount out of the remitted funds and paid the balance to the Technician as the Tool Benefit.
◆ The Promoter did not treat such amount as wages subject to FICA tax or income tax withholding.
◆ Accordingly, the recharacterized hourly rate was treated as nontaxable income, including the portion paid to the Promoter as the fee.
◆ ***Technicians continued to receive the same amount per hour as they did before the implementation of the Tool Plan, but it was split into two portions ... (1) one portion was treated as wages and (2) the other portion was treated as nontaxable reimbursement for tool expenses and the Tool Plan's administrative fee.*** |
| ***Accounting for Additional Tool Purchases*** | • Technicians could increase their Total Tool Dollar Amount or again participate in the Tool Plan after receiving full reimbursement of their original Total Tool Dollar Amount if they purchased additional tools and submitted a "Tool Purchase Quarterly Update" form.
• Unlike the costs or prices provided on the original enrollment forms, the new tool expenses included on the Tool Purchase Quarterly Update forms required the attachment of receipts or invoices for the expenses listed.
◆ The Promoter added these tool purchases to any balance of the Technician's previously computed Tool Inventory which had not yet been reimbursed.
◆ As the amount paid to a Technician as a Tool Benefit approached the Total Tool Dollar Amount, the Promoter informed the Employer.
◆ The letter (sent to the Employer) indicated how many pay periods were left for payment of the Tool Rate for the calculated reimbursement hours.
▪ If the number was "0," the letter also stated, "[M]ake sure that you do not take any more Tool Plan deduction until further notified. The technician should return to their [sic] regular pay." |

Facts	ILM 200745018 ... TOOL REIMBURSEMENT PLAN IS A NONACCOUNTABLE PLAN PATTERN OF ABUSE, FULLY TAXABLE PAYMENTS, PROMOTER INVOLVEMENT (Page 5 of 5)
Tool Reimbursement Payments to Technicians Were Ongoing	• Generally, a Technician continued to receive his Tool Benefit until he had received an amount equal to his Total Tool Dollar Amount or until he quit. ◆ The records provided by the Employer indicate that some Technicians received amounts as Tool Benefit in excess of their Total Tool Dollar Amounts. • The Employer has not shown that it required the Technicians to repay any excess reimbursements received or that it included these amounts on Forms W-2. ◆ Although the correct reporting of excess amounts would be on a Form W-2, we (i.e., the IRS Technicians involved with writing the ILM) also note that neither the Employer nor the Promoter reported such amounts on a Form 1099. • The Promoter asserts that if a Technician terminated employment, he forfeited the ability to obtain reimbursement of the remaining balance on his Tool Inventory. ◆ However, as a payment made on an hourly basis, such "forfeiture" was consistent with the simultaneous cessation in the payment of hourly wages upon termination.
Further Modification of Tool Plan in 2006	• At the end of 2005, six new Technicians and two Technicians who had received prior reimbursements were signed up for the Tool Plan with benefits starting in January of 2006. • At that time, the Tool Plan had been modified to treat the tool reimbursements as a "lump sum" pre-tax deduction from the technicians' pay check. ◆ The Tool Benefits would no longer be based upon the number of actual hours worked during a particular pay period. ◆ The "lump sum" deduction was determined as follows... ▪ The total hourly wage rate was multiplied by 35% to arrive at the Tool Rate (same as before). ▪ This rate was then multiplied by a set 80 hours per pay period to determine the pre tax "lump sum" deduction. • The Total Tool Dollar Amount (beginning tool inventory for the Technician plus the 10% administrative fee, same as above) was divided by the "lump sum" amount to determine how many pay periods the Technician's benefit would last. ◆ ***Therefore, each "lump sum" deduction and Tool Benefit payment to the employee would be exactly the same for each pay period.*** ◆ The Employer would issue a check each pay period to the Promoter for the total of the "lump sum" payment determined for the Technicians currently receiving benefits. ◆ The Promoter would issue a Tool Benefit check to each Technician after deducting its 10% administrative fee. ◆ The remainder of the prior wage amount was paid to Technician by the Employer and treated as taxable wages.
"Promoter"	• Note: The party administrating the Employer's plan is referred to as the "Promoter" throughout the entire ILM. ◆ An alternative reference to "Promoter" might have been "Third-Party Administrator."
ILM Supplementary Information	• **Analysis** ◆ Business Connection Requirement .... Pg. 42 ◆ Substantiation Requirement .... Pg. 44 ◆ Returning of Excess Requirement .... Pg. 45 ◆ Pattern of Abuse & Final Summation .... Pg. 45 • **Law** ◆ Section 62(c) & *Namyst v. Comm.* .... Pg. 46 ◆ Business Connection Requirement ... *Wage Recharacterization* .... Pg. 47 ◆ Substantiation Requirement .... Pg. 48 ◆ Requirement to Return Amounts in Excess of Expenses .... Pg. 49 ◆ Anti-Abuse Provision .... Pg. 49 ◆ Revenue Ruling 2005-52 .... Pg. 50
See Also	• Revenue Ruling 2006-56 ... *All Per Diem Reimbursements to Employees ... Not Just Excess Amounts ... Are Fully Taxable as Wages* ◆ Issues, Facts & Holding .... Pg. 51 ◆ Law & Analysis .... Pg. 52

