Willard J. De Filipps, CPA, PC

www.defilipps.com

A Periodic Update of Essential Tax Information

DEALER TAX WATCH

Volume 15, Number 1 Publisher: Willard J. De Filipps, C.P.A. Mid-Year 2008

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. WELCOME TO OUR 15th YEAR OF PUBLICATION. This is the first issue or edition of the *Dealer Tax Watch* under our new schedule for providing you with reliable, practical dealership tax information on a timely, need-to-know basis.

A glance at the Timeline calendar on page 3 will bring you up-to-date on the events and occurrences since our last issue which are discussed in this issue.

#2. THE "NEW" *DEALER TAX WATCH*. Right now, there are only 2 issues (mid-year and year-end) of the *DTW* scheduled for publication in 2008. As you can tell from this issue, I plan to cover the full year's worth of developments in the *Dealer Tax Watch*, but I will be dividing the year's coverage into two (semi-annual) issues, instead of four (quarterly) issues.

Also, whenever a ***major*** development occurs, that development will be the subject of a "Special Edition" issue of the *Dealer Tax Watch*. Obviously, I can't predict the frequency of these Special Edition issues; however, they will contain all of the materials that I would develop for a major seminar presentation.

These Special Editions will be separately priced and offered. In other words, these *Dealer Tax Watch* Special Edition issues are not included as part of your annual subscription cost.

I have made similar changes in the timing and frequency in publishing the *LIFO Lookout*. In this regard, the LIFO pooling issues addressed in Revenue Procedure 2008-23 followed many years of mulling over, consideration and review by the IRS. When it was finally published, this Revenue Procedure was a good example of a major or landmark LIFO development warranting "Special Edition" treatment in the *LIFO Lookout*.

Rev. Proc. 2008-23 became the subject of a separate audio seminar presentation that I gave on April 24, 2008. After that, I developed additional comprehensive materials, case studies and suggested proforma responses for Forms 970 and 3115. All of this - plus more - became the basis for the Special Edition (Spring 2008) of the *LIFO Lookout*.

The *Dealer Tax Watch* will afford similar treatment to other major IRS pronouncements - if they have precedential value. For example, consider the

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

WATCHING OUT FOR

(Continued from page 1)

lengthy and ongoing controversy over how the Section 263A inventory cost capitalization Regulations should be applied to automobile dealerships. This has been a major area of concern that we have tracked over the years in numerous *Dealer Tax Watch* articles.

So far, despite many promises on many occasions, the IRS has failed to issue anything comprehensive or precedential on Section 263A inventory cost capitalization. If the IRS eventually does provide precedential "guidance," that guidance will become the subject of a Special Edition of the *Dealer Tax Watch*.

I just cannot be sure about when the IRS will release anything. This unpredictability, in part, accounts for the change in the timing, frequency and new cost structure for our publications.

#3. AUTO DEALERSHIPS CAN NOW USE A SINGLE, COMBINED LIFO POOL FOR ALL NEW VEHICLES. To date, this is the most important development affecting dealerships in 2008. (And, if your dealerships are not on LIFO, I feel sorry for you because you missed out on an interest-free loan from the Treasury.)

Although my other publication, the *LIFO Lookout*, deals exclusively with LIFO inventory matters, including those affecting automobile dealerships, I don't want to completely ignore major LIFO developments here in the *Dealer Tax Watch* that should be brought to your attention.

Revenue Procedure 2008-23, issued in March, now permits auto dealerships to use a single, combined LIFO pool (instead of requiring two separate pools) for all new vehicles. The Spring 2008 Special Edition of the *LIFO Lookout* discussed all facets of the Revenue Procedure, including how CPAs could help their dealership clients understand and make these changes ... and know the right time to make the change.

I suggest that you do not jump to the knee-jerk conclusions (like those made unequivocally in at least one major CPA firm's newsletter) that all dealerships should automatically make the change for 2007 ... or conversely, that they should wait until 2008.

The change for 2007 can be made either on the calendar year 2007 income tax return when it is filed ... or on an amended return for 2007. The clock is running on a deadline - either September 15 or October 15, 2008 - to make this LIFO change for calendar year 2007 dealerships.

You'll find a brief summary of the Revenue Procedure on page 20 and a letter informing dealers of this development on page 21.

If you'd like to purchase the 60-page Special Edition (Spring 2008) of the *LIFO Lookout* which was devoted to Revenue Procedure 2008-23, you can use the enclosed order form.

#4. WALKING AROUND AT THE NADA CONVENTION. In February, I attended the NADA Convention in San Francisco. This year "walking around" was a little more of a challenge because of the layout of the Moscone Center ... 3 buildings - the North Hall, the South Hall and the West Hall - with exhibitors and meeting rooms on 3 different levels in the West Hall. So, in reality, there were 5 different exhibitor areas to cover.

Despite the logistics, the NADA Convention, as usual, was a great opportunity to renew acquaintances, catch up on the gossip, and pick up on new vendors, products and services.

I made my usual stop at the exhibitor booth that the IRS shared with several other Federal regulatory agencies. On the IRS literature rack, several new *Automotive Alerts* caught my eye.

In addition to the *Alerts* listed on the facing page (see the January listing in the Timeline), the IRS also was liberally dispensing copies of its recent new items list for new vehicle LIFO classification purposes and the full text of ILM 200745018 (which was discussed in full in the Dec. 2007 *Dealer Tax Watch*).

One of these new *Alerts* discusses the IRS' expanding task force ready to challenge tool equipment plans. Another discusses last year's TAM on dealership Section 263A issues. You'll find the full text of both of these *Alerts* in this issue of the *DTW*. These *Alerts* are always good items to bring to your dealership controllers' (or dealers') attention.

#5. IRS - NADA DEALER TAX ISSUE PRESENTATIONS. Ms. Terri Harris (the IRS Motor Vehicle Technical Advisor) conducted a workshop on dealer tax issues at the NADA Convention this year. She also made a similar presentation (in May) in a web seminar for NADA.

I think that the best way to cover all of this for you with minimum repetition and overlap is by means of the material beginning on page 5.

This compares Ms. Harris' coverage of various dealer tax issues in three of her recent presentations ... (1) at the AICPA Auto Dealership Conference in October 2007 in Orlando, (2) at the NADA Convention in February 2008 in Las Vegas and (3) during her web seminar in May 2008. This format allows you to see more easily what she has added or deleted or given greater or lesser emphasis in her presentations.

One big "surprise" in Ms. Harris' presentation during her web seminar in May was LIFO-related. This was directed to those dealers who might think that they terminated their LIFO elections in a bygone →

Calendar	*TIMELINE ... JANUARY 1 TO MID-YEAR 2008*
January	• Several new *Automotive Alerts*, all dated January 2008, are issued by the office of the IRS Motor Vehicle Technical Advisor ... ◆ ***IRC Section 263A** TAM 200736026 Addresses Dealership UNICAP Issues* ◆ ***Electronic Records Retention Requirements** for Auto Dealerships ... Rev. Proc. 98-25* ◆ ***Alternative Motor Vehicle Credit** for Qualified Hybrid Vehicles & Alternative Fuel Vehicles*
January 30	• General Alert issued on IRS Cross-Divisional Team re: ***Employee Tool & Equipment Plans***
Feb. 8 - 12	• At NADA Convention in San Francisco, CA, Ms. Terri Harris (IRS Motor Vehicle Technical Advisor - MVTA) presents a workshop on dealership Federal income tax issues.
Feb. 25	• Cost Segregation (depreciable asset lives) for dealerships is addressed comprehensively in a new chapter added to IRS *Audit Technique Guide.*
March 4	• U.S. Court of Appeals for the 6th Circuit affirmed Tax Court decision in *Huffman, et al.*, allowing IRS to change accountant's errors in LIFO calculations by making a Section 481(a) adjustment to the dealership's earliest open year.
March 8	• IRS permits dealerships to use a single, combined LIFO pool for all new vehicles ... and/or for all used vehicles (Rev. Proc. 2008-23). ◆ Alternatively, IRS clarifies how new and/or used crossover vehicles should be treated by dealerships if they do not elect to use the single, combined LIFO pool method.
March 26	• Sec. 263A ... NADA submission to the IRS requests that non-producer dealership cost capitalization issues be considered for guidance under the IIR Program.
April 2	• In *Irwin Muskat v. U.S.A.*, IRS prevails in District Court, and taxpayers who sold their business are not able to prove that $1 million of the proceeds received under a non-compete agreement were really allocable to goodwill that they sold in connection with their business.
April 16	• In *Solomon v. Comm.*, IRS prevails in Tax Court, and the individual sellers of a portion of their business are not successful in claiming that a portion of the proceeds received were received for the sale of customer lists (which should have been taxed as long-term capital gain). Instead, amounts received were attributable to the sellers' covenants not to compete.
April 24	• De Filipps seminar ... *How Auto Dealership LIFO Inventories Can Benefit by Using the New Single Pool Method* (a 2-hour CCH audio seminar)
May 7	• IRS Chief Counsel's Office issues Memo No. 200825044 ... Guidance on Combining Pools Under Rev. Proc. 2008-23 Vehicle-Pool Method
May 8	• NADA seminar ... *Recent Tax Issues Affecting Auto Dealers* presented by Mr. Paul Metrey (NADA) and Ms. Terri Harris (IRS Motor Vehicle Technical Advisor) (a 2-hour web seminar)
Various	• De Filipps seminar ... *Mid-Year 2008 Dealer Tax Update Tax Strategies & IRS Activities ...* various dates & locations
July 2	• ***Employee tool & equipment plans*** ... IRS issues Coordinated Issue Paper for the Motor Vehicle Industry (based upon Chief Counsel Advice issued in late 2007) ... LMSB-04-0608-037

Dealer Tax Watch Out (Continued)

year by filing Form 3115 with the IRS under the automatic change in accounting method procedures.

Some of these dealerships are now finding out (via a letter from the IRS) that the position of the IRS National Office is that dealership must request to terminate their LIFO elections by using the advance approval procedures. These LIFO terminations are not necessarily automatic. There are problems galore for these dealers.

#6. UPDATE ON SECTION 263A ... IRS GUIDANCE ON COST CAPITALIZATION FOR AUTO DEALERSHIPS. Halfway through this year, there is still nothing concrete to report on this. In the 3 major IRS presentations previously mentioned, Ms. Harris, in essence, had nothing new to report on the ongoing, ever-growing Section 263A controversy that would help you cope with this dilemma in the tax returns you need to file for dealership tax returns for 2007.

So, for the time being, you're on your own in finalizing dealership tax returns for 2007. Don't worry, when the IRS does *finally* come out with something *precedential*, we will analyze it fully for you in a Special Edition of the *DTW*. But until then, just sit tight. And, it's probably best to not make any changes in anticipation of what the IRS *might* say.

see DEALER TAX WATCH OUT, page 4

(Continued from page 3)

The *Automotive Alert* that was released in January 2008 basically just summarized TAM 200736026 (which was discussed fully in the Sept. 2007 *Dealer Tax Watch*).

Meanwhile, NADA has continued its efforts trying to convince the IRS to expand the Section 263A guidance that it said it would release on the so-called "producer" issue. NADA would like the IRS to also provide guidance on many of the other, broader Section 263A (i.e., the non-producer) cost capitalization issues affecting dealerships. In addition, NADA has continued to try to persuade the IRS to "stand down" on cost cap audits involving non-producer issues, many of which surfaced in TAM 200736026.

NADA's request for the IRS to include more Section 263A issues in its Industry Issue Resolution (IIR) Program contains an excellent statement of the status quo. NADA's IIR request is on page 14, and the IRS' *Automotive Alert* is on page 17.

#7. HOW FAST CAN YOU DEPRECIATE DEALERSHIP FIXED ASSETS? In February, the IRS released a Field Directive on cost segregation issues affecting auto dealerships. This Directive added a detailed matrix recommending the categorization and general depreciation lives for dealership expenditures.

Our coverage of this, including my own (more user-friendly) summary tables, begins on page 22 and runs through page 47.

#8. TOOL & EQUIPMENT PLAN UPDATE... BAD NEWS HERE. One topic that Ms. Harris has continued to stress in all of her recent presentations was the IRS' objection to tool and equipment plans.

In January 2008, the IRS published an Employee Tool and Equipment *Alert* warning of a more comprehensive and coordinated attack on "this problem" by the IRS. This *Alert* appears on pages 49.

Subsequently, on July 2, 2008, the IRS published a Coordinated Issue Paper (CIP) for the Motor Vehicle Industry addressing employee tool and equipment plans (LMSB-04-0608-037). This CIP is based on ILM 200745018, and it lays almost all of the IRS' cards on the table.

It should come as no surprise that the general conclusion of the Coordinated Issue Paper would deny accountable plan treatment to most of the auto dealership employee tool and equipment plans. The CIP concludes that ... "as the IRS has seen them to date, employee tool and equipment plans, under which amounts are paid to employees for the use of their tools and equipment, do not meet the accountable plan requirements."

There's a lot of fine print to go through, but most of it closely tracks to the ILM mentioned above, and this was discussed in painful detail in the Dec. 2007 *Dealer Tax Watch*. The revised Coordinated Issue Paper is on pages 50-62.

#9. DE FILIPPS' MID-YEAR DEALER TAX UPDATE SEMINAR. I've recently made several mid-year update presentations to different dealer-CPA groups. I thought you'd be interested in my outline because some of the items that I've included are not in the presentations made by Ms. Harris.

To avoid duplicating a lot of information, I've included only a condensed version of my presentation materials, emphasizing only those which are not discussed elsewhere. My outline begins on page 63.

#10. PERSONAL/INDIVIDUAL GOODWILL IN BUSINESS SALE SITUATIONS ... NEW CASES SHED SOME LIGHT. You'll note that my Mid-Year Update outline includes references to two recent cases bearing on the question of whether there can be individual goodwill (or the sale of other assets resulting in long-term capital gain treatment) in connection with the sale of a business by its individual owner employees.

These cases - *Solomon v. Commissioner* and *Irwin Muskat v. U.S.A.* - were both decided in April. Neither case involved the sale of an automobile dealership, but each is instructive, in its own way, on the question of the sale of personal goodwill.

#11. MAJOR INCOME TAX SAVING OPPORTUNITY IS STILL AVAILABLE FOR DEALERS' DIVIDEND INCOME. The reduced individual income tax rates on long-term capital gains and qualifying dividends (5%-15%) were scheduled to expire in 2008. However, these reduced rates have been extended through 2010. This affords - at least for the present time - tax planning opportunities for dealers and their dealerships.

We have mentioned using various strategies for dealers several times in previous issues of the *DTW*. It's worth keeping this in mind at this time, especially because there could be changes (i.e. increases) in the tax rates in the foreseeable near future.

For more, see the article on page 71.

#12. INDEX OF *DEALER TAX WATCH* ARTICLES THROUGH DEC. 31, 2007. We have updated and expanded our *Index* of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December 2007.

This *Index of Articles* is available for your review on our web site, or, if you prefer, you can contact us for a printed copy.

IRS Presentation Comparisons

DEALER TAX ISSUES ... WHAT'S NEW FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

Ms. Terri Harris (the IRS Motor Vehicle Technical Advisor) is a very popular and much sought after speaker for conferences where auto dealership Federal income tax issues are highly visible and of great concern. In the December *Dealer Tax Watch*, we summarized Ms. Harris' presentation in October 2007 to the AICPA National Auto Dealership Conference in Orlando. Since then, Ms. Harris has made several other presentations including conducting a workshop at the February 2008 NADA Convention in San Francisco and presenting a web seminar for NADA in May 2008.

In reporting on these two NADA-related presentations in February and May, in order to avoid too much repetition and overlap of material, the layout on the following pages compares these presentations, using her presentation at the AICPA Conference in 2007 as the major point of reference. This columnar format allows you to see easily what's been added, deleted or given greater or lesser emphasis. Also, the order of presentation (might) suggest(s) greater depth of coverage or emphasis for the particular audience. Some audiences are better served by general discussion, while others crave more detail.

Obviously, at the time when Ms. Harris is making her presentations, there are other major developments in process within the IRS which she is not at liberty to discuss publicly. Also, keep in mind that her presentations are tailored to the general experience and familiarity levels of the audience members.

Due to the high rate of personnel turnover at the upper / reviewer levels within the IRS, various projects seem to drag on or take forever to come to fruition. (Think: Section 263A cost capitalization here.) Other projects, like the Coordinated Issue Paper on employee tool and equipment plans released July 2008, reflect long gestation periods and have been finalized without the benefit of IIR Program status or consideration.