ILM 200745018 … Tool Reimbursement Plan Is a Nonaccountable Plan Pattern of Abuse, Fully Taxable Payments, Promoter Involvement

ILM Introduction to Analysis of Employer's Plan

- Based on the facts provided, the Employer's Tool Plan does not satisfy each of the three the requirements of an accountable plan (i.e., business connection, substantiation and return of excess).
- The Tool Plan fails the business connection and return of excess requirements, both in design and operation.
- Though the Tool Plan as outlined in the plan materials may appear to contain elements that satisfy the substantiation requirement, it is insufficient in both design and in operation and therefore also fails the substantiation requirement.

Analysis … Part #1 … Business Connection Requirement

- To satisfy the business connection requirement, the Tool Plan must pay amounts only for deductible business expenses that are actually paid or incurred or are reasonably expected to be paid or incurred.
  - A reimbursement arrangement can also reimburse nondeductible bona fide employee business expenses, but such reimbursements are treated as a separate plan and are includible in income and wages. [Reg. Sec. 1.62-2(d)]
- Additionally, the expenses must be paid or incurred by the Technician in connection with the Technician's performance of services for the Employer, rather than another employer.
  - If amounts are paid regardless of whether the Technician pays or incurs or is reasonably expected to pay or incur expenses, the business connection requirement is not satisfied.
- The ***first failure*** of the plan to satisfy the business connection requirement …
  - The Tool Plan does not require Technicians to provide information sufficient for the Employer to determine the amount of expenses (assuming for purposes of this analysis that all of the tools listed were in fact used in employment with Employer) related to the performance of services for the Employer that properly may be reimbursed.
    - [In contrast,] while Rev. Rul. 2005-52 references the ability for reasonable expectations to establish business connection, that Revenue Ruling does so in the context of a tool allowance provided under a plan that failed to follow up such reasonable expectations with the substantiation and return of excess necessary to satisfy the accountable plan rules.
  - While some versions of the enrollment forms requested information pertaining to prior depreciation and reimbursement of the cost of the tools, there is no indication that this information was actually obtained from the Technicians or taken into account.
  - The enrollment forms also failed to request information on other elements needed to establish business connection (for example when the tools were purchased) that could be used to determine whether the expenses were incurred in connection with employment for a different employer.
  - In fact, we (i.e., the IRS technicians involved with writing the ILM) understand that life-time guarantees, the payment for tools as part of tuition for educational programs, and the sharing of tools mean that it is quite possible in some cases that a complete tool inventory has little or no correlation to the actual types or amounts of expenses that may be related to performing services for the Employer.
    - Also, references in the Tool Plan materials to "value" of inventory may belie the Tool Plan's purported attempts to obtain information about cost.
  - Therefore, the amount that purportedly is being reimbursed under the Tool Plan is not based on the tool expenses incurred in connection with performing services for the Employer.
- The ***second failure*** of the plan to satisfy the business connection requirement … is perhaps more fundamental to the structure of the Tool Plan.
  - The amounts at issue are not reimbursements.
  - Instead, the Tool Plan merely ***recharacterized*** a portion of a Technician's compensation and labeled that compensation as a "reimbursement."
  - The employees (i.e., the Technicians) received the same hourly amount regardless of whether they incurred or would reasonably be expected to incur expenses.
    - The hourly amount was merely broken down into two components and issued via two different payment methods.

Analysis ... Part #1 ... Business Connection Requirement (continued)

- The ***second failure*** of the plan to satisfy the business connection requirement ... (continued)
  - The Technicians continued to receive the same amount of total compensation regardless of the amount of expenses paid or incurred, and the amount treated as wages varied in relation to the amount of the Tool Benefit. [See Rev. Rul. 2004-1.]
  - Under the totality of circumstances, the Plan effectively served to recharacterize as expense reimbursement that which was previously treated as wages and would be treated as wages again once the total Tool Benefit amount had been paid out.
    - In fact, the Plan materials marketed the fact that Technicians' gross compensation would stay the same, with more take-home pay in light of the saved taxes.
    - Under the Plan, once a Technician received his full Tool Benefit, the Technician's "wages" automatically reverted back to its original hourly amount.
  - The fact that the Technician's previous hourly wages may have inherently included some unstated portion to cover any tool expenses does not mean the Tool Plan merely altered a previous "nonaccountable" reimbursement plan into an "accountable" reimbursement plan only to go back to a nonaccountable plan once the entire Tool Benefit was paid.
    - An employer's general intent that the compensation it pays be sufficient to cover any expenses does not create an expense reimbursement arrangement of any sort, even a nonaccountable one.
    - The Employer has not shown that there was any type of reimbursement arrangement in place prior to implementation of the Tool Plan.
- The ***third failure*** of the plan to satisfy the business connection requirement ...
  - An accountable plan may not reimburse an expense that had already been reimbursed, regardless of whether the first "reimbursement" was taxed.
  - Even if the Employer had a taxable reimbursement arrangement (i.e., a nonaccountable plan) prior to implementation of the Tool Plan, the Tool Plan would still need to satisfy all the requirements of the accountable plan rules.
  - Consequently, in order for the Tool Plan to have qualified as an accountable plan, the Employer would have had to distinguish the previously reimbursed expenses, whether reimbursed in full by the Employer or reimbursed in part through depreciation, from any expenses reimbursed by the Tool Benefit.
  - However, the Tool Benefit amount was based on the entire tool inventory cost, including those expenses that purportedly had been reimbursed under the prior nonaccountable plan, and did not identify any previously reimbursed expenses.
- The ***fourth failure*** of the plan to satisfy the business connection requirement ...
  - The gross amount paid to the Technicians prior to implementation of the Tool Plan, the gross amount paid under the Tool Plan, and the gross amount paid once the Tool Benefit Amount had been paid are identical.
    - The only difference is the portion treated as taxable.
    - Accordingly, the facts above evidence impermissible wage recharacterization under the totality of the circumstances surrounding the Tool Plan since the Technicians' gross compensation remained the same and was payable in all events.
- Based on the failure of the Tool Plan to demonstrate the connection between the tools listed and the supposed expenses incurred in performing services for the Employer and the impermissible wage recharacterization, the Tool Plan fails the business connection requirement, both in its design and operation, and does not qualify as an accountable plan.
- The failure to satisfy the business connection requirement is sufficient to disqualify the Tool Plan as an accountable plan and to require treatment of all payments made under the Tool Plan as taxable wages.
- However, for purposes of providing a complete legal analysis, we will also address whether the Tool Plan satisfied the substantiation and return of excess requirements.

Analysis ... Part #2 ... Substantiation Requirement

- Based on the facts provided, the Tool Plan also fails the substantiation requirement.
  - The general substantiation requirement under Reg. Sec. 1.62-2(e)(3) requires the substantiation of the elements of the expense in accordance with Reg. Sec. 1.162-17(b)(4), which includes providing an expense account or other written statement showing the amount and business nature of each expense.
- The Tool Plan fails the substantiation requirement because the plan fails to require substantiation of all of the elements of the expenses.
  - Reg. Sec. 1.62-2(e)(3) requires substantiation of each element of an expenditure or use, including business purpose and amount.
  - The plan does not require substantiation of purchase dates, prior depreciation, prior reimbursements, and other relevant information required to substantiate these elements.
  - To the extent the Tool Plan relied on cost totals for categories of tools without obtaining any information regarding the acquisition date, to determine when the initial expense was incurred, and any depreciation of such tools or prior reimbursement to the Technician, the Tool Plan failed to require the Technicians to substantiate the elements of the expenses so that the Employer could determine which expenses were attributable to its business activities. [See Reg. Sec. 1.62-2(e)(3).]
- The Tool Plan's requirement for receipts for new expenses submitted on the Quarterly Update form, while satisfying substantiation for those particular expenses, does not salvage the substantiation failures in the design or operation of the remainder of the Tool Plan.
- The Employer attempts to rely on the *Cohan* rule for the tools not subject to Section 274(d) to assert that its use of estimates is permissible.
  - The *Cohan* rule allows the use of estimates to establish the amount of expenses not subject to the substantiation requirements of Section 274(d).
  - However, there must be a reasonable evidentiary basis for the estimate. [*Namyst v. Commissioner*]
  - There is no indication that the Employer made any attempt to obtain accurate cost information before relying on estimates.
  - Additionally, there is no reasonable evidentiary basis to establish the other elements of the expenses that the Employer must substantiate ... such as whether the expenses for the tools were paid or incurred in connection with performing services for the Employer or whether any of the cost was previously recovered ..., and no indication that the Employer made any attempt to obtain this information.
- Some of Technicians' tools may include computer components and may be subject to the more rigorous substantiation requirements of Section 274(d).
  - These statutory requirements supersede the *Cohan* rule, and a court may not estimate deductible expenses when the requirements are not met. [*Sanford v. Commissioner*, 50 T.C. 823, 827-828 (1968), aff'd per curiam 412 F.2d 201 (2d Cir.); *Chong v. Commissioner*, T.C. Memo 2007-12.]
  - The Employer and the Tool Plan did not obtain substantiation that would satisfy Section 274(d).
- As a result, the Tool Plan in overall design and operation fails the substantiation requirement, and it does not qualify as an accountable plan for this additional reason.
- Although some specific expenses incurred in connection with performing services for the Employer appear to have been properly substantiated (i.e., the Quarterly Update form), the reimbursement of these expenses nonetheless fails the business connection requirement.