AGENDA IN ORDER OF PRESENTATION OF TOPICS

October 2007 *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association Convention*	*May 2008* *NADA Web Seminar*
• LIFO Pooling and IIR Process	• Section 263A Inventory Cost Capitalization	• LIFO - Vehicle-Pool Method
• Cost Segregation *ATG*	• LIFO Pooling and IIR Process	• Employee Tool & Equipment Plans
• Section 263A Inventory Cost Capitalization	• Cost Segregation *ATG*	• Cost Segregation Studies
• Employee Tool & Equipment Plans	• Employee Tool & Equipment Plans	• LIFO Terminations ... Automatic vs. Non-Automatic Changes
• Alternative Motor Vehicle Credits	• Alternative Motor Vehicle Credits	• UNICAP (IRC 263A)
• Cash Reporting Team - Form 8300	• Cash Reporting Team - Form 8300	• Questions
• Other Items of Interest *	• Other Items of Interest *	

PRESENTATION COMPARISON SUMMARIES

DEALER TAX ISSUES ... WHAT'S NEW FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
LIFO Pooling & IIR (Industry Issue Resolution) Process	• Industry Issue Resolution (IIR) process was described and discussed. IIR team consists of representatives from ... LMSB & SBSE Examination ... Appeals ... Field Counsel ... Chief Counsel ... Treasury. • 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.	• Basically the same coverage at NADA. • IIR Process consists of ◆ Review and consideration of submissions. ◆ Research and discussion among team members. ◆ Meet with interested external parties. ◆ Develop IIR team recommendation (assuming guidance is warranted). ◆ Brief and receive preliminary approval. ◆ Draft guidance and initiate approval process. ◆ Publication and implementation.	• IIR process was discussed more in the context of what the IRS is not planning to do in connection with Section 263A issues. (See pages 3-4 of 9.) • The IIR Process was credited with resulting in the issuance of Rev. Proc. 2008-23. (See page 8 of 9.)
Cost Segregation ***Audit Technique Guide*** **Depreciation Lives**	• 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, ◆ This will probably be in the form of 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.	• Basically the same coverage at NADA. • Identified the following as specifically being "areas for discussion... ◆ Epoxy flooring ◆ Vehicle display pads ◆ Service area trenches & grease pits ◆ Under-floor exhaust systems ◆ Break room and hospitality-area sinks, cupboards and counters ◆ Parking lot assets including lighting, concrete work and paving ◆ Movable partitions and interior walls	• A new chapter has now been added to the Cost Segregation *Audit Technique Guide* by the LMSB Heavy Manufacturing Industry Director's Directive. ◆ Issued February 25, 2008 ◆ LMSB Control No. 4-0208-006 ◆ Available at www.irs.gov ***[Note: For additional coverage of detail fixed asset classifications & recovery periods, see summary tables and detailed matrix presentations in this issue of the Dealer Tax Watch.]***

DEALER TAX ISSUES ... WHAT'S NEW FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
Section 263A Cost Capitalization General	• 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. • 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. • 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. ◆ 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.	• Basically the same coverage at NADA. • Uncertainty still remains over what the IRS is willing to commit to provide, or not to provide, in issuing guidance that would be binding on the IRS. ◆ Fate of GLAMs and TAMs (other than the one already issued), status for potential IIR Program consideration, "stand-downs" on Sec. 263A audit issues, etc. ... ***["Only the Shadow knows... but it does seem as if the IRS is rapidly backing out the door.]***	• Very detailed coverage on Sec. 263A. ***[Note: For additional discussion of audit issues and potential controversies in the letter NADA sent to the IRS requesting IIR Program consideration, see "NADA Requests More Guidance" in this issue of the Dealer Tax Watch.]***

Dealer Tax Issues ... What's New from the IRS Motor Vehicle Technical Advisor

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
TAM 200736026 Section 263A Cost Capitalization	• Key questions in this TAM 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, the only guidance available is TAM 200736026 ◆ The TAM concludes that the facility of the dealership in question is a dual-function facility. • Although TAM 200736026 (like all other TAMs) "has no 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. ◆ It is reasonable to expect that IRS 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.	• Discussion was much more focused on TAM 200736026 ... probably because the TAM had been in the "general domain" for a few months and CPAs and dealers had some time to recover from initial shock.	• PowerPoint slides include... ◆ Treatment of direct and indirect costs ◆ Application of 263A to property produced by a taxpayer vs. property acquired for resale (including various exceptions) and various definitions ◆ Resellers with production activities ◆ *De minimis* production activities ◆ What direct costs are required to be capitalized ◆ Lengthy (but not all-inclusive) list of types of indirect costs are to be capitalized ... See Regs. ◆ Purchasing cost examples ◆ Purchasing labor cost allocation election (1/3 -2/3 Rule) ◆ Handling cost examples ◆ Storage costs ◆ Simplified computational methods ◆ Key questions to be considered ***[Note: The full text of the Automotive Alert on TAM 200736026 is included elsewhere in this issue of the Dealer Tax Watch.]***

Dealer Tax Issues ... What's New from the IRS Motor Vehicle Technical Advisor

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
Employee Tool & Equipment Plans	• This controversial subject 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 these plans 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 during her presentation. • Some of the information from her PowerPoint slides appears on the following page.	• Basically the same coverage of this subject at NADA. • Reference was made to the *Alert* issued in January 2008 which discusses the new "cross-divisional and cross-functional team" set up by the IRS to address tool plan issues. ***[Note: The full text of the Alert on "Employee Tool & Equipment Plans" is included elsewhere in this issue of the Dealer Tax Watch.]***	• Basically the same coverage of this subject. ***[Note: Undoubtedly, Ms. Harris was aware that a revised Coordinated Issue Paper (CIP) slamming employee tool and equipment plans was just about ready to see daylight. However, she really didn't tip her hand on this imminent development in her AICPA or NADA presentations.*** ***On July 2, 2008, the IRS published the revised CIP for the Motor Vehicle Industry addressing employee tool and equipment plans (LMSB-04-0608-037). This CIP is based on ILM 200745018 and it lays almost all of the IRS' cards on the table.*** ***The general conclusion of the CIP would deny accountable plan treatment to most of the auto dealership employee tool and equipment plans.*** ***The CIP concludes that ... "as the IRS has seen them to date, employee tool and equipment plans, under which amounts are paid to employees for the use of their tools and equipment, do not meet the accountable plan requirements."*** ***This is not good news for most plans.]*** ***[Note: The full text of the revised Coordinated Issue Paper dated July 2, 2008 is included elsewhere in this issue of the Dealer Tax Watch.]***

Dealer Tax Issues … What's New from the IRS Motor Vehicle Technical Advisor

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
What Is a Tool Plan?	• 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).	• See notes on page 5 of 9.	• See notes on page 5 of 9.
Typical Programs	• 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	• 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.		

DEALER TAX ISSUES ... WHAT'S NEW FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
IRS Significant Concerns	• 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	• See notes on page 5 of 9.	• See notes on page 5 of 9.
Revenue Ruling 2005-52	• Rev. Rul. 2005-52 addressed plans as they existed at the time, but did not ultimately resolve all of the concerns. ◆ (Auto Dealer) Industry mistakenly thinks that Rev. Rul. 2005-52 doesn't apply to dealerships. ◆ Plans have adapted a bit to add substantiation-sounding concepts to plan.		
Aggressive IRS Responses to Plans	• 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.		
Programs Are Currently Being Marketed to ...	• Auto and Truck Dealerships • Aviation techniques • Rig Welders • Construction Workers • Heavy Equipment and Farm Implement Dealers • Electrical, HVAC, plumbing contractors and repairmen		
IRS Guidance	• 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.		

Dealer Tax Issues ... What's New from the IRS Motor Vehicle Technical Advisor

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
Revenue Procedure 2008-23 Single LIFO Pool Now Permitted for All New Vehicles	• See comments on page 2 of 9 re: IRS consideration of the LIFO pooling issue. *[Note: Rev. Proc. 2008-23 was not issued until March, 2008.* ***This Revenue Procedure was fully analyzed in the 60-page Spring 2008 Special Edition of the LIFO Lookout.]***	*[Note: Rev. Proc. 2008-23 was not issued until March, 2008.* ***This Revenue Procedure was fully analyzed in the 60-page Spring 2008 Special Edition of the LIFO Lookout.]***	• Provides an alternative dollar-value, LIFO pooling method for: ◆ Retail dealers and wholesale distributors (resellers) of cars and light trucks (14,000 lbs. or less). ◆ Automatic Consent Procedures to change to this method. ◆ Modifies Rev. Procs. 97-36 [New Vehicles] and 2001-23 [Used Vehicles] - (Alternative LIFO Methods for Auto Dealers). • Rev. Proc. is a recognition by IRS & Treasury that distinctions between cars and trucks have diminished since last guidance. • Allows resellers to maintain ***one pool*** for ***new*** cars and light-duty trucks and ***one pool*** for ***used*** cars and light-duty trucks. ◆ Including crossovers and sport utility vehicles ◆ For example: 2 pools rather than 4 ▪ Light-duty trucks: Gross vehicle weight ≤ 14,000 lbs. ▪ Class I, II, III • Elective Method of Accounting ◆ Automatic change for years ending on or after 12/31/07. • Additional guidance sought regarding methods of combining pools. ***[Note: See Chief Counsel Memo 200825044.]*** • Dealers who do not elect the method must comply with prior guidance. ◆ Appropriate selection and consistent use of a pool for crossover vehicles and sport utilities.
LIFO Terminations Automatic Changes vs. Non-Automatic Changes	• Nothing was mentioned in Ms. Harris' presentation about LIFO termination issues.	• Nothing was mentioned in Ms. Harris' presentation about LIFO termination issues.	• Some dealers opting to cease using the LIFO inventory method of accounting. ◆ Some changes in method of accounting require advance permission from the IRS before the change can be made; other changes are automatic. ◆ For LIFO termination - automatic change provisions apply ***only*** if the taxpayer uses the same method (valuation and identification) for its entire non-LIFO inventory. • IRS Office of Chief Counsel has recently denied automatic change status to multiple dealerships. ◆ Dealerships remain on LIFO and may have filed income tax returns using an improper method. • MVTA in contact with Chief Counsel and additional information may follow. ***[Note: This can be/will be extremely problematic for dealers who - for several years - thought they had terminated their LIFO elections and made corresponding repayments, etc.]***

DEALER TAX ISSUES … WHAT'S NEW FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

Presentation Comparisons	*October 2007* *AICPA National Auto Dealership Conference*	*February 2008* *National Auto Dealer Association (NADA) Convention Workshop*	*May 2008* *NADA Web Seminar*
Alternative Motor Vehicle Credits	• Thorough discussion of all four credits found in 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.	• This subject was covered in considerable detail, with PowerPoint slides.	• This subject was not included in the web seminar.
Form 8300 Cash Reporting	• Basic … 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.*	• Basically the same coverage at NADA.	• This subject was not included in the web seminar.
Dealership Electronic Recordkeeping Requirements	• Activity progressing under Rev. Proc. 98-25. ◆ Dealership received a compliance check letter from the IRS. ◆ Vendor will not receive a letter. • Data archiving systems may or may not be in compliance. ◆ Rev. Proc. 97-22 governs archiving. ◆ Compliance with Rev. Proc. 97-22 does not necessarily equal compliance with Rev. Proc. 98-25. • Dealers & CPA should retain tax preparation software and data.	• Basically the same coverage at NADA.	• This subject was not included in the web seminar.
Other Items of Interest	• PORC … Pricing case recently docketed in Tax Court. • Cancellation of Distributor Agreement … Rev. Rul. 2007-37. • Manufactured vehicles are subject to excise tax … TAM 200732015. • Power units installed on tractors are subject to excise tax … LTR 200711006	• Basically the same coverage at NADA.	• These topics were not included. ***[Note: The PORC pricing case docketed in Tax Court could become a very significant issue for dealers with PORC activities.]***

March 26, 2008

Via E-Mail

Internal Revenue Service
Office of Pre-filing and Technical Services
Large and Mid-Size Business Division LM:PFT
Mint Building, 3rd Floor M3-420
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: IIR Program Submission on behalf of NADA

Dear Sir/Madam:

The National Automobile Dealers Association ("NADA") submits the issue outlined below for inclusion in the Industry Issue Resolution ("IIR") Program as provided in Rev. Proc. 2003-36 and announced in IR-2008-31 (March 3, 2008).

NADA represents approximately 20,000 franchised automobile and truck dealers who sell new and used motor vehicles and engage in service, repair, and parts sales. Together our members employ well in excess of 1 million people nationwide. NADA closely monitors federal laws and regulations that impact its members and frequently collaborates with federal agencies on effective ways to streamline and manage the burdens imposed by these requirements.

The general issue we propose for inclusion in the IIR Program is the application of the uniform capitalization rules under section 263A of the Internal Revenue Code ("UNICAP rules") to franchised automobile and truck dealers. The specific UNICAP issues we seek to include are those listed in the attachment that will not otherwise be addressed in the UNICAP guidance on the producer issue that will be issued pursuant to the Department of the Treasury ("Treasury") 2007 – 2008 Priority Guidance Plan ("PGP").

Brief Background

- In recent years, several Internal Revenue Service ("IRS" or "Service") field examiners began applying the UNICAP rules to franchised car and truck dealers in a manner that significantly departs from the way the IRS has applied the rules since they were added to the Internal Revenue Code in 1986. The field examiners' new approach, which has occurred in the absence of a statutory or regulatory change, has led them to conclude that 2 dealers must capitalize, instead of expense, several additional categories of costs associated with their inventories. The field examiners have applied their approach to dealers retroactively, which has resulted in staggering and unexpected proposed income adjustments amounting to hundreds of thousands of dollars. This represents a considerable portion of dealers' after-tax net annual profit.
- This alarming development was prompted by the field examiners' unprecedented determination that dealers are resellers with production activity ("producers") based on service work they perform on, among other things, dealer owned vehicles in their inventories. The field examiners based this approach on the inclusion of the words "install" and "improve" in the Code's definition of "produce."

This caught dealers completely by surprise as: (i) there are no known instances of dealers ever having been classified as producers in the thousands of dealer audits that have occurred since the inception of the UNICAP rules, and (ii) the Service has approved hundreds of dealer applications for a change in accounting method (Form 3115) authorizing dealers to be treated as retailers who can utilize special allocation and *de minimis* rules that do not require capitalization of some or all of these costs.

- In addition to classifying dealers as producers, the field examiners began classifying several dealer transactions, including lease transactions with consumers, as not constituting on-site retail sales. These classifications, which also caught dealers by surprise, require them to capitalize, instead of expense, inventory costs associated with handling and storage activities. Even in audits where field examiners have not pursued the producer issue, dealers' liability exposure on these reseller issues has been considerable. In one audit involving a typical dealership that was brought to our attention, the proposed adjustment stemming from non-producer issues was nearly $700,000.
- These developments prompted NADA to engage IRS and Treasury officials for clarification on the full range of UNICAP issues (both producer and reseller issues, including allowable allocation methods) impacting franchised car and truck dealers. In July 2006, the Service informed NADA that its concerns would be addressed in a Generic Legal Advice Memorandum ("GLAM"), which would be issued alongside a Technical Advice Memorandum ("TAM") involving a franchised car dealer. TAM 200736026 was issued in May 2007 and released in September 2007. The Service, however, never issued the GLAM, opting instead to support the inclusion of the producer issue in the PGP. The PGP, in fact, includes guidance on the producer issue and, we have been informed, the guidance may be released by June 30, 2008.

Current Situation

- As it presently stands, the PGP is the Service's only planned industry-wide UNICAP guidance that will be issued. TAM 200736026 does not address several unresolved producer and reseller issues, and it may not be used or cited as precedent for the issues it does address. The PGP will not address several critical reseller issues, and it is not clear whether it will address all of the unresolved producer issues (including the critically 3 important issue of what constitutes *de minimis* production activity under a facts and circumstances test (26 C.F.R. § 1.263A-3(a)(2)(iii)(A)(1)).
- Against this backdrop, dealer taxpayers today are collectively in a state of confusion concerning the nature, extent, and timing of their UNICAP obligations. Some field examiners who are conducting dealer audits have followed the novel positions mentioned above while others have not, notwithstanding the similarity in the business operations of the audited dealers. This inconsistent enforcement has resulted in a dramatically different tax burden for dealers depending on who has been assigned to conduct their audit. With regard to audited dealers who have received, or expect to receive, significant income adjustments, several have appealed or intend to appeal the adverse determinations.
- This unsettled situation is not confined to dealers presently under audit. Numerous dealer accountants, seeking to minimize the audit exposure of their clients, are attempting to determine whether to request a change in accounting method and, if so, what the request should include. While the forthcoming PGP guidance hopefully will provide direction on several of the producer issues, its limited scope will preclude it from addressing many unresolved reseller issues, including the appropriateness of various allocation methods.