Analysis … Part #3 … Return of Excess Requirement

- All amounts paid under the Plan that were not properly substantiated are treated as excess reimbursements.
- Based on the facts provided, both as designed and implemented, the Employer's reimbursement arrangement does not require that employees actually return any amounts paid in excess of substantiated expenses.
- Furthermore, the facts show that several Technicians received amounts in excess of their Tool Inventory value as calculated by Promoter and were not required to return the additional amounts.
- The Tool Plan therefore does not satisfy the return of excess requirement, either in design or operation, and it does not qualify as an accountable plan for this additional reason.

Analysis … Part #4 … Pattern of Abuse

- We (i.e., the IRS technicians involved with writing the ILM) also note that, ***in addition to violating all three of the basic requirements*** of an accountable plan, ***the Plan*** (as adopted by the Employer and as administered by the Promoter) ***may also evidence a pattern of abuse*** under Reg. Sec. 1.62-2(k), requiring the treatment of payments made under the Plan as made under a nonaccountable plan.
- These violations were not isolated errors with regard to a particular Technician or particular period of time or type of tool.
- These violations were routine and fundamental to the design of the Tool Plan, where the goal is to ensure that the gross pay of each Technician never changes, by altering the compensation structure so that the amount of wages decreases by the same amount "reimbursed" in order to save on income and employment taxes that otherwise should have been withheld and paid.
- The accountable plan rules were not meant to allow taxpayers to avoid paying taxes on their wages, even if for a short period of time, in the guise of expense reimbursement.
- The routine reimbursement of unsubstantiated expenses and the practice of recharacterizing wages as reimbursement until expenses are reimbursed, only to reinstate the original compensation amount at that point, evidence an abuse of the accountable plan rules.

Analysis … Final Summation (Holding)

- In light of the failure to satisfy any of the three requirements for an accountable plan and the pattern of abuse, the Employer's reimbursements to its employee Technicians do not satisfy the requirements of an accountable plan and are to be treated as paid under a nonaccountable plan.
- Therefore, amounts paid to the employee Technicians under the Employer's Tool Plan must be …
  - Included in the Technician's gross income,
  - Reported as wages or other compensation on the Technician's Form W-2, and
  - Subject to withholding and payment of employment taxes.

IRS Legal Memorandum 200745018 from the Branch Chief, Employment Tax Branch 1 (Exempt Organizations/ Employment Tax/Government Entities) … Dated August 2, 2007 … Released November 11, 2007.

ILM 200745018 Denies Accountable Plan Status Under Sec. 62(c)
Citations ... Code, Regulations, Rulings & Cases

Discussion of Law ... Contents

- The ILM 200745018 discussion of law consists of ...

Section 62(c) & *Namyst*

- Section 61 defines gross income as all income, from whatever source derived.
- Section 62 defines adjusted gross income as gross income minus certain identified deductions.
  - Section 62(a)(2)(A) provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement.
  - Section 62(c) provides that, for purposes of Reg. Sec. 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if
    (1) The arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or
    (2) The arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.
- A reimbursement or other expense allowance arrangement satisfies the requirements of Sec. 62(c) if it meets the requirements of ...
  (1) Business connection,
  (2) Substantiation, and
  (3) Returning amounts in excess of substantiated expenses. [Reg. Sec. 1.62-2(c)(1)]
- If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. *See* Reg. Sec. 1.62-2(c)(2).
- Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages on the employee's Form W-2, and are exempt from withholding and payment of employment taxes. *See* Reg. Sec. 1.62-2(c)(4).
- Conversely, if the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan and are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. *See* Reg. Sec. 1.62-2(c)(3) and (5).
- The business connection, substantiation and return of excess requirements apply on an employee-by-employee basis.
  - The failure of one employee to substantiate his expenses would not cause reimbursements to other employees to be treated as made under a nonaccountable plan. *See* Reg. Sec. 1.62-2(i) and *Namyst.*

Namyst ... ***4 Issues & Tax Court Holdings (Affirmed by Appeals Court)***	• Namyst had received significant payments which he omitted from income on the basis of his belief that these amounts were received as payments from his employer under an accountable plan. • ***First...*** Were amounts received by Namyst excludable from his income because they were received under a Section 62(c) accountable plan? ... ***No, the payments Mr. Namyst received were includable in his gross income.*** • ***Second...*** Were the amounts received by Namyst for the sale of his tools includable in his gross income? ... ***Yes, the amounts he received for the sale of tools were includable in gross income.*** • ***Third...*** Did the 6-year statute of limitations under Section 6501 apply? ... ***Yes, the 6-year statute applied because the amounts not reported were large enough to trigger the 25% limitation that extended the statute of limitations from 3 to 6 years.*** • ***Fourth...*** Was Namyst subject to accuracy-related penalties under Section 6662? ... ***No, the accuracy-related penalties did not apply.***
Citations	• *Steven J. and Terry L. Namyst v. Comm.*, T.C. Memo 2004-263 (November 17, 2004) • Affirmed ... U.S. Court of Appeals for the Eighth Circuit, 435 F.3d 910 (8th Cir. 2006) (Jan. 27, 2006)