- Unless the Service announces its intention to issue a revenue procedure or another appropriate document that will provide comprehensive, industry-wide guidance beyond the producer issue, it can be expected that the release of the PGP guidance will trigger a flood of dealer requests to the IRS for a change in accounting method. This should come as no surprise as dealer accountants, having received the last (and only) industry-wide guidance to be issued on UNICAP, will move to bring their clients into compliance with the new producer guidance (which, to the extent the guidance follows the approach taken in TAM 200736026, will describe an accounting method that differs from the accounting methods in place at dealerships today). Of course, these Form 3115 requests will not be confined to the issues contained in the forthcoming PGP guidance, but rather will seek to resolve all of the UNICAP issues confronting dealers (i.e., any residual producer issues that are not addressed in the PGP guidance and the full range of reseller issues). Because there presently is no industry-wide guidance on these issues, the 3115 requests will not follow a standard template that lends itself to quick and easy processing. In addition, because the new UNICAP approach likely impacts each of our nearly 20,000 members due to the similarity in their basic operations (i.e., maintaining a service department that installs parts on vehicles in their new and used vehicle inventories), the Service will be confronted not only with significant qualitative differences in the content of the 3115 requests but also with a quantity of requests that could easily overwhelm the resources it can devote to processing them.

Relief Requested

In light of (i) the broad, unresolved, and complex nature of these issues, (ii) the massive number of taxpayers involved, (iii) the significant audit exposure and potential tax liability confronting dealer taxpayers, (iv) the field examiners' inconsistent treatment and enforcement of these requirements, (v) the incomplete industry-wide guidance that will exist even after the PGP 4 guidance is released, (vi) the inadequate administrative mechanisms the Service has in place to respond to the unaddressed issues, and (vii) the likelihood of frequent and ongoing taxpayer disputes over these issues, we believe it is essential that the Service accept the application of the UNICAP rules to automobile and truck dealers (as described in the attachment) into the IIR Program. This is perhaps the only viable process that can produce well informed, comprehensive, and timely UNICAP guidance in a fair and administratively feasible manner.

This certainly is preferable to the alternative, in which taxpayers and IRS field examiners will continue to struggle with these issues and only obtain guidance in piecemeal fashion over a prolonged period of time through the issuance of technical advice memoranda, revenue and letter rulings, appeals determinations, 3115 approvals, court opinions, etc. NADA has participated in the IIR Program on several occasions and is aware of its potential to resolve contentious and complex tax administration issues. We firmly believe the issue we have suggested for inclusion into the Program satisfies all of the selection criteria and warrants the efforts and resources of Service and Treasury officials and industry representatives.

Thank you for considering NADA's request. Please contact me if we can provide you with additional information.

Sincerely,

Paul D. Metrey
Director, Regulatory Affairs
National Automobile Dealers Association

Attachment

IRC §263A

TAM 200736026

Addresses Dealership UNICAP Issues

IRS

Automotive Alert

Motor Vehicle Technical Advisor

January 2008

Introduction

In a September 2007 National Office Technical Advice Memorandum, TAM 200736026, the IRS addressed Uniform Capitalization (UNICAP) issues with respect to a specific automobile dealership.. The TAM is a complex document addressing many UNICAP issues. These issues can be broadly categorized as (1) "Production" issues and (2) "Storage and Handling Costs" issues. Due to the technical nature and number of issues, this document is not intended to be a comprehensive discussion of dealership UNICAP issues. The TAM analyzed one specific dealership and cannot be used or cited as precedent. Nevertheless, the TAM provides insight as to how the Service would interpret similar facts for similarly situated taxpayers. Although non-precedential, an analysis of conclusions in TAM 200736026 should be considered to the extent a dealership's facts and circumstances are similar to those in the TAM.

The Primary Issues

In the "Producer" category, the issues for consideration in the TAM were whether the repair/installation activities relating to dealership owned and/or customer owned vehicles in the dealership's service department constituted production activity (i.e., resulted in the production of property subject to section 263A). This also impacts whether a dealership's repair/installation activities are handling costs as discussed below.

The "Storage and Handling Costs" issues concern whether certain sales (*e.g.*, sales of vehicles to finance companies in cases of customers who lease their vehicles) constitute off-site sales or on-site sales to retail customers and whether the dealership's two locations containing vehicles constitute on-site, off-site, or dual function storage facilities. The transactions considered by the TAM include trade-in vehicles (some of which were subsequently disposed of at auction), dealer trade vehicles, leased vehicles, fleet sale vehicles, and parts sales to various customer categories.

The TAM also addresses many sub-issues related to the primary issues discussed above.

"Producer" Issues

Internal Revenue Code Section 263A defines the term "produce" very broadly. Production activities include construct, build, install, manufacture, develop, or improve. The terms "install" and "improve" are particularly relevant for dealerships. Dealership service and body shops regularly install parts and may improve both customer and dealership owned vehicles. Although dealerships may be involved in a production activity, it is not considered to be producing property subject to section 263A unless it is also the owner of the property. The TAM concludes that because the dealership was the owner of its new and used vehicle inventory, the dealership engaged in production activities relating to those vehicles. The dealership was not the "producer" of customer owned vehicles because it did not have the benefits and burdens of ownership (*i.e.*, the customer did, an artisan's lien notwithstanding).

Dealerships may perform differing levels of repair, installation, and improvement on new and used vehicles. Whether a dealership's activities in servicing new and used vehicles constitute production or handling activities depends on the specific facts. For example, a dealership may install parts to make the vehicle more saleable or replace defective parts to make the vehicle more readily marketable or to add utility to the product. The TAM concluded that "Costs that make property more readily marketable and/or add utility to a product, making it more suitable for use and consumption, are production costs."

The TAM also concluded that some minor activities may not constitute production of property and that to the extent that certain activities are not production activities, the related costs are handling costs and not costs of producing property. The UNICAP regulations require handling costs to be capitalized, unless they are incurred at a retail sales facility with respect to property sold to retail customers at the facility (or the on-site portion of a dual function storage facility). A dealership must consider its activities in light of the conclusions in the TAM. Whether a dealership's activities in servicing new and used vehicles constitute production activities or handling costs depends on the specific facts.

In addition to the items discussed above, the TAM considers subcontractor activities, certain de minimis exceptions, and whether the taxpayer is permitted to use the simplified resale method. In order to fully understand and apply the conclusions in the TAM, these additional issues must be considered.

Storage and Handling Issues

Essentially, a dealership will not be a retail sales facility unless it exclusively engages in on-site sales to the final purchasers of the vehicle. Thus, as a practical matter the second major category of issues addressed in the TAM center around whether the dealership's primary location is a dual function storage facility. A dual function facility is one in which there are both on-site and off-site sales. On-site sales are defined as sales made to retail customers physically present at a facility.

A typical dealership enters into many types of transactions. The TAM considers the following transactions and determines whether they are on-site sales to retail customers. (1) Vehicles taken in trade or purchased at auction and subsequently resold at wholesale; (2) Vehicles sold to another dealership at cost; (dealer trades) (3) Leased vehicles; (4) Vehicles sold as part of a fleet sale; and (5) Wholesale sales of certain parts.

Applying the regulatory definition of on-site sales, the TAM concluded that "...few of the sales under consideration constitute on-site sales to retail customers." The TAM expands on that conclusion by explaining that most of the vehicles in question are not sold to the final purchaser of the merchandise. For instance, most vehicles disposed of on the wholesale market are not sold to the end user. Likewise, the TAM concluded that dealer trades are not sold to the "end user". Finally, the TAM concludes that vehicles leased to customers are sold to an off site leasing or credit company and do not qualify as on-site sales.

Assuming that fleet customers purchase fleet vehicles at the dealership's location, fleet sales do qualify as on-site sales. The TAM also addressed several parts sales scenarios. The reader should refer to the full text of the TAM for the conclusions on parts sales.

As a result of the TAM's conclusion that the primary dealership facility engages in both on-site and off-site sales, the location qualifies as a dual function storage facility and the dealership must determine storage and handling costs attributable to the off-site sales.

The TAM also considered a second dealership location that was not physically attached or an integral part of a retail sales facility where the dealer engaged in no sales to retail customers. The TAM ruled that this second location was an off-site storage facility.

The TAM's Conclusions – Summary

To summarize, under the circumstances described in the ruling, the TAM reached the following conclusions on key issues (list is not all inclusive):

(1) the dealership's repair/installation activities relating to customer owned vehicles do not constitute production activities because the dealership does not hold the benefits and burdens of vehicle ownership;

(2) the dealership's repair/installation activities relating to dealership owned vehicles may constitute production activities under IRC 263A; and

(3) vehicles sold at wholesale, dealer trades, leased vehicles, and some parts sales are not on-site sales to retail customers and as a result the dealership's main location is a dual function storage facility for purposes of IRC 263A.

The TAM addresses numerous other issues including qualifications for a de minimis exception to the production activity requirements, identification of mixed service costs, and qualifications for and operation of the simplified resale method and the simplified production methods. The entire TAM should be considered and the reader should not limit their consideration to the issues described in this document.

What Does This Mean for Dealerships?

In general UNICAP requires certain taxpayers to capitalize, or add, certain cost to inventory increasing the value of the inventory for tax purposes. Capitalizing additional costs to inventory may result in additional tax costs to the dealership. The UNICAP rules contain certain de minimis rules and methods to simplify compliance. Prior to the issuance of the TAM, many tax practitioners interpreted the UNICAP regulations quite differently.

UNICAP is a method of accounting and changes to methods of accounting require that the taxpayer seek approval from the IRS prior to making the change. Dealers who wish to change a method of accounting complete a Form 3115, Application for Change in Method of Accounting and submit it to the IRS following the requirements applicable to the particular change.

The Department of the Treasury and IRS Chief Counsel included auto dealership UNICAP issues in the 2007-2008 Priority Guidance Plan. Thus, precedential guidance on these two general issues will be forthcoming.

Executive Summary	***DEALERSHIPS MAY NOW USE A SINGLE, COMBINED LIFO POOL FOR ALL NEW (OR FOR ALL USED) VEHICLE INVENTORIES***
What's the Bottom Line?	• In Revenue Procedure 2008-23, the IRS finally concedes that an automobile dealership will be allowed to pool all new vehicles in a single, combined pool for LIFO purposes. • This can be accomplished by electing/adopting/choosing to use the ***"Vehicle-Pool" Method***. • This single-pool approach for vehicles on LIFO is also available for used vehicles.
Effective Date	• Generally, applies to taxable years ending on or after December 31, 2007.
Advantages	• For taxpayers, the general rule has always been that, for LIFO purposes, the fewer the number of pools, the better. • Therefore, purely from a LIFO standpoint, the ability of a dealership (or any taxpayer, for that matter) to be able to use a smaller number of pools, rather than a larger number of pools, over time, will have the effect of prolonging the LIFO reserve and comparatively mitigating the payback of LIFO reserves that have been previously built up. ◆ In other words, as long as the dealership's total investment of dollars in new vehicles does not decrease, the dealership should experience little, if any, payback (of the LIFO reserve it has built up) due to a decrease in one of its classes of new vehicle inventory. • Using the single, combined LIFO pool method completely eliminates all of the (past and future) questions or debates with the IRS over whether a particular "crossover" vehicle should have been put in one pool or the other for LIFO purposes.
Disadvantages	• Hard to think of any, offhand ... But, theoretically, there are a few. • One concern: If a dealership analyzes the potential benefit of using a single pool for 2007 and finds that it is definitely not to its advantage to do so, and therefore, it decides to make the change in 2008 ... The change for 2008 may not be automatic. That has to be carefully evaluated. • For some dealerships, changing to a single, combined pool might be inadvisable until such time as they have "managed their reserves" by managing their year-end inventory investment levels.
Recommendation	• Generally, dealers should embrace the opportunity to change to a single pool for LIFO purposes. • Because of the concern mentioned above, in some cases, it may be better to make the change effective for calendar year 2007 (than to wait until 2008 and have to get IRS permission in advance).
Form 3115 Filings to Make Changes	• Generally, change to the Vehicle-Pool (single, combined pool) Method is an automatic change if made for 2007. Advance approval from the IRS to make the change is not required. ◆ No filing fee is required. • There is no Section 481(a) adjustment because use of the cut-off method is required. • Careful attention must be given to procedural aspects of filing Form 3115 if the change is to be made on an amended return filed for calendar year 2007. • The change may not be automatic if it is made for 2008.
Special Calculations Required	• The new automobile and light-duty truck pools must be properly combined. ◆ Special adjustments are required if the base years (i.e., the origins of the LIFO computations in the two pools) are different. • After the LIFO pools are combined, the indexes (i.e., the valuation factors) for the layers in the resulting single pool must be rebased to 1.0000.
What About "Crossover" Vehicles?	• Is it fish or fowl? Is "crossover vehicle X" an automobile? ... Or, is it a (light-duty) truck? ◆ The question of what LIFO pool to put a "crossover" vehicle in becomes academic if the dealership elects the Vehicle-Pool (single, combined pool) Method. • If a dealership, for whatever reason, does not change to the Vehicle-Pool (single, combined pool) Method... ◆ The new rule is that the crossover vehicle must be assigned to whichever pool "is more reasonable under all the facts and circumstances." ◆ This rule is applicable to both new vehicles and to used vehicles on LIFO. ◆ This rule could have change in (LIFO) accounting method implications depending on how the dealership previously pooled "crossover" vehicles.
Citation	• Revenue Procedure 2008-23, published March 7, 2008 (2008-12 I.R.B. 1)

IRS Now Approves a Single LIFO Pool for All New Vehicles

Sample Letter

April ____, 2008

Mr./Ms. Dealer and/or CFO
XYZ Dealership Group

Dear ___________:

In Revenue Procedure 2008-23, the IRS recently announced that it would permit automobile dealerships to use a single, combined pool for their new vehicle LIFO calculations. The IRS will permit this change to be made as early as for your calendar year 2007 LIFO calculations.

Generally, a dealership will be better off with one LIFO pool than two for its new vehicles. With one pool, a dealership will be able to preserve the benefits of its LIFO election for a longer period of time, even though that dealership may experience a reduction of dollars invested in one class of goods (new automobiles) compared to another (new light-duty trucks). Since most dealers want to defer the repayment of their LIFO reserves for as long as possible, this recent change by the IRS is very good news.

It is advisable to compare the results of your 2007 LIFO calculations which were made using two separate pools with the result that you would have if a single new vehicle LIFO pool were used for your 2007 calculations. This comparison will indicate whether there is a compelling reason to make the change for 2007 in order to avoid any immediate significant repayment of your LIFO reserve. (In some instances, based on this comparison, a single LIFO pool for 2007 might not produce a more beneficial result.)

The mechanics of making the change (filing Form 3115) and following the computational requirements do not affect the amount of the LIFO reserve previously built up by your dealership before 2007.

It is possible to make the change for calendar year 2007 by filing an amended return for 2007 if the income tax return has already been filed. However, in order to make this change effective for 2007, the amended return would have to be filed on or before either September 15, 2008 (if the original due date of the dealership's 2007 tax return was March 15) or October 15, 2008 (if the original due date of the dealership's 2007 tax return was April 15).

Some dealers have indicated that since their LIFO calculations for 2007 have already been completed, they would prefer to wait and consider making the change in connection with their 2008 LIFO computations. This is a logical response, and for most dealers, it would be the way to proceed.

Potential "trap" to be avoided. The new rules permit a dealership to make the change from two separate LIFO pools (for new vehicles) to a single, combined LIFO pool without first obtaining advance consent from the IRS. However, this automatic IRS consent only applies if the dealership makes the change effective for its first year ending on or after December 31, 2007.

If a dealership waits until 2008 (or a later year) to make the change, that dealership will be permitted to make the change as an automatic change only if, within the past 5 years (counting the year of change), that dealership has not previously made a change in its LIFO methodology. If within the past 5 years the dealership has made a different or another change in its LIFO methodology, it may be required to obtain advance permission from the IRS in order to change to the single, combined pool method.

Although obtaining advance permission from the IRS to make the change should not be difficult, this "non-automatic" procedure is decidedly more problematic. The dealership will be required to pay a user fee for the privilege of making the change. In addition, the Form 3115 requesting permission to make the change must be filed before the end of the year of change.

For these reasons, dealers seeking the course of least resistance in dealing with the IRS on LIFO matters may want to make the change to the single, combined LIFO pool method for 2007 ... rather than waiting until a later year.

As part of the Revenue Procedure, the IRS provides a similar opportunity to use a single, combined pool for all used vehicles on LIFO. There is no requirement that a dealership change to the single, combined pool method, and if it does not, there is now a new, clear-cut rule for determining how crossover vehicles should be assigned to the appropriate LIFO pool.

Please call at your convenience so that we can discuss this further and determine how to proceed for 2007.

HOW FAST CAN YOU DEPRECIATE A DEALERSHIP'S FIXED ASSETS?

FIXED ASSET WRITE-OFFS

For this question, we now have some fairly specific answers or guidance. But, be warned: This stuff does not have any precedential value!

A little background. As many dealers have constructed or purchased new facilities, or improved their existing facilities, CPAs have used cost segregation studies to speed up the overall tax benefits available from the dealer's investment.

These studies are intended to determine whether an asset is ***Section 1245 property*** (***shorter*** cost recovery period property - depreciable personal property, such as equipment) or ***Section 1250 property*** (***longer*** cost recovery period property - such as buildings and building components, which generally are not Section 1245 property).

This difference in the 5, 7, 15 or 39-year recovery periods can be significant in most dealership situations, and it usually places the IRS and the dealership in adversarial positions.

In April of 2004, the IRS released a *Cost Segregation Audit Technique Guide (ATG)* to assist its auditors in reviewing and examining cost segregation studies. We provided an overview of this *ATG* in the December 2004 issue of the *Dealer Tax Watch*.

The original 2004 *ATG* did not specifically refer to automobile dealerships. However, it did contain useful information, particularly in its listings of useful lives for various types of depreciable fixed assets and their categorization as either Section 1245 or 1250 property. The *Guide* also spelled out, in some detail, the essential ingredients (from the IRS' point of view) for any cost segregation study to pass muster.

Recently, the IRS Motor Vehicle Technical Advisor circulated a "draft" copy of a fixed asset depreciation matrix that might become the basis for a "new chapter" in the *ATG*. This matrix specifically addressed auto dealerships' fixed asset investments.

February 2008 ... The new IRS "matrix." In February of 2008, the IRS released the final version of the new *Audit Technique Guide* chapter specifically devoted to dealerships. This came in the form of a detailed matrix which recommends (to IRS agents) the categorization and general depreciation lives for dealership expenditures.

Hopefully, this matrix will be used as an audit tool to reduce unnecessary disputes and to foster consistent audit treatment.

INCLUDED ON THE FOLLOWING PAGES

- ***Two summaries*** of the IRS matrix of depreciable lives for dealership fixed assets.
- ***An overview of the Audit Technique Guide*** from our previous *Dealer Tax Watch* coverage. This reprint shows the continuity between the matrix for dealership fixed assets and the remainder of the *ATG* to which it has been added.
- ***The detailed matrix*** issued by the IRS on Feb. 25, 2008 (LMSB Control No. 4-0208-006). We have included all of the detail descriptions, etc., in this IRS release. However, we have "tweaked" the presentation and formatting somewhat to make it more user-friendly.
- ***A "rearranged" version of the IRS matrix.*** This format groups together all assets with the same depreciable lives by recovery period.

This IRS Directive contains a few caveats.

First, "if the taxpayer's tax return position for these assets is consistent with the recommendations in [the] Auto Dealership Matrix, examiners should not make adjustments to categorization and recovery periods. If the taxpayer reports assets differently, then adjustments should be considered."

Second, this LMSB Directive is not an official pronouncement of the law or the position of the IRS. It cannot be used, cited or relied upon as such. Note: This means that there is (some?) leeway here.

Third, the *ATG* should be considered in its entirety, especially Appendix Chapter 6.3 which provides examples and general rules for asset classification.

The final (Feb. 2008) version differs somewhat from the draft that was previously circulating. The final (Feb. 2008) version is particularly detailed in analyzing certain asset expenditure categories such as bollards and guardrails, exterior lighting fixtures, restroom accessories and site preparation grading and excavation.

Also in the final version, there is a more detailed analysis of landscaping and shrubbery, which breaks these expenditures into two categories - one of which is treated as non-depreciable land.

Summary #1 — Depreciable Lives (Recovery Periods) for Dealership Fixed Assets

Asset Class	*5 Years*	*7 Years*	*15 Years*	*39 Years*	*Non-Depreciable*
Awnings & Canopies	✓				
Bollards & Guardrails *	✓		✓	✓	
Cabinetry *	✓			✓	
Computers	✓				
Concrete Foundations & Footings *	✓		✓	✓	
Data Handling Equipment	✓				
Doors *	✓			✓	
Electrical *	✓			✓	
Elevators & Escalators				✓	
Energy Management Systems				✓	
Exit Signs				✓	
Fire Protection & Alarm Systems				✓	
Fire Protection Equipment	✓				
Floor Coverings *	✓			✓	
Floors				✓	
Floor Pits & Trenches *	✓			✓	
Heating, Ventilating & Air Conditioning (HVAC) *	✓			✓	
Inventory Display Equipment *	✓		✓		
Landscaping & Shrubbery *			✓		✓
Light Fixtures - Interior *	✓			✓	
Light Fixtures - Exterior *	✓		✓	✓	
Loading Docks *	✓			✓	
Machinery & Equipment	✓				
Millwork *	✓			✓	
Office - Furniture **		✓			
Parking Lots			✓		
Parking Structures				✓	
Plumbing	✓				
Point of Sale (POS) Systems	✓				
Poles			✓		
Premise (Pylon) Sign - Exterior *	✓		✓		
Restroom Accessories				✓	
Restroom Partitions				✓	
Retail Accessories	✓				
Retail Fixtures	✓				
Roof				✓	
Security Systems *	✓			✓	
Sidewalks & Curbs			✓		
Signs *	✓			✓	
Site Preparation Grading & Excavation *			✓	✓	✓
Site Utilities				✓	
Site Work			✓		
Sound Systems	✓				
Trash Enclosures *			✓	✓	
Wall Coverings *	✓			✓	
Walls - Exterior				✓	
Walls - Interior Partitions *	✓			✓	
Windows				✓	
Window Treatments	✓				

* The *Audit Technique Guide* subdivides several asset categories indicated by (*) above. Therefore, these categories have entries (✓) in more than 1 column.

** Includes Communication Equipment & Hook-ups

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Summary #2 DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Asset Class	Sec. 1245 Property 5 Years	Sec. 1245 Property 7 Years	Sec. 1245 or Sec. 1250 Property 15 Years	Sec. 1250 Property 39 Years	Non-Depreciable
Landscaping & Shrubbery *					✓
Site Preparation Grading & Excavation *					✓
Awnings & Canopies	✓				
Bollards & Guardrails *	✓				
Cabinetry *	✓				
Computers	✓				
Concrete Foundations & Footings *	✓				
Data Handling Equipment	✓				
Doors *	✓				
Electrical *	✓				
Fire Protection Equipment	✓				
Floor Coverings *	✓				
Floor Pits & Trenches *	✓				
Heating, Ventilating & Air Conditioning (HVAC) *	✓				
Inventory Display Equipment *	✓				
Light Fixtures - Interior *	✓				
Light Fixtures - Exterior *	✓				
Loading Docks *	✓				
Machinery & Equipment	✓				
Millwork *	✓				
Plumbing	✓				
Point of Sale (POS) Systems	✓				
Premise (Pylon) Sign - Exterior *	✓				
Retail Accessories	✓				
Retail Fixtures	✓				
Security Systems *	✓				
Signs *	✓				
Sound Systems	✓				
Wall Coverings *	✓				
Walls - Interior Partitions *	✓				
Window Treatments	✓				
Office - Furniture **		✓			

See Legend & Notes at bottom of Page 2 of 2

A WORD ABOUT THESE DEALER TAX WATCH SUMMARIES

The matrix published by the IRS showing the depreciable lives (recovery periods) for dealership fixed assets is extremely thorough; however, it is quite dense. In reviewing it and deciding how it could be presented in a more "user-friendly" fashion, I decided to prepare two summary tables and to reformat the content of the detailed matrix (leaving nothing out that appears in the original).

Summary #1 (on the previous page) shows you at a glance how the IRS subdivided a dealership facility in terms of asset categories. Summary #1 shows all categories and the depreciable lives that are available for these categories or subcategories.

Summary #2 (above, and continued on the facing page) groups all of the categories and subcategories together based on whether they are 5 - 7 - 15 or 39 year life properties.

Some readers may find one summary format easier than the other to find what they are looking for.

Summary #2 DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Asset Class	Sec. 1245 Property *5 Years*	Sec. 1245 Property *7 Years*	Sec. 1245 or Sec. 1250 Property *15 Years*	Sec. 1250 Property *39 Years*	*Non-Depreciable*
Bollards & Guardrails *			✓		
Concrete Foundations & Footings *			✓		
Inventory Display Equipment *			✓		
Landscaping & Shrubbery *			✓		
Light Fixtures - Exterior *			✓		
Parking Lots			✓		
Poles			✓		
Premise (Pylon) Sign - Exterior *			✓		
Sidewalks & Curbs			✓		
Site Preparation Grading & Excavation *			✓		
Site Work			✓		
Trash Enclosures *			✓		
Bollards & Guardrails *				✓	
Cabinetry *				✓	
Concrete Foundations & Footings *				✓	
Doors *				✓	
Electrical *				✓	
Elevators & Escalators				✓	
Energy Management Systems				✓	
Exit Signs				✓	
Fire Protection & Alarm Systems				✓	
Floor Coverings *				✓	
Floors				✓	
Floor Pits & Trenches *				✓	
Heating, Ventilating & Air Conditioning (HVAC) *				✓	
Light Fixtures - Interior *				✓	
Light Fixtures - Exterior *				✓	
Loading Docks *				✓	
Millwork *				✓	
Parking Structures				✓	
Restroom Accessories				✓	
Restroom Partitions				✓	
Roof				✓	
Security Systems *				✓	
Signs *				✓	
Site Preparation Grading & Excavation *				✓	
Site Utilities				✓	
Trash Enclosures *				✓	
Wall Coverings *				✓	
Walls - Exterior				✓	
Walls - Interior Partitions *				✓	
Windows				✓	

* The *Audit Technique Guide* subdivides several asset categories indicated by (*) above. Therefore, these categories have entries (✓) in more than 1 column.
** Includes Communication Equipment & Hook-ups
Note: In the case of certain leasehold improvement property, the classifications in the LMSB Directive are superseded to the extent that the *American Jobs Creation Act of 2004* modifies Section 168. Thus, a 15-year straight-line recovery period should replace the recovery period shown in the matrix if the asset is "qualified leasehold improvement property" (as defined in Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08. Also, Section 1245(a)(5) may be applicable to certain qualified recovery non-residential real estate placed in service after 1980 and before 1987.
Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*** LMSB Control No. 4-0208-006 (Feb. 25, 2008)

What the IRS Wants

COST SEGREGATION STUDIES
IRS AUDIT TECHNIQUES GUIDE

Page 1 of 2

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

(... What the IRS Is Looking for)

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

Report Format - Contents

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

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

Cost Seg Matrix

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Awnings & Canopies	5 (A)				• Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, a window, or a door; or used inside a structure to identify a particular department or selling area. • Also includes canopies designed to protect employees and gasoline fueling equipment from weather conditions and to act as advertising displays that are anchored with bolts and are not attached to buildings or other structures. • Does not include permanent canopies that are an integral part of a building's structural shell, such as porte-cochere (covered entrances for vehicle drive-up) and porticos (covered porches), or over docks. • See also **Concrete Foundations & Footings, Loading Docks and Signs**.
Bollards & Guardrails				39 (F)	• Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in a concrete foundation or sturdily affixed to the ground so as to create a protective barrier around areas of the building vulnerable to vehicle traffic such as Service Bay doors, glass storefront partitions, doors, door frames, HVAC components, building corners, etc. • Bollards and Guardrails can be located inside or outside the building are permanently attached and are intended to be permanent. (Placement to protect the building).
			15 (E) Note #1		• Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in the ground or concrete to protect machinery and equipment from vehicular damage, or to prevent vehicles from trespassing onto specific areas. • Placement to protect land improvements and non-building items such as signs, sign poles, flagpoles, trees, as well as inventories of autos and trucks. • Bollard and Guardrails are permanently attached and intended to be permanent.
	5 (A)				• Bollards (heavy steel posts) and Guardrails, not permanently attached and not intended to be permanent, placed near machinery and equipment inside buildings that can be damaged by vehicular traffic. • Bollards and Guardrails withstand vehicular impact and protect personal property items such as: forklift recharging stations, service write-up station, hazardous material storage racks, service department air compressors, etc.
Cabinetry				39 (F)	• Includes cabinets and counters constructed or installed within buildings that relate to the general operation and maintenance of the building. ◆ For example, cabinets and counters used to house or enclose electrical equipment, plumbing components, sinks, fire protection systems and other structural elements of a building which are designed to remain in place. • Includes counters and cabinets in restrooms, **Employee Break Areas, Employee Coffee Bars and Office Areas**. • See also **Restroom Accessories.**
	5 (A)				• Includes cabinets and counters related to the retail activity and not related to the operation and maintenance of the building. ◆ For example: retail counters and cabinets, display shelving and cabinets, customer reception counter, **Customer Lounge Area** cabinets and counters, **Sales Area** cabinets and counters, parts counters, etc. • See also **Retail Fixtures** and **Office Furniture.**

Classification Key

- *(A)* ... *5 yrs* ... Sec. 1245 ... 57.0 ... *Distributive Trades & Services*
- *(B)* ... *7 yrs* ... Sec. 1245 ... 00.11 ... *Office Furniture, Fixtures & Eqpt.*
- *(C)* ... *5 yrs* ... Sec. 1245 ... 00.12 ... *Information Systems*
- *(D)* ... *5 yrs* ... Sec. 1245 ... 00.13 ... *Data Handling Eqpt. Except Computers*
- *(E)* ... *15 yrs* ... * **Note #1** ... 00.3 ... *Land Improvements*
- *(F)* ... *39 yrs* ... Sec. 1250 ... *Building or Building Component*

Also, see Notes #1 & #2 at bottom of Page 10 of 10

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Computers	5 (C)				• Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers and other peripheral equipment. • Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g. fire detection, heating, cooling, or energy management systems, etc.). • See also **Point of Sale (POS) Systems.**
Concrete Foundations & Footings				39 (F)	• Foundations and footings necessary for the proper setting of the building. Excavation and backfill for building foundations. • Excavation and backfill for special equipment foundations where contained within the footprint of the building. Includes formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
			15 (E) Note #1		• Foundations or footings for signs, light poles and other land improvements (except buildings). • Includes excavation, backfill, formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
	5 (A)				• A foundation, pad or footing for machinery or equipment that is so specially designed that it is in essence a part of the machinery or equipment. • Any function as a building component must be strictly incidental to the function as an essential part of the item of machinery or equipment that necessitated the special design of the foundation. • Increased thickness of the building's slab alone is not sufficient to show that the foundation, pad or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. • Excavation and backfill are not included where the foundation, pad or footing is contained within the footprint of the building. • Includes formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
Data Handling Equipment	5 (D)				• Includes adding and accounting machines, calculators, copiers and duplicating machines. • Excludes computers and computer peripheral equipment.
Doors				39 (F)	• Interior and exterior doors, regardless of decoration. • Includes, but not limited to, double opening doors, fire doors and fire containment safety doors, overhead and roll-up doors, revolving doors, roll-up or sliding wire mesh or steel grills, **Service Bay** doors. • Also includes related door hardware such as doorknobs, closers, kick plates, hinges, locks, automatic openers, computerized door locks, etc. • See also **Millwork.**
	5 (A)				• Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. ◆ For example, flexible doors, or clear or strip curtains used between stock and selling areas.

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years*				
	5	*7*	*15*	*39*	
Electrical				39 (F)	• Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general applicability and accessibility, lighting, heating, ventilation, air conditioning and electrical wiring. • Includes, but is not limited to, general purpose outlets connected to copy machines, fax machines, personal computers and general purpose outlets in the **Break Rooms, Coffee Rooms, Lounges**, etc.
	5 (A)				• Includes electrical outlets specifically associated to a particular item of machinery or equipment located in the **Service Department, Body Shop and Showroom.** • Special electrical connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment. ◆ Examples include: Dedicated electrical outlets, wiring, conduit and circuit breakers by which machinery and equipment is connected to the electrical distribution system. • Does not include electrical outlets of general applicability and accessibility. ◆ See Chapter 5 of the *Cost Segregation Audit Techniques Guide* for allocation examples. • Examples include: Dedicated electrical service to lifts, jacks and *Service Bay* equipment; paint booths; car washes; oil change stations; frame straightening equipment and **Body Shop** equipment. • Also includes dedicated electrical to **Customer Areas**, such as suspended television monitors.
Elevators & Escalators				39 (F)	• Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. ◆ They relate to the operation or maintenance of the building and are structural components. • Includes elevators to move autos in multi-story dealerships.
Energy Management Systems				39 (F)	• Energy management systems control all energy-using systems in a building, automatically checking occupancy schedules, reading temperatures and re-circuiting light levels, causing all heating, cooling and lighting equipment to operate so as to minimize energy costs. ◆ Includes, for example, detection devices such as smoke, motion and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, occupancy sensors, electronic ballasts and all related wiring and conduit. • May also provide for fire and burglary protection.
Exit Signs				39 (F)	• Signs posted along exit routes within buildings that indicate the direction of travel to the nearest exit. • These signs typically read "EXIT" and may have distinctive colors, illumination or arrows indicating the direction to the exit.
Fire Protection & Alarm Systems				39 (F)	• Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency lighting and signage and wall mounted fire extinguishers necessary for the protection of the building.
Fire Protection Equipment	5 (A)				• Includes special fire detection or suppression systems directly associated with a piece of equipment and designed and used for protection against a particular hazard created by the business activity (such as in the **Body Shop**).