Business Connection Requirement ... *Wage Recharacterization*

- An arrangement satisfies the business connection requirement if it provides advances, allowances or reimbursements only for business expenses that are allowable as deductions ... and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. [Reg. Sec. 1.62-2(d)(1)]
    - Not only must an employee pay or incur a deductible business expense, but the expense must arise in connection with the employment.
    - If an employer reimburses a deductible tool expense that the employee paid or incurred prior to employment, the reimbursement arrangement does not meet the business connection requirement.
    - Further, if an employer pays an advance or allowance based on an approximation of value or hypothetical expenses ... regardless of whether the employee incurs (or is reasonably expected to incur) the type of deductible business expenses described above ... the reimbursement arrangement does not meet the business connection requirement.
- "Paid or incurred" requires that there be an actual expense, not fair rental value or use, or some other intangible figure, with which the advance, allowance or reimbursement is associated.
    - In the case of an advance or allowance, the payment by the employer may precede the incurring or payment of the specific expense by the employee, assuming the substantiation requirements are met in a timely manner.
- If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer's business, the arrangement does not satisfy the business connection requirement and all amounts paid will be treated as paid under a nonaccountable plan. [Reg. Sec. 1.62-2(d)(3)(i)]
    - A payor arranges to pay an amount to an employee regardless of whether the employee is reasonably expected to incur bona fide business expenses by supplementing the wages of those employees not receiving the reimbursement (so that the same gross amount is paid regardless of the characterization), by reducing the wage payment in light of expenses incurred and paying the same or similar amount as reimbursement allowance to the employee, or by routinely paying a reimbursement allowance to an employee who has not incurred bona fide business expenses.
    - Example 1 of Reg. Sec. 1.62-2(j) illustrates a violation of the this reimbursement requirement by the payment of wages in lieu of a reimbursement allowance to an employee who has not incurred bona fide business expenses.
        - In the example, Employer S pays its engineers $200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of Reg. Sec. 1.62-2(d)(3)(i). Thus, no part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees' Form W-2 and must withhold and pay employment taxes on the entire $200 when paid.
- If a plan serves to recharacterize as a reimbursement allowance amounts previously paid as wages, amounts paid under it will not be treated as paid under an accountable plan.
    - Such recharacterization violates the business connection requirement of Reg. Sec. 1.62-2(c) because the employees receive the same amount regardless of whether expenses are incurred, the only difference being the ratio of the amount treated as taxable wages to the amount treated as nontaxable reimbursement.
        - Rev. Rul. 2004-1 (2004-1 C.B. 325) holds that a reimbursement arrangement that subtracted a mileage allowance (calculated at the standard business mileage rate) from the driver's set commission rate and treated only the remaining commission as wages failed the business connection requirement.
        - The variable allocation between commission and mileage allowance in essence recharacterized as mileage allowance amounts otherwise payable as commission.
        - Consequently, all reimbursement allowances paid under the plan must be treated as paid under a nonaccountable plan, and must be included in the employees' gross income and reported as wages for FICA tax, FUTA tax, etc.
    - The recharacterization as a reimbursement allowance of amounts previously paid as wages violates the business connection requirement of Reg. Sec. 1.62-2(c) regardless of whether the employee actually incurs (or is reasonably expected to incur) deductible business expenses related to the employer's business.
- The prohibition against wage recharacterization does not preclude an employer's prospective alteration of its compensation structures to include reimbursements of substantiated expenses, as long as such amounts, however identified or denominated, are only paid if qualifying expenses are incurred and substantiated.
- ***The presence of wage recharacterization is based on the totality of facts and circumstances so that temporary alterations in compensation structures may in reality be invalid attempts to temporarily shift a portion of an employee's taxable compensation for services into a nontaxable reimbursement with the intent or expectation to shift it back once a certain amount is paid purportedly tax-free.***

Substantiation Requirement

- An arrangement will be treated as meeting the substantiation requirement if it requires each business expense to be substantiated to the payor ... within a reasonable period of time. [Reg. Sec. 1.62-2(e)(1)]
  - What constitutes a reasonable period of time depends on the facts and circumstances of each arrangement. [Reg. Sec. 1.62-2(g)(1)]
- An arrangement that reimburses expenses governed by Section 274(d), meets the requirements of Reg. Sec. 1.62-2(e)(2) if information sufficient to satisfy the substantiation requirements of Section 274(d) is submitted to the payor. [Reg. Sec. 1.62-2(e)(2)]
  - Section 274(d) applies to "listed property" under Section 280F(d)(4). This "list" is limited to items such as property used for transportation including an automobile, computer or peripheral equipment and cellular telephone or similar telecommunications equipment.
  - Most technicians' tools are not listed in Section 280F(d)(4).
  - No deduction is allowed for an expense associated with such property under Section 274(d)(4), and any "reimbursement" of the expense must be treated as wages subject to withholding and payment of employment taxes, unless the taxpayer establishes by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of the expense, (B) the time and place of the use of the subject property, (C) the business purpose of the expense, and (D) the business relationship to the person using the property.
- An arrangement that reimburses business expenses which are not governed by Section 274(d) meets the requirements of Reg. Sec. 1.62-2(e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities.
  - Each of the elements of an expenditure or use must be substantiated to the payor, and it is not sufficient for an employee to merely aggregate expenses into broad categories or to report individual expenses through the use of vague, non-descriptive terms.
- An employee need not report on his tax return expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer, or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. [Reg. Sec. 1.162-17(b)]
  - This Regulation is cross-referenced to Reg. Sec. 1.62-2(e)(3).
  - The term to "account" as used in this Section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses broken down into broad categories such as transportation, meals and lodging while away from home overnight, entertainment expenses and other business expenses.
- The Tax Court addressed the substantiation requirements for an accountable plan in *Namyst v. Commissioner*, in which it stated:

  > "The substantiation rules for business expense deductions under Sections 162 and 274(d) are incorporated by Reg. Sec. 1.62-2(e)(1) through (3), for the purpose of determining whether a reimbursement arrangement constitutes an accountable plan."
- Employers must satisfy record keeping and substantiation requirements for tax benefits they claim.
  - Such records must show a sufficient business connection. [*Chong v. Commissioner*, T.C. Memo 2007-12]
  - Deductions are provided as a matter of legislative grace and the taxpayer has the burden of proving entitlement to them. [*New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934)]
  - When the evidence shows that the taxpayer incurred a deductible expense, but the taxpayer does not have evidence of the exact amount, a court can allow an approximate amount. [*Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930)]
    - However, before the court will apply the "Cohan rule," the record must contain sufficient evidence for the court to conclude that the taxpayer incurred a deductible expense, rather than a nondeductible personal expense, in at least the amount allowed. [Citations omitted.]
    - In applying the Cohan rule, a court is free to disregard testimony of a taxpayer if the testimony is not credible evidence that a deductible expense was incurred. [*Charron v. United States*, 200 F.3d 785, 793 (Fed. Cir. 1999)]

Requirement to Return Amounts in Excess of Expenses

- In general, an arrangement meets the requirement of returning amounts in excess of expenses if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated. [Reg. Sec. 1.62-2(f)]
  - An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the return of excess requirement only if three conditions are met...
    - The amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures,
    - The advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and
    - Any amounts in excess of the expenses substantiated are required to be returned to the payor within a reasonable period of time after the advance is received.
  - An arrangement will not meet the return of excess requirement if it fails to satisfy the substantiation requirement under Reg. Sec. 1.62-2(e) since any amounts paid under the arrangement that are not substantiated are treated as excess and must be returned.

Anti-Abuse Provision

- If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of Section 62(c), all payments made under the arrangement will be treated as made under a nonaccountable plan. [Reg. Sec. 1.62-2(k)]

Revenue Ruling 2006-56

Patterns of Abuse

- If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of Section 62(c) and the Regulations thereunder, all payments made under the arrangement are treated as made under a nonaccountable plan.
- Payments made by employers under such plans are ...
  - Included in the employees' gross income amounts,
  - To be reported as wages or other compensation on the employees' Forms W-2, and
  - Subject to withholding and payment of employment taxes.
- If an arrangement satisfies all three requirements of an accountable plan, but an allowance is paid under the arrangement that exceeds the amount that may be deemed substantiated, no actual substantiation is provided for the meals and incidental expenses (M&IE) covered by the allowance, and the excess allowance is not returned, [then] the excess allowance is treated as wages.
- However, if the facts and circumstances evidence a pattern of abuse of the rules of Section 62(c), including the rule to treat excess allowances as wages, all payments made under the arrangement are treated as wages.

Revenue Ruling 2005-52 (2005-35 I.R.B. 423)