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Floor Coverings				39 (F)	• Floor covering affixed with permanent adhesive, nailed or screwed in place. ◆ Examples include ceramic or quarry tile, marble, paving brick and other coverings cemented, mudded or grouted to the floor; epoxy or sealers; and wood flooring.
	5 (A)				• Floor covering that is installed by means of strippable adhesives. • For the auto dealership industry, all vinyl composition tile (VCT), sheet vinyl and carpeting will be treated as not permanently attached and not intended to be permanent.
Floors				39 (F)	• Includes concrete slabs and other floor systems. • Floors include special treatments applied to, or otherwise a permanent part of, the floor. ◆ For example, reflective flooring, express lube and reconditioning area floors and epoxy floor paint or sealant applied directly to the concrete slab to keep a sealed, water and oil resistant, easy-to-clean surface. • See also **Floor Coverings.**
Floor Pits & Trenches				39 (F)	• Work areas built at a lower level than the garage floor to allow technicians to stand beneath the vehicles while working. • These floor pits allow the technician to service a vehicle from below (for example, to change automotive oil, radiator and transmission fluids). • Work areas include pits and trenches with concrete floors and walls with overhead access to vehicles. ◆ Some of these floor pits resemble full basements allowing multiple technicians access to vehicles above.
	5 (A)				• Equipment included in the floor pits and trenches, such as ◆ Lifts, trays and piping for supply fluid systems, ◆ Waste fluid recovery and containment systems and ◆ Automotive fluid waste tanks.
Heating, Ventilating & Air Conditioning (HVAC)				39 (F)	• Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. • HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.
	5 (A)				• Only separate HVAC units that meet the sole justification test are included (i.e., machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or paint). ◆ For example, special ventilation for paint booths, **Body Shop and Service Area** exhaust removal systems. • ***Allocation of HVAC is not appropriate.***
Inventory Display Equipment			15 (E) Note #1		• Includes inventory displays that are permanently added to the land. ◆ Examples include concrete ramps and pedestals and exterior "turntable" displays that are permanently affixed.
	5 (A)				• Includes inventory displays that are not permanently added to the land and intended to be moved. ◆ Examples include metal ramps, portable "turntable" displays, etc.

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	Depreciable Life ... Years: 5	7	15	39	Description
Landscaping & Shrubbery	-	-	-	-	• Landscaping that will not be replaced contemporaneously with a related depreciable asset or that will not be destroyed when the related depreciable asset is replaced. ◆ Examples include landscaping, shrubbery, trees, plant foliage or sod placed around the perimeter of the tract of land. • ***This class of asset expenditures is considered to be non-depreciable (land).***
			15 (E) Note #1		• Landscaping that will be replaced contemporaneously with a related depreciable asset or that will be destroyed when the related depreciable asset is replaced. ◆ Examples include depreciable landscaping, shrubbery, trees, plant foliage or sod placed around the parking lot in outdoor **Sales Area**. ◆ Includes associated irrigation systems (sprinkler systems).
Light Fixtures - Interior				39 (F)	• Includes lighting such as recessed and lay-in lighting, night lighting and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. • For emergency and exit lighting, see **Fire Protection & Alarm Systems.**
	5 (A)				• Special display lighting specifically for highlighting automobiles in the **Showroom**, or highlighting displays of merchandise, decorative lighting and specific task lighting in the service area. • Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. • If the decorative or task lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. • If the decorative or task lighting is the **primary** source of lighting, then it is Section 1250 property.
Light Fixtures - Exterior				39 (F)	• Exterior lighting is considered Section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. • This category includes building mounted lighting to illuminate walkways, entrances, parking, etc. (whether decorative or not).
			15 (E) Note #1		• Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, **Employee Parking Area, Customer Parking Area and Product Display Parking Areas.** ◆ See also **Poles**.
	5 (A)				• Exterior lighting that highlights the merchandise and building exterior (for example a floodlight, spotlight and uplighting which do not illuminate parking areas or walkways). • Does not include the pole mounted lighting systems used to illuminate **Employee Parking Area, Customer Parking Area and Product Display Parking Areas.** • See also **Poles**.
Loading Docks				39 (F)	• Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies and overhead doors used in the receiving and shipping of merchandise. • See also **Awnings & Canopies.**
	5 (A)				• Includes equipment such as compactors, conveyors, hoists and balers.

Cost Seg Matrix

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Machinery & Equipment	5 (A)				• Tangible personal property not covered elsewhere, which is in the nature of machinery or equipment. Includes... ◆ Machinery and equipment located in the **Body Shop, Parts Department and Service Departments**, such as: ▪ Paint booths ▪ Exhaust systems ▪ Air compressors ▪ Pneumatic tools systems (including support equipment such as piping and related pumps) ▪ Tanks and related pumps ▪ Automotive fluid and waste fluid recovery systems ▪ Above-ground lifts ▪ Car wash systems • Does not include structural components of a building or other inherently permanent structure. • See also **Concrete Foundation & Footings, Electrical** and **Plumbing.**
Millwork				39 (F)	• ***General millwork*** is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways and special woodwork). • Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.
	5 (A)				• ***Decorative millwork*** is the decorative finish carpentry in the building. ◆ Examples include detailed crown moldings, lattice work placed over finished walls or ceilings and merchandise display cabinets. • The decorative millwork serves to enhance the overall décor of the dealership and is not related to the operation of the building. • Cabinets and counters in the restroom are excluded from this category. • See also **Cabinetry** and **Restroom Accessories.**
Office - Furniture (includes Communication Equipment and Hook-ups)		7 (B)			Tangible personal property not covered elsewhere, which is in the nature of office furniture and/or office equipment... ◆ Desks ◆ Chairs ◆ Cashiers safes ◆ Credenzas ◆ File cabinets ◆ Tables (or other furniture such as workstations and the **Sales Manager's Office Tower**) ◆ Shelving, including cost of shelves in record storage room ◆ Telephone equipment ◆ Fax machines ◆ Other communications equipment, but not including communications equipment included in other asset classes in Rev. Proc. 87-56.

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

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	Description
Parking Lots			15 (E) Note #1		• Depreciable improvements directly to or added to land, whether such improvements are Sec. 1245 or Sec. 1250 property. • Grade level surface parking and base area usually constructed of asphalt, brick, concrete, stone or similar material. • Also includes bumper blocks, curb cuts, curb work, striping, concrete landscape islands, gates, fences, truck parking ramps and staging areas and traffic control systems (such as traffic lights and detectors, card readers, parking equipment, etc.). • Includes *Employee* **Parking, Customer Parking and New and Used Vehicle Parking Areas.**
Parking Structures				39 (F)	• Any structure or edifice the purpose of which is to provide parking space. • Includes, for example, garages, parking ramps or other parking structures.
Plumbing				39 (F)	• All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g. toilets) and piping, sinks, electric water coolers and all other components of a building plumbing system (water or gas) not specifically identified elsewhere. • Includes floor drains which ultimately lead to the municipal sewer system or site septic system.
	5 (A)				• Special plumbing connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment. • Includes dedicated piping, valves and hook-ups by which machinery and equipment is connected to the building or other inherently permanent structure's plumbing distribution system(s). • Example includes plumbing hook-ups to the car wash system. • Does not include plumbing hook-ups of general applicability and accessibility. • See also **Floor Pits & Trenches.**
Point of Sale (POS) Systems	5 (A)				• A register or terminal based data collection system used to control and record all sales (cash, charge, COD, gift cards, layaway, etc.) at the point of sale. • Includes cash registers, computerized sales systems and related peripheral equipment, satellite systems, scanners and wands. • See also **Electrical** for hook-ups.
Poles			15 (E) Note #1		• Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. • See also **Bollards & Guardrails, Signs,** and **Light Fixtures - Exterior**.
Premise (Pylon) Sign - Exterior			15 (E) Note #1		• Pylons made of concrete, brick, wood frame, stucco or similar materials usually set in the ground or on a concrete foundation and usually used for signage. • See also **Poles.**
	5 (A)				• Includes only the sign face and/or message screen and related components. • Includes brand displays and dealership brand image enhancements.
Restroom Accessories				39 (F)	• Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations and other items generally found in public restrooms that are built into or mounted on walls or partitions.
Restroom Partitions				39 (F)	• Includes shop-made and standard manufacture toilet partitions, typically metal, but may be plastic, sheetrock, wall board or other materials.

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Retail Accessories	5 (A)				• Accessories used to better display merchandise, advertising and brochures that are not held for sale. • Includes assets such as audio/video display devices, graphic rear projection displays, artwork (if depreciable), **Showroom** displays, decorative mobile props, holiday decorations, lamps, mirrors, pictures, plaques, potted plants and props (such as sporting equipment or memorabilia, etc.). • Does not include non-depreciable art, antiques or collectibles.
Retail Fixtures	5 (A)				• Includes ... ◆ The retail counter space within the **Body Shop** ◆ Shelving to store parts and supplies ◆ Mechanical retrieval system or equipment for parts and supplies ◆ Clocks, including time clocks ◆ Counter space related to the **Parts Department**, including retail counter space and cashier, etc. ◆ Shelving systems ◆ Shelf racks in the **Service Department** tool room ◆ Counter space within the **Service Department** (including dispatcher counter and parts counter for technicians) ◆ Other dealership fixtures needed in the business operation that are not a building component • Also includes ... ◆ Fixtures and shelving for vehicle brand clothing and accessory **Retail Shop,** ◆ Children's **Play Area** improvements for customers ◆ Fixtures for inventory information centers ◆ Express lube after care business fixtures
Roof				39 (F)	• All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders and gutters. • Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. • If removal of the decorative element results in the direct exposure of building components to water, snow, wind or moisture damage, or if the decorative element houses lighting fixtures, wiring or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.
Security Systems				39 (F)	• Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. • Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.
	5 (A)				• Electronic surveillance systems used to track and monitor tangible items (e.g., devices used to protect New and Used automobile inventory). • Includes scanners, electronic gates, surveillance cameras, recorders, monitors and related equipment.
Sidewalks & Curbs			15 (E) Note #1		• Depreciable improvements directly to or added to land, whether such improvements are Section 1245 or 1250 property. • Sidewalks and curbs are usually constructed of concrete, asphalt, stone or similar material.

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*** LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Signs				39 (F)	• Exit signs, restroom identifiers, room numbers and other signs relating to the operation or maintenance of a building. • See also **Exit Signs.**
	5 (A)				• Interior and exterior signs used to display brand or theme identity. ◆ For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. • For pylon signs, includes only sign face. • See also **Poles** and **Premise (Pylon) Sign - Exterior.**
Site Preparation Grading & Excavation	-	-	-	-	• In general, land preparation costs include the one time cost of clearing and grubbing, site stripping, mucking and fill or excavation to allow development of land. ◆ Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. ◆ Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. ◆ Mucking is the removal of unstable soils and materials to insure a solid base for intended improvements. • The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land. • ***This class of asset expenditures is considered to be non-depreciable (land).***
				39 (F)	• Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building. • This includes building the showroom facility on a mound foundation for higher visibility and enhanced visual impact for the dealership building.
			15 (E) Note #1		• Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the associated asset.
Site Utilities				39 (F)	• Site utilities are the systems that are used to distribute utility services from the property line to the building. • Includes water, sanitary sewer, gas, electrical services and data and communication lines.
Site Work			15 (E) Note #1		• Site work includes curbing, paving, general site improvements, fencing, depreciable landscaping, roads, sewers, sidewalks, site drainage and all other site improvements (such as storm water retention basins) not directly related to the building. • Does not include land preparation costs, see also **Site Preparation Grading & Excavation.** • For sanitary sewers, see **Site Utilities.** • See also **Landscaping & Shrubbery.**
Sound Systems	5 (A)				• Equipment and apparatus, including wiring, used to provide amplified sound or music. ◆ For example, public address by way of paging a customer or employee. • Excludes applications linked to fire protection and alarm systems.

Cost Seg Matrix — DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: ***Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry***
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

Asset Class	*Depreciable Life … Years* 5	7	15	39	
Trash Enclosures				**39 (F)**	• Enclosures for waste receptacles that are attached to the building. • Typically constructed of the same materials as the building shell with either interior or exterior access. • These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.
			15 (E) Note #1		• Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. • Serves both safety and decorative functions.
Wall Coverings				**39 (F)**	• Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and wall panels such as fiberglass, stainless steel and plastic wall panels.
	5 (A)				• Strippable wallpaper that causes no damage to the underlying wall or wall surface.
Walls - Exterior				**39 (F)**	• Includes all exterior walls and building support regardless of construction materials. • Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc. • Also includes drive-through bay, windows and doors.
Walls - Interior Partitions				**39 (F)**	• Includes all load bearing interior partitions regardless of construction. • Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. • Includes rough carpentry and plaster, dry wall or gypsum board and other finishes.
	5 (A)				• Interior walls where the partition can be 1) Readily removed and remain in substantially the same condition after removal as before, or 2) Intended to be moved and reused, stored, or sold in their entirety.
Windows				**39 (F)**	• Exterior windows, including store front windows and exterior glass partitions. • Includes interior glass partitions from floor to ceiling or as a part of an interior wall.
Window Treatments	**5 (A)**				• Window treatments such as drapes, curtains, louver, blinds, post construction tinting and interior decorative theme décor which are readily removable.

Classification Key

- *(A) … 5 yrs …* Sec. 1245 … 57.0 … *Distributive Trades & Services*
- *(B) … 7 yrs …* Sec. 1245 … 00.11 … *Office Furniture, Fixtures & Eqpt.*
- *(C) … 5 yrs …* Sec. 1245 … 00.12 … *Information Systems*
- *(D) … 5 yrs …* Sec. 1245 … 00.13 … *Data Handling Eqpt. Except Computers*
- *(E) … 15 yrs …* *** Note #1** … 00.3 … *Land Improvements*
- *(F) … 39 yrs …* Sec. 1250 … *Building or Building Component*

Notes … #1 … Land Improvements & #2 … Leasehold Improvements

* *Note #1:* Asset Class 00.3 Land improvements includes both Sec. 1245 and Sec. 1250 property per Rev. Proc. 87-56.
The Revenue Procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.
An asset described in both an asset and an activity category is classified in the asset category.