- ***Facts in Rev. Rul.*** The employer paid each employee an hourly wage plus a set amount for each hour worked as a "tool allowance" to cover costs the employee incurred for acquiring and maintaining tools.
  - The employer set each employee's tool allowance annually by using a combination of data from a national survey of average tool expenses for automobile service technicians and specific information concerning tool-related expenses provided by the employee in response to an annual questionnaire completed by all service technicians who work for the employer.
  - Employer then used a projection of the total number of hours the employee was expected to work during the year that would require the use of tools to convert the employee's estimated annual tool expenses into an hourly rate for the tool allowance.
  - Therefore, the tool allowance was an estimate of the tool expense projected to be incurred per hour by the employee over the course of the coming year.
- At the end of each pay period, each employee reported the number of hours worked requiring the use of tools. The employer then multiplied the number of hours reported as worked requiring the use of tools by the employee's hourly rate for the tool allowance and paid the resulting amount to the employee in addition to compensation for services performed during the pay period.
- The employer furnished each employee with a quarterly statement that reported the amount paid to the employee as a tool allowance during the quarter, and the tool expenses estimated to be incurred in the quarter.
- The employees were not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports were issued.
- The employer did not require employees to return any portion of the tool allowance that exceeded the expenses they actually incurred either before or after the quarterly reports were issued.
- ***Holding in Rev. Rul. 2005-52.*** The Revenue Ruling concludes that the arrangement fails to meet both the substantiation and return of excess requirements because it does not require employees to substantiate the actual expenses they incur; rather, the employees report their time worked requiring the use of tools and employer converts the hours into an amount treated as expenses incurred based on statistical data.
- The Ruling provides that although reasonable expectations for expenses can be used to establish that a plan providing an allowance meets the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on actual expenses.
- The Ruling emphasizes that employers may not substitute a reasonable estimate of expenses based on statistical data and hours worked for the substantiation of actual expenses as required by Reg. Sec. 1.62-2(e)(3), absent explicit guidance permitting the use of such "deemed" substantiation.
- The Ruling provides that the employer does not cure the absence of substantiation or return of excess by providing the employees with the quarterly statements, since the employer does not require the employees to provide substantiation of expenses actually incurred, nor does employer require employees to return any excess received within a reasonable period of time after receiving the quarterly statement.
- The Ruling holds that employer does not provide a periodic statement within the meaning of Reg. Sec. 1.62-2(g)(2)(ii).
- The Ruling goes on to provide that, even if employer required its employees to substantiate the actual amount of expenses incurred and treated any excess amount as additional wages, the arrangement would still fail to qualify as an accountable plan.
  - To qualify as an accountable plan, an arrangement must require that amounts paid in excess of substantiated expenses be returned.
  - Simply including excess amounts in wages does not satisfy the requirement of returning amounts in excess of expenses, the exception being where employee expenses are covered through a mileage or per diem allowance pursuant to Reg. Sec. 1.62-2(f)(2).
- Consequently, the ruling holds that the arrangement described is not an accountable plan and all tool allowances paid under the arrangement must be included in the employees' gross income, reported as wages on the employees' Forms W-2, and subject to withholding and payment of Federal employment taxes.
- ***Rev. Rul. 2005-52 distinguished from ILM.***
  - It is important to note that Rev. Rul. 2005-52 did not address how an arrangement intending to reimburse tool expenses can satisfy the business connection requirement.
    - Rev. Rul. 2005-52 did not address the prohibition against wage recharacterization nor the level of detail necessary to establish the requisite connection between the expense and the employee's job.
    - Such analysis was not necessary in light of the tool allowance's failure to satisfy the equally fundamental requirements of substantiation and return of excess.

Rev. Rul. 2006-56

ALL PER DIEM "REIMBURSEMENTS" TO EMPLOYEES ... NOT JUST EXCESS AMOUNTS ... ARE FULLY TAXABLE AS WAGES

Issue & Holding

- ***Issue*** ... ***Whether*** (... under an expense allowance arrangement which has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and which routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all expenses or repayment of the excess amount ...) ***the failure to treat the excess allowances as wages for employment tax purposes causes all payments made under the expense allowance arrangement to be treated as made under a nonaccountable plan.***
- ***Holding*** ... This failure causes all payments made under the arrangement to be treated as wages.
  - *All payments are disqualified from receiving Sec. 62(c) benefit treatment ... not just the "excess" amounts.*