** *Note #2:* In the case of certain leasehold improvement property, the classifications in this LMSB Directive are superseded to the extent that the *American Jobs Creation Act of 2004* modifies Sec. 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the matrix if the asset is "qualified leasehold improvement property" (as defined in Sec. 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

5 - 7 - 15 - 39

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Asset Class	*Depreciable Life … Years* 5	7	15	39	Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008) † Indicates that the asset class described has two or more subdivisions. **Page 1 of 10**
Landscaping & Shrubbery†	-	-	-	-	• Landscaping that will not be replaced contemporaneously with a related depreciable asset or that will not be destroyed when the related depreciable asset is replaced. ◆ Examples include landscaping, shrubbery, trees, plant foliage or sod placed around the perimeter of the tract of land. • ***This class of asset expenditures is considered to be non-depreciable (land).***
Site Preparation Grading & Excavation†	-	-	-	-	• In general, land preparation costs include the one time cost of clearing and grubbing, site stripping, mucking and fill or excavation to allow development of land. ◆ Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. ◆ Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. ◆ Mucking is the removal of unstable soils and materials to insure a solid base for intended improvements. • The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land. • ***This class of asset expenditures is considered to be non-depreciable (land).***
Awnings & Canopies	5 (A)				• Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, a window, or a door; or used inside a structure to identify a particular department or selling area. • Also includes canopies designed to protect employees and gasoline fueling equipment from weather conditions and to act as advertising displays that are anchored with bolts and are not attached to buildings or other structures. • Does not include permanent canopies that are an integral part of a building's structural shell, such as porte-cochere (covered entrances for vehicle drive-up) and porticos (covered porches), or over docks. • See also **Concrete Foundations & Footings, Loading Docks and Signs.**
Bollards & Guardrails†	5 (A)				• Bollards (heavy steel posts) and Guardrails, not permanently attached and not intended to be permanent, placed near machinery and equipment inside buildings that can be damaged by vehicular traffic. • Bollards and Guardrails withstand vehicular impact and protect personal property items such as: forklift recharging stations, service write-up station, hazardous material storage racks, service department air compressors, etc.
Cabinetry†	5 (A)				• Includes cabinets and counters related to the retail activity and not related to the operation and maintenance of the building. ◆ For example: retail counters and cabinets, display shelving and cabinets, customer reception counter, **Customer Lounge Area** cabinets and counters, **Sales Area** cabinets and counters, parts counters, etc. • See also **Retail Fixtures** and **Office Furniture.**
Computers	5 (C)				• Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers and other peripheral equipment. • Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g. fire detection, heating, cooling, or energy management systems, etc.). • See also **Point of Sale (POS) Systems.**

Classification Key

- *(A)* … *5 yrs* … Sec. 1245 … 57.0 … *Distributive Trades & Services*
- *(B)* … *7 yrs* … Sec. 1245 … 00.11 … *Office Furniture, Fixtures & Eqpt.*
- *(C)* … *5 yrs* … Sec. 1245 … 00.12 … *Information Systems*
- *(D)* … *5 yrs* … Sec. 1245 … 00.13 … *Data Handling Eqpt. Except Computers*
- *(E)* … *15 yrs* … *** Note #1** … 00.3 … *Land Improvements*
- *(F)* … *39 yrs* … Sec. 1250 … *Building or Building Component*

5 - 7 - 15 - 39 — *Depreciable Lives (Recovery Periods) for Dealership Fixed Assets*

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Concrete Foundations & Footings†	5 (A)				• A foundation, pad or footing for machinery or equipment that is so specially designed that it is in essence a part of the machinery or equipment. • Any function as a building component must be strictly incidental to the function as an essential part of the item of machinery or equipment that necessitated the special design of the foundation. • Increased thickness of the building's slab alone is not sufficient to show that the foundation, pad or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. • Excavation and backfill are not included where the foundation, pad or footing is contained within the footprint of the building. • Includes formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
Data Handling Equipment	5 (D)				• Includes adding and accounting machines, calculators, copiers and duplicating machines. • Excludes computers and computer peripheral equipment.
Doors†	5 (A)				• Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. ◆ For example, flexible doors, or clear or strip curtains used between stock and selling areas.
Electrical†	5 (A)				• Includes electrical outlets specifically associated to a particular item of machinery or equipment located in the **Service Department, Body Shop and Showroom.** • Special electrical connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment. ◆ Examples include: Dedicated electrical outlets, wiring, conduit and circuit breakers by which machinery and equipment is connected to the electrical distribution system. • Does not include electrical outlets of general applicability and accessibility. ◆ See Chapter 5 of the *Cost Segregation Audit Techniques Guide* for allocation examples. • Examples include: Dedicated electrical service to lifts, jacks and *Service Bay* equipment; paint booths; car washes; oil change stations; frame straightening equipment and **Body Shop** equipment. • Also includes dedicated electrical to **Customer Areas**, such as suspended television monitors.
Fire Protection Equipment†	5 (A)				• Includes special fire detection or suppression systems directly associated with a piece of equipment and designed and used for protection against a particular hazard created by the business activity (such as in the **Body Shop**).
Floor Coverings†	5 (A)				• Floor covering that is installed by means of strippable adhesives. • For the auto dealership industry, all vinyl composition tile (VCT), sheet vinyl and carpeting will be treated as not permanently attached and not intended to be permanent.
Floor Pits & Trenches†	5 (A)				• Equipment included in the floor pits and trenches, such as ◆ Lifts, trays and piping for supply fluid systems, ◆ Waste fluid recovery and containment systems and ◆ Automotive fluid waste tanks.
Heating, Ventilating & Air Conditioning (HVAC)†	5 (A)				• Only separate HVAC units that meet the sole justification test are included (i.e., machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or paint). ◆ For example, special ventilation for paint booths, **Body Shop and Service Area** exhaust removal systems. • ***Allocation of HVAC is not appropriate.***

5 - 7 - 15 - 39 DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	*Depreciable Life … Years* 5	7	15	39	
Inventory Display Equipment†	5 (A)				• Includes inventory displays that are not permanently added to the land and intended to be moved. ◆ Examples include metal ramps, portable "turntable" displays, etc.
Light Fixtures - Interior†	5 (A)				• Special display lighting specifically for highlighting automobiles in the **Showroom**, or highlighting displays of merchandise, decorative lighting and specific task lighting in the service area. • Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. • If the decorative or task lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. • If the decorative or task lighting is the **primary** source of lighting, then it is Section 1250 property.
Light Fixtures - Exterior†	5 (A)				• Exterior lighting that highlights the merchandise and building exterior (for example a floodlight, spotlight and uplighting which do not illuminate parking areas or walkways). • Does not include the pole mounted lighting systems used to illuminate **Employee Parking Area, Customer Parking Area and Product Display Parking Areas**. • See also **Poles**.
Loading Docks†	5 (A)				• Includes equipment such as compactors, conveyors, hoists and balers.
Machinery & Equipment	5 (A)				• Tangible personal property not covered elsewhere, which is in the nature of machinery or equipment. Includes… ◆ Machinery and equipment located in the **Body Shop, Parts Department and Service Departments**, such as: ▪ Paint booths ▪ Exhaust systems ▪ Air compressors ▪ Pneumatic tools systems (including support equipment such as piping and related pumps) ▪ Tanks and related pumps ▪ Automotive fluid and waste fluid recovery systems ▪ Above-ground lifts ▪ Car wash systems • Does not include structural components of a building or other inherently permanent structure. • See also **Concrete Foundation & Footings, Electrical** and **Plumbing.**
Millwork†	5 (A)				• ***Decorative millwork*** is the decorative finish carpentry in the building. ◆ Examples include detailed crown moldings, lattice work placed over finished walls or ceilings and merchandise display cabinets. • The decorative millwork serves to enhance the overall décor of the dealership and is not related to the operation of the building. • Cabinets and counters in the restroom are excluded from this category. • See also **Cabinetry** and **Restroom Accessories**.

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Plumbing†	5 (A)				• Special plumbing connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment. • Includes dedicated piping, valves and hook-ups by which machinery and equipment is connected to the building or other inherently permanent structure's plumbing distribution system(s). • Example includes plumbing hook-ups to the car wash system. • Does not include plumbing hook-ups of general applicability and accessibility. • See also **Floor Pits & Trenches**.
Point of Sale (POS) Systems	5 (A)				• A register or terminal based data collection system used to control and record all sales (cash, charge, COD, gift cards, layaway, etc.) at the point of sale. • Includes cash registers, computerized sales systems and related peripheral equipment, satellite systems, scanners and wands. • See also **Electrical** for hook-ups.
Premise (Pylon) Sign - Exterior†	5 (A)				• Includes only the sign face and/or message screen and related components. • Includes brand displays and dealership brand image enhancements.
Retail Accessories	5 (A)				• Accessories used to better display merchandise, advertising and brochures that are not held for sale. • Includes assets such as audio/video display devices, graphic rear projection displays, artwork (if depreciable), **Showroom** displays, decorative mobile props, holiday decorations, lamps, mirrors, pictures, plaques, potted plants and props (such as sporting equipment or memorabilia, etc.). • Does not include non-depreciable art, antiques or collectibles.
Retail Fixtures	5 (A)				• Includes ... ◆ The retail counter space within the **Body Shop** ◆ Shelving to store parts and supplies ◆ Mechanical retrieval system or equipment for parts and supplies ◆ Clocks, including time clocks ◆ Counter space related to the **Parts Department**, including retail counter space and cashier, etc. ◆ Shelving systems ◆ Shelf racks in the **Service Department** tool room ◆ Counter space within the **Service Department** (including dispatcher counter and parts counter for technicians) ◆ Other dealership fixtures needed in the business operation that are not a building component • Also includes ... ◆ Fixtures and shelving for vehicle brand clothing and accessory **Retail Shop,** ◆ Children's **Play Area** improvements for customers ◆ Fixtures for inventory information centers ◆ Express lube after care business fixtures
Security Systems†	5 (A)				• Electronic surveillance systems used to track and monitor tangible items (e.g., devices used to protect New and Used automobile inventory). • Includes scanners, electronic gates, surveillance cameras, recorders, monitors and related equipment.

5 - 7 - 15 - 39 | DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Signs†	5 (A)				• Interior and exterior signs used to display brand or theme identity. ◆ For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. • For pylon signs, includes only sign face. • See also **Poles** and **Premise (Pylon) Sign - Exterior**.
Sound Systems	5 (A)				• Equipment and apparatus, including wiring, used to provide amplified sound or music. ◆ For example, public address by way of paging a customer or employee. • Excludes applications linked to fire protection and alarm systems.
Wall Coverings†	5 (A)				• Strippable wallpaper that causes no damage to the underlying wall or wall surface.
Walls - Interior Partitions†	5 (A)				• Interior walls where the partition can be 1) Readily removed and remain in substantially the same condition after removal as before, or 2) Intended to be moved and reused, stored, or sold in their entirety.
Window Treatments	5 (A)				• Window treatments such as drapes, curtains, louver, blinds, post construction tinting and interior decorative theme dĕcor which are readily removable.
Office - Furniture (includes Communication Equipment and Hook-ups)		7 (B)			Tangible personal property not covered elsewhere, which is in the nature of office furniture and/or office equipment… ◆ Desks ◆ Chairs ◆ Cashiers safes ◆ Credenzas ◆ File cabinets ◆ Tables (or other furniture such as workstations and the **Sales Manager's Office Tower**) ◆ Shelving, including cost of shelves in record storage room ◆ Telephone equipment ◆ Fax machines ◆ Other communications equipment, but not including communications equipment included in other asset classes in Rev. Proc. 87-56.
Bollards & Guardrails†			15 (E) Note #1		• Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in the ground or concrete to protect machinery and equipment from vehicular damage, or to prevent vehicles from trespassing onto specific areas. • Placement to protect land improvements and non-building items such as signs, sign poles, flagpoles, trees, as well as inventories of autos and trucks. • Bollard and Guardrails are permanently attached and intended to be permanent.
Concrete Foundations & Footings†			15 (E) Note #1		• Foundations or footings for signs, light poles and other land improvements (except buildings). • Includes excavation, backfill, formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
Inventory Display Equipment†			15 (E) Note #1		• Includes inventory displays that are permanently added to the land. ◆ Examples include concrete ramps and pedestals and exterior "turntable" displays that are permanently affixed.

5 - 7 - 15 - 39 DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	Depreciable Life ... Years 5	7	15	39	
Landscaping & Shrubbery†			15 (E) Note #1		• Landscaping that will be replaced contemporaneously with a related depreciable asset or that will be destroyed when the related depreciable asset is replaced. ◆ Examples include depreciable landscaping, shrubbery, trees, plant foliage or sod placed around the parking lot in outdoor **Sales Area.** ◆ Includes associated irrigation systems (sprinkler systems).
Light Fixtures - Exterior†			15 (E) Note #1		• Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, **Employee Parking Area, Customer Parking Area and Product Display Parking Areas.** ◆ See also **Poles.**
Parking Lots			15 (E) Note #1		• Depreciable improvements directly to or added to land, whether such improvements are Sec. 1245 or Sec. 1250 property. • Grade level surface parking and base area usually constructed of asphalt, brick, concrete, stone or similar material. • Also includes bumper blocks, curb cuts, curb work, striping, concrete landscape islands, gates, fences, truck parking ramps and staging areas and traffic control systems (such as traffic lights and detectors, card readers, parking equipment, etc.). • Includes *Employee* **Parking, Customer Parking and New and Used Vehicle Parking Areas.**
Poles			15 (E) Note #1		• Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. • See also **Bollards & Guardrails, Signs,** and **Light Fixtures - Exterior.**
Premise (Pylon) Sign - Exterior†			15 (E) Note #1		• Pylons made of concrete, brick, wood frame, stucco or similar materials usually set in the ground or on a concrete foundation and usually used for signage. • See also **Poles.**
Sidewalks & Curbs			15 (E) Note #1		• Depreciable improvements directly to or added to land, whether such improvements are Section 1245 or 1250 property. • Sidewalks and curbs are usually constructed of concrete, asphalt, stone or similar material.
Site Preparation Grading & Excavation†			15 (E) Note #1		• Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the associated asset.
Site Work			15 (E) Note #1		• Site work includes curbing, paving, general site improvements, fencing, depreciable landscaping, roads, sewers, sidewalks, site drainage and all other site improvements (such as storm water retention basins) not directly related to the building. • Does not include land preparation costs, see also **Site Preparation Grading & Excavation.** • For sanitary sewers, see **Site Utilities.** • See also **Landscaping & Shrubbery.**
Trash Enclosures†			15 (E) Note #1		• Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. • Serves both safety and decorative functions.

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	Depreciable Life ... Years				
	5	7	15	39	
Bollards & Guardrails†				39 (F)	• Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in a concrete foundation or sturdily affixed to the ground so as to create a protective barrier around areas of the building vulnerable to vehicle traffic such as Service Bay doors, glass storefront partitions, doors, door frames, HVAC components, building corners, etc. • Bollards and Guardrails can be located inside or outside the building are permanently attached and are intended to be permanent. (Placement to protect the building).
Cabinetry†				39 (F)	• Includes cabinets and counters constructed or installed within buildings that relate to the general operation and maintenance of the building. ◆ For example, cabinets and counters used to house or enclose electrical equipment, plumbing components, sinks, fire protection systems and other structural elements of a building which are designed to remain in place. • Includes counters and cabinets in restrooms, **Employee Break Areas, Employee Coffee Bars and Office Areas.** • See also **Restroom Accessories.**
Concrete Foundations & Footings†				39 (F)	• Foundations and footings necessary for the proper setting of the building. Excavation and backfill for building foundations. • Excavation and backfill for special equipment foundations where contained within the footprint of the building. Includes formwork, reinforcement, concrete block and pre-cast or cast-in-place work.
Doors†				39 (F)	• Interior and exterior doors, regardless of decoration. • Includes, but not limited to, double opening doors, fire doors and fire containment safety doors, overhead and roll-up doors, revolving doors, roll-up or sliding wire mesh or steel grills, **Service Bay** doors. • Also includes related door hardware such as doorknobs, closers, kick plates, hinges, locks, automatic openers, computerized door locks, etc. • See also **Millwork.**
Electrical†				39 (F)	• Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general applicability and accessibility, lighting, heating, ventilation, air conditioning and electrical wiring. • Includes, but is not limited to, general purpose outlets connected to copy machines, fax machines, personal computers and general purpose outlets in the **Break Rooms, Coffee Rooms, Lounges**, etc.
Elevators & Escalators				39 (F)	• Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. ◆ They relate to the operation or maintenance of the building and are structural components. • Includes elevators to move autos in multi-story dealerships.
Energy Management Systems				39 (F)	• Energy management systems control all energy-using systems in a building, automatically checking occupancy schedules, reading temperatures and re-circuiting light levels, causing all heating, cooling and lighting equipment to operate so as to minimize energy costs. ◆ Includes, for example, detection devices such as smoke, motion and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, occupancy sensors, electronic ballasts and all related wiring and conduit. • May also provide for fire and burglary protection.

5 - 7 - 15 - 39 — *DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS*

Asset Class	*Depreciable Life ... Years* 5	7	15	39	Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008) † Indicates that the asset class described has two or more subdivisions. **Page 8 of 10**
Exit Signs				39 (F)	• Signs posted along exit routes within buildings that indicate the direction of travel to the nearest exit. • These signs typically read "EXIT" and may have distinctive colors, illumination or arrows indicating the direction to the exit.
Fire Protection & Alarm Systems†				39 (F)	• Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency lighting and signage and wall mounted fire extinguishers necessary for the protection of the building.
Floor Coverings†				39 (F)	• Floor covering affixed with permanent adhesive, nailed or screwed in place. ◆ Examples include ceramic or quarry tile, marble, paving brick and other coverings cemented, mudded or grouted to the floor; epoxy or sealers; and wood flooring.
Floors				39 (F)	• Includes concrete slabs and other floor systems. • Floors include special treatments applied to, or otherwise a permanent part of, the floor. ◆ For example, reflective flooring, express lube and reconditioning area floors and epoxy floor paint or sealant applied directly to the concrete slab to keep a sealed, water and oil resistant, easy-to-clean surface. • See also **Floor Coverings.**
Floor Pits & Trenches†				39 (F)	• Work areas built at a lower level than the garage floor to allow technicians to stand beneath the vehicles while working. • These floor pits allow the technician to service a vehicle from below (for example, to change automotive oil, radiator and transmission fluids). • Work areas include pits and trenches with concrete floors and walls with overhead access to vehicles. ◆ Some of these floor pits resemble full basements allowing multiple technicians access to vehicles above.
Heating, Ventilating & Air Conditioning (HVAC)†				39 (F)	• Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. • HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.
Light Fixtures - Interior†				39 (F)	• Includes lighting such as recessed and lay-in lighting, night lighting and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. • For emergency and exit lighting, see **Fire Protection & Alarm Systems.**
Light Fixtures - Exterior†				39 (F)	• Exterior lighting is considered Section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. • This category includes building mounted lighting to illuminate walkways, entrances, parking, etc. (whether decorative or not).
Loading Docks†				39 (F)	• Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies and overhead doors used in the receiving and shipping of merchandise. • See also **Awnings & Canopies.**
Millwork†				39 (F)	• ***General millwork*** is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways and special woodwork). • Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.

DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry* LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	Depreciable Life ... Years: 5	7	15	39	
Parking Structures				39 (F)	• Any structure or edifice the purpose of which is to provide parking space. • Includes, for example, garages, parking ramps or other parking structures.
Plumbing†				39 (F)	• All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g. toilets) and piping, sinks, electric water coolers and all other components of a building plumbing system (water or gas) not specifically identified elsewhere. • Includes floor drains which ultimately lead to the municipal sewer system or site septic system.
Restroom Accessories				39 (F)	• Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations and other items generally found in public restrooms that are built into or mounted on walls or partitions.
Restroom Partitions				39 (F)	• Includes shop-made and standard manufacture toilet partitions, typically metal, but may be plastic, sheetrock, wall board or other materials.
Roof				39 (F)	• All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders and gutters. • Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. • If removal of the decorative element results in the direct exposure of building components to water, snow, wind or moisture damage, or if the decorative element houses lighting fixtures, wiring or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.
Security Systems†				39 (F)	• Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. • Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.
Signs†				39 (F)	• Exit signs, restroom identifiers, room numbers and other signs relating to the operation or maintenance of a building. • See also **Exit Signs.**
Site Preparation Grading & Excavation†				39 (F)	• Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building. • This includes building the showroom facility on a mound foundation for higher visibility and enhanced visual impact for the dealership building.
Site Utilities				39 (F)	• Site utilities are the systems that are used to distribute utility services from the property line to the building. • Includes water, sanitary sewer, gas, electrical services and data and communication lines.
Trash Enclosures†				39 (F)	• Enclosures for waste receptacles that are attached to the building. • Typically constructed of the same materials as the building shell with either interior or exterior access. • These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.

5 - 7 - 15 - 39 | DEPRECIABLE LIVES (RECOVERY PERIODS) FOR DEALERSHIP FIXED ASSETS

Source: *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*
LMSB Control No. 4-0208-006 (Feb. 25, 2008)

† Indicates that the asset class described has two or more subdivisions.

Asset Class	*Depreciable Life ... Years* 5	7	15	39	
Wall Coverings†				39 (F)	• Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and wall panels such as fiberglass, stainless steel and plastic wall panels.
Walls - Exterior				39 (F)	• Includes all exterior walls and building support regardless of construction materials. • Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc. • Also includes drive-through bay, windows and doors.
Walls - Interior Partitions†				39 (F)	• Includes all load bearing interior partitions regardless of construction. • Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. • Includes rough carpentry and plaster, dry wall or gypsum board and other finishes.
Windows				39 (F)	• Exterior windows, including store front windows and exterior glass partitions. • Includes interior glass partitions from floor to ceiling or as a part of an interior wall.

Classification Key

- *(A) ... 5 yrs* ... Sec. 1245 ... 57.0 ... *Distributive Trades & Services*
- *(B) ... 7 yrs* ... Sec. 1245 ... 00.11 ... *Office Furniture, Fixtures & Eqpt.*
- *(C) ... 5 yrs* ... Sec. 1245 ... 00.12 ... *Information Systems*
- *(D) ... 5 yrs* ... Sec. 1245 ... 00.13 ... *Data Handling Eqpt. Except Computers*
- *(E) ... 15 yrs* ... *** Note #1** ... 00.3 ... *Land Improvements*
- *(F) ... 39 yrs* ... Sec. 1250 ... *Building or Building Component*

Notes ... #1 ... Land Improvements & #2 ... Leasehold Improvements

* *Note #1:* Asset Class 00.3 Land improvements includes both Sec. 1245 and Sec. 1250 property per Rev. Proc. 87-56.
The Revenue Procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.
An asset described in both an asset and an activity category is classified in the asset category.

** *Note #2:* In the case of certain leasehold improvement property, the classifications in this LMSB Directive are superseded to the extent that the *American Jobs Creation Act of 2004* modifies Sec. 168. Thus, a 15-year straight-line recovery period should replace the recovery period shown in the matrix if the asset is "qualified leasehold improvement property" (as defined in Sec. 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

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

MID-YEAR UPDATE

This topic continues to be among the most significant that the IRS is pursuing in terms of its application to auto dealerships.

In addition to the recent remarks by the IRS Motor Vehicle Technical Advisor in her various presentations this year, our 2008 Mid-Year Update focuses on two further developments ... (1) an *Employee Tool & Equipment Alert* (dated January 30, 2008) and (2) a revised Coordinated Issue Paper (CIP) for the Motor Vehicle Industry entitled *Employee Tool & Equipment Plans* (dated July 2, 2008).

EMPLOYEE TOOL & EQUIPMENT ALERT

This document shows that the range of the IRS' concern about tool plans goes well beyond the attempts at establishing accountable plans in the automobile dealership industry. It has not been identified by the IRS as an *Automotive Alert* ... It is broader in scope.

The Alert (see the facing page) shows the significant extent of the resources that the IRS has committed to police ... perhaps even to shut down ... these plans.

ILM 200745018

The IRS was liberally dispensing copies of ILM 200745018 (released in November 2007) at its exhibitor booth at the NADA Convention in February. We extensively discussed this IRS Legal Memorandum in the Dec. 2007 issue of the *Dealer Tax Watch* on pages 34-52.

The plan under review in this ILM involved service technicians who were required to provide their own tools as a condition of employment. The exact nature of the employer's business was not specified. During the 4-year period that the plan was under IRS audit, it had been changed several times.

In discussing this ILM, we commented that "the importance of this ILM cannot be overstated ... [because it] 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 analyzed the issue of "wage recharacterizations" and Revenue Ruling 2005-52, and it discussed both *Namyst* decisions (Tax Court and Appeals).

In the ILM, the IRS concluded that the tool plan under review failed each of the three Section 62(c) requirements of (1) business connection, (2) substantiation and (3) return to the employer of excess "reimbursements" received by the employee.

In addition, the ILM found evidence of a pattern of abuse in the structure and operation of the plan. On top of that, the IRS was concerned about how this plan had been "promoted" and how it had gone through various permutations during the years under audit.

We believed, at the time, that this ILM would eventually provide the background for a more comprehensive document from the IRS on the subject of tool and equipment plans.

COORDINATED ISSUE PAPER

Just recently, on July 2, 2008, the IRS published a Coordinated Issue Paper for the Motor Vehicle Industry on tool and equipment plans. This CIP revised an earlier CIP that was issued in the year 2000.

It should come as no surprise that the conclusion of this revised CIP would deny accountable plan treatment to most auto dealership employee tool and equipment plans. ***"As the IRS has seen them to date, employee tool and equipment plans, under which amounts are paid to employees for the use of their tools and equipment, do not meet the accountable plan requirements."***

This is not good news for most plans.

The July 2008 CIP does not discuss what the ramifications might be if the IRS were to become concerned about promoter involvement in employee tool and equipment plans. There are some cases under review by the IRS at the present time which may, if litigated, provide further insight into this aspect. However, it's quite clear that the IRS has plenty of weapons at its disposal if it suspects promoter abuse.

The CIP does not discuss the possibility of the IRS imposing Section 6662 accuracy penalties; nor does it discuss potential imposition of Section 6694 tax return preparer penalties. (Neither did the ILM, for that matter.)

We have taken only slight liberties in its presentation format in reproducing the CIP on the following pages. Many of the articles in previous issues of the *Dealer Tax Watch* have recited the applicable law, Regulations, Rulings and cases (including *Shotgun Delivery*, which was, and *Namyst*, which was not, mentioned in the CIP). If you are already familiar with this background, you can just skip over the "applicable law" pages.

Employee Tool & Equipment Alert

January 30, 2008

IRS Convenes Cross Divisional Team to Consider Employee Tool & Equipment Plans

The Internal Revenue Service has established a ***cross divisional team to address significant concerns with certain Employee Tool and Equipment Plans***, sometimes called Service Technician's Tool Reimbursement Plans, that purport to receive tax-favored treatment as "accountable plans" under Internal Revenue Code § 62(c) and the accompanying regulations.

An expense reimbursement arrangement is a tax-favored accountable plan if it satisfies the three requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses, and if it does not evidence a pattern of abuse of the rules applicable to such plans. 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. Conversely, if the arrangement fails any of the requirements or otherwise evidences a pattern of abuse of the rules, the 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.

Many of the tool plans currently being marketed do not meet the requirements to be tax-favored accountable plans despite their claims to the contrary. In addition to its concerns with the lack of substantiation provided by the technicians to ensure that only expenses incurred for that employer are included in the plan, the Service is focusing on the fact that ***the majority of the plans being marketed are designed and operated around a structure that recharacterizes a portion of the employee's existing pay as a "reimbursement" for the employee's tools merely to generate tax savings for both the employer and the employee.*** In other words, the employee continues to receive the same gross pay but what was previously paid as taxable compensation is recharacterized as nontaxable reimbursement until the employee's alleged tool costs have been recovered, then the employee returns to his original amount of taxable compensation. The accountable plan rules make clear that amounts paid whether or not there are expenses incurred are not reimbursements and are not eligible for tax-favored treatment.

The Service's attention to tool plans is not new. ***In 2000, the Service issued a Coordinated Issue Paper, Service Technicians' Tool Reimbursement Plans.*** The Coordinated Issue Paper concluded that "...generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements." Although directed specifically at motor vehicle service technicians, the conclusion of the Coordinated Issue Paper was consistent with fact patterns also found in other industries. ***In 2005, Revenue Ruling 2005-52*** addressed the tax consequences of a tool plan, as typically operated at that time. ***The ruling concluded that the arrangement failed to meet both the substantiation and return of excess requirements*** and therefore was not a tax-favored accountable plan. While the tool plan promoters responded to the revenue ruling by changing elements of their plans to address some of the shortcomings regarding the substantiation of expenses, the Service continues to be concerned about the currently marketed tool plans. Of particular concern to the Service is the apparent design and operation of the tool plans to recharacterize a portion of the compensation otherwise payable to the employee rather than reimburse substantiated expenses incurred for the employer.

The Service's cross-divisional team includes members of all examination divisions, Appeals, and the Office of Chief Counsel. The Service has also initiated promoter investigations and employer examinations identified from promoter client lists. To the extent that plans do not meet the accountable plan rules, there will be employment tax and potentially penalty assessments. ***The Service is also currently revising the 2000 Coordinated Issue Paper, Service Technicians' Tool Reimbursement Programs, to reflect facts consistent with plans currently being marketed.***

These plans are widely marketed to various industries, including the automotive, heavy equipment, construction, aircraft maintenance, agriculture, and other industries. Taxpayers that are considering implementing such a plan are advised to take a cautious approach. ***[Emphasis added]***

Internal Revenue Service
United States Department of the Treasury

Coordinated Issue - Motor Vehicle Industry

LMSB-04-0608-037
Revision Date: July 2, 2008

Coordinated Issue

Motor Vehicle Industry
Employee Tool & Equipment Plans
Previously – Service Technicians' Tool Reimbursement Plans
UIL 62.15-00

ISSUE

Whether amounts paid to employees under Employee Tool and Equipment Plans for the use of their tools and equipment are paid under an accountable plan so that the payments are excluded from the employees' gross income and are exempt from the withholding and payment of employment taxes.

CONCLUSION ... SUMMARY

As the Internal Revenue Service (Service) has seen them to date, Employee Tool and Equipment Plans (Tool Plans), under which amounts are paid to employees for the use of their tools and equipment, do not meet the accountable plan requirements.

Therefore, the amounts are treated as paid under a nonaccountable plan and must be 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 federal employment taxes.

CONCLUSION ... EXPANDED

As the Service has seen them to date, Tool Plans do not satisfy the three requirements of an accountable plan, and possibly evidence a pattern of abuse. As a result, payments made to employees under these Tool Plans will be treated as paid under a nonaccountable plan.

Therefore, amounts paid under these Tool Plans must be included in the employee's gross income, reported as wages or other compensation on the employee's Form W-2, and subject to withholding and payment of employment taxes.

The facts of each plan allegedly reimbursing employee tool and equipment expenses should be reviewed to determine whether they differ from the Tool Plans described in this document and whether they satisfy all of the accountable plan rules. For example, it is relevant to know when the employer implemented the arrangement and whether the hourly wage rate was reduced at such time only to be reinstated at the previous hourly wage rate after the tool expenses are reimbursed.

CONCLUSION ... EXPANDED (continued...)

It should be determined whether the arrangement is written, and, if so, the writing should be reviewed to determine if its terms comply with the requirements of an accountable plan. Whether the written terms of the arrangement are actually followed is equally important. For example, what substantiation is requested and required to establish the expenses incurred for the tools and when such expenses were incurred in relation to the employee's employment with the employer?

The employee's understanding of the arrangement also should be considered. For example, it would be relevant to know whether the employee was informed that he/she would always receive at least the same amount of gross pay as he/she received prior to implementation of the arrangement, regardless of the amount of tool expenses incurred or reasonably expected to be incurred for the employer. Statements in any marketing materials may demonstrate a clear expectation that the wage portion will be reduced for the tool allowance only to be reinstated once the tool inventory is "reimbursed."

Employers frequently assert that it is industry practice to pay employees for the use of their tools and equipment. There is no "industry practice" exception to the accountable plan requirements. Employers may reimburse employees for the expenses attributable to the use of their tools and equipment; however, only if the accountable plan rules are followed may they treat those reimbursements as nontaxable.

After analyzing the arrangement, a determination can be made whether it meets the accountable plan requirements under the analysis outlined in this paper.

PRIVATE LETTER RULINGS

The Service will not issue a private letter ruling or determination letter in relation to whether amounts related to a salary reduction and paid under a purported reimbursement or other expense allowance arrangement will be treated as paid under an accountable plan in accordance with Reg. Sec. 1.62-2(c)(2). (See Revenue Procedure 2008-3, Section 5.01.)

Contents of Coordinated Issue Paper

Page

Facts	EMPLOYEE TOOL & EQUIPMENT PLANS ... COORDINATED ISSUE PAPER DENYING ACCOUNTABLE PLAN STATUS UNDER SEC. 62(C) Page 1 of 2
General	• Each plan alleging to reimburse expenses should be reviewed to determine whether the accountable plan rules are met. This paper discusses Tool Plans as encountered by the Service to date and analyzes such facts under the accountable plan requirements. • Employees in automobile, truck, and equipment dealerships, repair and body shops, and various other enterprises in several industries including aviation, agriculture, and construction, are hired to perform repair and maintenance services. • As a condition of employment, the employees are required to provide and maintain their own tools and equipment, which may be kept on-site at the business locations or possibly even stored at home. • Generally, the tools and equipment are used exclusively by the employee to whom they belong and may range from simple tools to sophisticated electronic and computer equipment. • Many Tool Plans are being marketed to employers in these industries. ◆ The Tool Plans are administered either by a third party for a fee or by the employer. ◆ These Tool Plans purport to operate as accountable plans as described in Internal Revenue Code (Code) Section 62(c) and Reg. Sec. 1.62-2. ◆ Under Section 62(c) and the regulations, reimbursements for employee business expenses meeting certain requirements are not wages includible in income or subject to the withholding and payment of employment taxes.
Before Adoption of Plan	• Prior to the implementation of the Tool Plan, the employee's compensation is typically determined using an hourly rate and is paid in one check per employee per pay period, with no specific amount attributed to the provision of tools or equipment or other factors related to their employment qualifications, and with no amount identified as reimbursement for specific expenses.
After Adoption of Plan	• After implementation of the Tool Plan, the employee's compensation is divided into two components, one treated as taxable and one treated as nontaxable, the sum of which generally equals the employee's previous hourly compensation. ◆ The sum may be slightly different if the employer allocates some of its tax savings to the employee by increasing the total amount paid to the employee. • The employee usually receives two separate checks - ◆ (1) one from the employer computed at the reduced hourly wage rate, which the employer treats as wages and as subject to Federal Insurance Contributions Act (FICA) tax (both the employer and employee shares of social security and Medicare) and income tax withholding, and ◆ (2) one from the employer or Tool Plan administrator that is characterized as "tool and equipment reimbursement" or "tool allowance," which the employer or administrator treats as nontaxable and not subject to FICA tax and income tax withholding. Because the Tool Plan treats the payments as nontaxable, the Tool Plan payments are not reported on Form W-2 or Form 1099.
Plan Variations	• Employers and Tool Plan administrators use various methods to determine what amount will be paid as purported reimbursement for the employee's tool and equipment expenses and how the amount will be paid. With respect to what total amount will be paid as a tool allowance, the Tool Plans vary in the details, but generally base the total amount paid on some version of the value or cost of the complete inventory of tools and equipment each employee owns. Some plans also take into account "other expenses" such as tool maintenance or insurance when determining the total amount to be paid as purported reimbursement.