Facts

- The Employer is an employer of long-haul truck drivers in the transportation industry.
- The Employer uses a monthly payroll period and compensates its drivers for their services on a mileage basis.
- For 2006, the Employer pays its drivers compensation of X cents-per-mile driven during each month.
- The Employer reports the compensation on the drivers' Forms W-2 and treats the compensation as wages for Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax and for Federal income tax withholding purposes (collectively, "employment taxes").
- The Employer also reimburses its drivers for meal and incidental expenses (M&IE) paid or incurred while traveling away from home during the monthly payroll period.
  - The Employer reimburses its drivers for these expenses through an allowance for each day the driver is away from home for the Employer's business.
  - For 2006, the allowance is Y cents-per-mile driven.
  - The Employer's industry commonly used this cents-per-mile driven method before December 12, 1989.
- The Employer establishes the Y cents-per-mile rate based on its expectation of the amount of daily M&IE that will be paid or incurred, and its expectation of the average number of daily miles driven during the payroll period.
  - The Employer bases its expectations on reliable industry data and on the Employer's own data from recent years.
  - ***Based on Employer's specific methodology and data, the Employer's projected allowance is reasonably calculated not to exceed the drivers' anticipated daily M&IE.***
- The Employer requires its drivers to provide logs to substantiate the time, place, and business purpose of the travel away from home for each day (or partial day).
  - The Employer does not require its drivers to substantiate the amount of actual M&IE. Instead, for its drivers' substantiation of the amount of M&IE paid or incurred by the drivers, the Employer relies on administrative guidance published annually by the IRS under which the amount of ordinary and necessary business expenses of an employee for M&IE paid or incurred while traveling away from home is deemed substantiated when the Employer provides a *per diem* allowance to cover the expenses.
  - ***Per diem allowances.*** The guidance applicable for *per diem* allowances paid to an employee on or after Oct. 1, 2005, with respect to travel away from home on or after that date, is Rev. Proc. 2005-67, 2005-2 C.B. 729.
- For 2006, the Employer elects to treat $52 per day as the Federal M&IE rate for all localities of travel.
  - Thus, for 2006, $52 or less per day of M&IE paid or incurred by a driver while traveling away from home may be deemed substantiated ... pursuant to Sec. 4.04 of Rev. Proc. 2005-67.
  - ***The allowances paid by the Employer to many of its drivers*** for M&IE incurred on travel away from home during the monthly payroll period ***routinely exceed $52 per day***, even when computed on a monthly basis pursuant to the periodic rule provided in Sec. 4.04 of Rev. Proc. 2005-67.
- The Employer requires its drivers to return any amounts paid to them for M&IE with respect to days they were not away from home on business travel.
  - ***The Employer does not require drivers to return the portion of the allowance paid for days they were away from home on business travel that exceeds the $52 per day that may be deemed substantiated.***
- Neither the policies nor actual practices of the employer's expense allowance arrangement include any process for tracking the amount of the cents-per-mile M&IE allowance paid to each driver on a *per diem* basis, nor is there any mechanism in place to determine when the allowances exceed the amount of expenses that may be deemed substantiated under Rev. Proc. 2005-67.
  - The Employer does not treat the excess allowances over $52 per day as wages for withholding or employment tax purposes, nor does the Employer report the excess allowances as wages on the drivers' Forms W-2.

Rev. Rul. 2006-56

ALL PER DIEM "REIMBURSEMENTS" TO EMPLOYEES ... NOT JUST EXCESS AMOUNTS ... ARE FULLY TAXABLE AS WAGES

Law & Analysis

- *A substantial portion of the law and analysis discussion in this Revenue Ruling has been omitted below because it recites the general provisions in Code Section 62(c) and/or the Regulations thereunder.*
- Under the facts set forth above, the arrangement to reimburse the Employer's drivers for M&IE paid or incurred while traveling away from home meets the ***business connection*** requirement.
  - The Employer is permitted to compute a *per diem* allowance based upon the number of miles driven during the payroll period as that method was commonly used in the Employer's industry before December 12, 1989.
- For purposes of satisfying the ***substantiation*** requirements for 2006, the Employer relies on the special deemed substantiation rules provided for the transportation industry which are found in Sec. 4.04 of Rev. Proc. 2005-67.
- With respect to the ***return of excess*** requirement, the Employer is permitted to pay *per diem* allowances for M&IE paid or incurred while traveling away from home that exceed the deemed substantiated amount without requiring return of the excess. [*See* Reg. Sec. 1.62-2(f)(2) and Sec. 7.02 of Rev. Proc. 2005-67.]
  - ***Under these rules, however, the Employer must take steps to ensure that the excess allowances are tracked and treated as wages subject to withholding and payment of employment taxes and reporting on Forms W-2.***
- In implementing its expense allowance arrangement for 2006, the Employer has not included any mechanism or process that tracks allowances and permits it to determine when the allowances paid to its drivers, computed on a *per diem* basis, exceed the $52 per day that may be deemed substantiated.
  - The Employer does not receive actual substantiation for the M&IE covered by the allowances.
  - The Employer neither requires repayment of the excess allowances nor treats the excess allowances as wages for purposes of withholding and payment of employment taxes and reporting on Forms W-2.
- As operated in 2006, the Employer's expense allowance arrangement routinely results in payment of excess allowances that are not repaid or treated as wages.
- The Employer's failure to track the excess allowances and its routine payment of excess allowances that are not repaid or treated as wages ***evidence a pattern of abuse*** under Reg. Sec. 1.62-2(k).
  - Although the excess allowances that have not been repaid or treated as wages may be small in comparison to the total allowance paid to an individual driver, to the amount that may be deemed substantiated for any given period of travel away from home, and to the aggregate allowances paid to all of the Employer's drivers, ***the Employer's arrangement is neither structured nor operated to meet the requirements of the accountable plan regulations for per diem allowance arrangements.***
- More than just a failure ... Rather, a pattern of abuse.
  - The Employer has more than a failure to account for a particular driver's excess allowance or excess allowances paid to drivers for a particular period of travel.
  - ***The Employer's arrangement evidences a pattern of abuse of the accountable plan rules.***
- ***Accordingly,*** even if the Employer's expense allowance arrangement otherwise meets the business connection, substantiation, and return of excess requirements of an accountable plan for the allowances paid to the Employer's drivers up to the amount that may be deemed substantiated, ***all payments made under the Employer's expense allowance arrangement are treated as paid under a nonaccountable plan.***

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