Facts	***Employee Tool & Equipment Plans ... Coordinated Issue Paper Denying Accountable Plan Status under Sec. 62(c)***
Determining Total Payment ***Tool Lists***	• To determine the total amount to be paid, some Tool Plans may ask each employee for a list of their tool and equipment inventory and for any available receipts at the time the Plan is being implemented. • In many cases, the inventory includes tools or equipment purchased while the employee was employed by a prior employer or perhaps tools acquired as part of the education or schooling process. • When the employee does not have receipts to establish cost, either an estimate of the cost (produced by the employee or the Tool Plan administrator) or the current replacement value of the tools or equipment (or category of tools or equipment) may be used. • The Tool Plans may use catalogs from various tool and equipment vendors to determine the current replacement value. • The estimated cost may be based on factors such as the type of tool or equipment, its useful life, and the geographic location of the worker. • Some Tool Plans ask questions or request certification regarding any prior depreciation taken by the employee for tools in inventory, but the Tool Plans do not appear to follow through on obtaining the information, including when the tools were acquired or whether the initial cost was deducted by the employee, necessary to determine the expenses actually incurred by the employee in performing services for that employer. • Accordingly, none of the methods for determining the amount to be paid as a tool allowance appear to be directly correlated with or based exclusively on the actual expenses paid or incurred, or reasonably expected to be incurred, by the employee for tools and equipment in performing services for that employer.
One Tool Plan Variation	• With respect to how the amount is paid, one Tool Plan variation breaks down the total amount to be paid into a fixed hourly "tool allowance" rate. • The "tool allowance" rate is initially based on a set percentage (e.g., 30%, 35%) of the employee's original hourly wage rate, but may be modified so that when the "tool allowance" rate is subtracted from the original hourly wage rate, the revised hourly wage rate remains at or above minimum wage. • The hourly "tool allowance" rate is then multiplied by the number of hours actually worked during a pay period to result in a periodic tool allowance payment (often paid at the same time as payroll) until the total periodic tool allowance payments equal the total amount to be "reimbursed" under the plan. • During pay periods when an employee is receiving a periodic tool allowance, the employee also receives the reduced hourly wage rate for his/her actual hours worked.
Another Tool Plan Variation	• Another Tool Plan variation determines a fixed "tool allowance" amount by multiplying a set percentage (e.g., 30%, 35%) of each employee's hourly wage rate by a set number of hours that the employee is expected to work during a payroll period that require the use of tools and equipment (such as 80 hours during a two-week payroll period). • This fixed amount is then deducted as a lump sum from the employee's pretax compensation each payroll period and is paid separately to the employee on a periodic basis as the tool allowance (often paid at the same time as payroll) until the total periodic tool allowance payments equal the total amount to be "reimbursed" under the plan.
When Payments Equal Amounts to Be "Reimbursed"	• As indicated, employees receive tool allowance payments, however determined and paid, until they have received an amount equal to the total amount to be "reimbursed" under the plan, i.e., the value or estimated cost of the employee's inventory, however calculated. • Once an employee has received periodic tool allowance payments equal to the total amount to be "reimbursed", the employee stops receiving tool allowance payments and returns to his/her regular pay at the hourly wage rate earned prior to implementation of the Tool Plan. • However, most Tool Plans permit employees to increase their total amount to be "reimbursed" under the Tool Plan or again participate in the Tool Plan with respect to new inventory by having the employees submit information regarding expenses incurred for any new or additional tools or equipment. • The Tool Plans generally require receipts for new purchases.

EMPLOYEE TOOL & EQUIPMENT PLANS ... COORDINATED ISSUE PAPER DENYING ACCOUNTABLE PLAN STATUS UNDER SEC. 62(C)

Discussion of Applicable Law

- The discussion of applicable law in the Coordinated Issue Paper consists of ...

In General

- In general, wages are defined for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax withholding purposes as all remuneration for employment unless otherwise excluded. (Code Sections 3121(a), 3306(b), and 3401(a))
- There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses.
- However, Reg. Sec. 1.62-2(c)(4) provides that amounts an employer pays to an employee to reimburse for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. See also Reg. Sec. 31.3121 (a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations, and Reg. Sec. 1.6041-3(h)(1) of the Income Tax Regulations.
  - Since FUTA tax is usually not at issue with respect to the proper treatment of tool allowances because the taxpayers pay other wages in excess of the FUTA tax wage base, the remainder of this paper only addresses the income tax withholding and FICA tax consequences.

Accountable Plan

- Section 61 of the Internal Revenue Code defines gross income as all income, from whatever source derived. Section 62 defines adjusted gross income as gross income minus certain "above-the-line" deductions.
- Section 62(a)(2)(A) allows an employee an above-the-line deduction by providing 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 Section 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if ...
  - The arrangement does not require the employee to substantiate the expense covered by the arrangement to the person providing the reimbursement, or
  - The arrangement provides the employee the right to retain any amount in excess of the substantiated expense covered under the arrangement.
- Reg. Sec. 1.62-2(c)(1) provides that a reimbursement or other expense allowance arrangement satisfies the requirements of Section 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses.
- If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan.
  - 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.
  - In contrast, 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 under Reg. Sec. 1.62-2(d), (e), and (f) apply on an employee-by-employee basis.

Business Connection Requirement

- An arrangement meets the business connection requirement of Reg. Sec. 1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (Section 161 and the following), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer.
- Thus, not only must an employee pay or incur a deductible business expense, but the expense must arise in connection with performing services for that employer.
- If an employer reimburses deductible business expenses that the employee incurred prior to employment, the plan does not meet the business connection requirement.
- "Paid or incurred" requires that there be an actual expense.
- If an arrangement is making payments to compensate for the fair rental value or use of tools or equipment rather than expenses incurred, it will not meet the business connection requirement.
- Reg. Sec. 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the 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.
- 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 reasonable expectation to incur expenses), by routinely paying a reimbursement allowance to an employee who has not incurred bona fide business expenses, or by reducing the wage payment in light of expenses incurred or reasonably expected to be incurred only to then increase the wage payment again after the expenses have been reimbursed.
- Reg. Sec. 1.62-2(j) example 1 illustrates a violation of the Reg. Sec. 1.62-2(d)(3)(i) requirement that a reimbursement be paid only when expenses are incurred.
- The example provides that 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 nontaxable reimbursement for the engineer's travel expenses.
  - On all other days, the engineer receives the full $200 as taxable wages.
  - Because Employer S pays an engineer $200 a day regardless of whether the engineer is 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 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 employee's Form W-2.
    - And Employer S must withhold and pay employment taxes on the entire $200 when paid.
- ***Where a plan serves to recharacterize amounts as a reimbursement allowance that would otherwise be paid as wages*** if there were no expenses reasonably expected to be incurred for the employer, amounts paid under the plan 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 employee receives the same amount regardless of whether expenses were incurred or reasonably expected to be incurred.
    - [Note: See also Rev. Rul. 2004-1, 2004-1 C.B. 325. In Rev. Rul. 2004-1 the Service concluded, in relevant part, that a reimbursement arrangement that subtracted a mileage allowance (calculated at the standard business mileage rate for the miles traveled) 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 essentially recharacterized as a mileage allowance amount otherwise payable as commission, thereby ensuring that each driver received the same total amount regardless of the amount of deductible employee business expenses actually incurred.]

Business Connection Requirement (continued...)

- Consequently, all amounts paid under the plan must be treated as ...
  - Paid under a nonaccountable plan,
  - Must be included in the employee's gross income, and
  - Must be reported as wages for FICA tax and income tax withholding purposes.
- ***The prohibition against wage recharacterization does not preclude an employer's prospective alteration of its compensation structure to include reimbursement of substantiated expenses under an accountable plan, as long as [i.e., provided that] ...***
  - Such amount, however identified or denominated, is only paid if bona fide expenses are incurred or reasonably expected to be incurred for the employer, and
  - The employer does not use an alternate method to get the same amount of gross pay to employees when qualifying expenses are not incurred or reasonably expected to be incurred and subsequently substantiated (e.g., increased compensation, bonus, reduction in wages for the reimbursement "amount" with subsequent increase once the "reimbursement" is complete).
    - [Note: Whether or not there is wage recharacterization is a separate determination from whether a compensation structure raises additional issues, such as constructive receipt.]
- ***The presence of wage recharacterization is based on the totality of facts and circumstances.***
  - Furthermore, an employer may convert from a nonaccountable plan to an accountable plan only if the employer keeps track of the expenses that have been reimbursed under the nonaccountable plan to ensure they are not reimbursed a second time under the accountable plan.

Shotgun Delivery v. U.S.

- In *Shotgun Delivery v. United States*, 269 F.3d 969 (October 16, 2001), the United States Court of Appeals for the Ninth Circuit affirmed in part and reversed in part the District Court's decision which upheld the Internal Revenue Service's assessment of more than $450,000 in delinquent employment taxes, plus interest and penalties.
- The Court agreed with the district court's determination that Shotgun's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of Reg. Sec. 1.62-2 and that the contested payments should have been treated as wages and taxed as such.
- In *Shotgun*, the plaintiff provided courier services.
  - It charged customers an amount called a tag rate that was based on distance, time required for delivery, waiting time, and weight.
  - The employees used their own vehicles for deliveries and were paid 40% of the tag rate.
  - The couriers were compensated with two separate checks.
    - The ***first check*** was a "wage check," which paid the couriers an hourly amount.
    - The ***second check*** was for "reimbursement of expenses/lease fee" and equaled 40% of the tag rate minus the amount paid on the wage check.
  - ***Thus, the couriers were always paid 40% of the tag rate.***
- The Court found the arrangement was not an accountable plan because it failed to meet the business connection requirement.
- The Court stated that "the evidence suggests that the plan's primary purpose was to treat the least amount possible of the driver's commission as taxable wages" and concluded that "as Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred it was an abuse of Section 62(c) and was therefore a nonaccountable plan."

Substantiation Requirement

- Reg. Sec. 1.62-2(e)(1) provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated in accordance with paragraph (e)(2) or (e)(3) of that Section, whichever is applicable, to the payor (the employer, its agent or a third party) within a reasonable period of time.
- Reg. Sec. 1.62-2(g)(1) provides that what constitutes a reasonable period of time depends on the facts and circumstances of each arrangement.
- However, Reg. Sec. 1.62-2(g)(2) provides a safe harbor for substantiation under which the substantiation requirement is met if an expense is substantiated within 60 days after the expense is paid or incurred.
- Reg. Sec. 1.62-2(e)(2) provides that 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) and the Regulations is submitted to the payor.
- Section 274(d) applies to "listed property" under Section 280F(d)(4).
  - Most tools are not listed in Section 280F(d)(4).
  - The list is limited to items such as property used for transportation including an automobile, computer or peripheral equipment as defined in Section 168(i)(2)(B), and cellular telephone or similar telecommunications equipment.
- No deduction is allowed for an expense associated with such listed 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 employee establishes by adequate records or by sufficient evidence corroborating the taxpayer's own statement …
  - The amount of each expenditure,
  - The amount of each business or investment use of the listed property and its total use,
  - The date of the expenditure or use, and
  - The business purpose for an expenditure or use of any listed property. (Reg. Sec. 1.274-5T(b)(6))
- Reg. Sec. 1.62-2(e)(3) provides that an arrangement that reimburses business expenses 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.
- Reg. Sec. 1.62-2(e)(3) references Reg. Sec. 1.162-17(b) which provides substantiation rules for employee business expenses.
- Reg. Sec. 1.162-17(b)(1) provides that an ***employee need not report on his/her tax return*** expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him/her solely for the benefit of his/her employer for which he/she is required to account and does account to his/her 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 the advances, reimbursements, and charges is equal to the expenses.***
- Reg. Sec. 1.162-17(b)(4) requires an employee 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.

Return of Excess Requirement

- Reg. Sec. 1.62-2(f) provides that, 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) further provides that an arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the return of excess requirement only if ...
  - 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.
- Furthermore, 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.
- Reg. Sec. 1.62-2(g)(2)(ii) provides a ***safe harbor*** under which periodic statements may be used.
  - The Section provides that if a payor provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated in accordance with Reg. Sec. 1.62-2(e), and requesting the employee to substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid) and/or return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time.

Revenue Ruling 2005-52

- In Rev. Rul. 2005-52, 2005-2 C.B. 423, the Service addressed the tax consequences of a tool allowance plan.
- In the Revenue Ruling, 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.
  - The 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.
  - The tool allowance, therefore, 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.
- 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, and in the absence of substantiation, had no means of knowing whether it had made any excess payments.

Revenue Ruling 2005-52 (continued...)

- 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 hours worked in which the use of tools was required, and the employer reimburses them per hour at their tool allowance rate, which is based on estimated annual tool expenses and statistical data.
- The Ruling provides that although reasonable expectations for expenses can be used to establish that a plan 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 to be incurred 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 the employer require employees to return any excess received within a reasonable period of time after receiving the quarterly statement.
  - Therefore, the Revenue Ruling concludes that the employer does not provide a periodic statement within the meaning of Reg. Sec. 1.62-2(g)(2)(ii).
- The Revenue Ruling goes on to provide that, even if the 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 did not address how an arrangement intending to reimburse tool expenses can satisfy the business connection requirement.
  - Accordingly, Rev. Rul. 2005-52 did not address the prohibition against wage recharacterization nor the necessity of establishing that expenses being reimbursed are incurred in the course of performing services for the employer.
  - 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.

Anti-Abuse Provision

- Reg. Sec. 1.62-2(k) provides that 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, all payments made under the arrangement will be treated as made under a nonaccountable plan.
- See discussion of ***Shotgun Delivery*** above.

In General

- Under current law, amounts paid to employees for the use of their tools and equipment can be excluded from wages only if paid under an accountable plan. A plan must satisfy the accountable plan requirements of business connection, substantiation, and return of excess under Section 62(c) and Reg. Sec. 1.62-2 in order for payments made under it to be excludable from wages. A purported reimbursement arrangement that merely allocates compensation between wages and tool and equipment payments will not satisfy the requirements of Sec. 62(c) and Reg. Sec. 1.62-2.
- Based on the arrangements the Service has seen, amounts paid to employees under Tool Plans with the aspects described herein do not satisfy the requirements of an accountable plan. However, the facts of each arrangement should be reviewed to determine whether they differ from the Tool Plans described in this document and whether they satisfy the accountable plan rules.

Analysis ... Requirement #1 ... Business Connection Requirement

- ***Tool Plans fail the business connection requirement.***
- The amounts being paid under the Tool Plans are paid routinely in the absence of information necessary to establish a reasonable expectation of the expenses to be incurred and are not true reimbursements or advances of expenses incurred or reasonably expected to be incurred in performing services for the employer. Rather, the Tool Plans designate a portion of an employee's existing compensation and label it as a "nontaxable reimbursement" only until the employee's total amount of tool inventory has been paid out, at which point the portion is again designated as taxable wages. The employee continues to be paid the same gross pay, including the portion temporarily designated as a tool allowance, without regard to whether expenses are incurred or reasonably expected to be incurred. Employees receive the same gross pay before, during, and after they are "reimbursed" for expenses. In fact, it is our understanding that the Tool Plans assure employers and employees that there is no out-of-pocket cost for either of them in implementing a Tool Plan and that the only difference is tax savings and more take-home pay.
- If the employee incurs any future expenses for the employer after the total amount of tool inventory has been paid, the employee's wage portion again will be reduced and a periodic tool allowance will be paid until the expenses have been reimbursed, at which time the wage portion will again be increased. Where an employer arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses, the arrangement fails to meet the business connection requirement.
- The same reasoning applies here that was used by the court in Shotgun Delivery Service, where a portion of the employee's commission was designated as an expense reimbursement, but the amount had no logical connection to the expenses incurred. In the case, two drivers following identical routes and incurring the same expenses received the same total amount for the delivery. However, if one took longer to drive the route, the employer treated a larger proportion of his payment for that delivery as taxable hourly wages, and a smaller proportion as a nontaxable expense reimbursement. Thus, the expense reimbursements paid to the two drivers were not the same even though the expenses incurred should have been the same.
- Tool Plans suffer from the same problem. In Tool Plans, two employees who have the same inventory of tools but who pay or incur very different expenses for that employer, because of their different history of purchases, past reimbursements and/or depreciation, would nonetheless receive the same total amount through tool allowance payments. Tool allowance payments made in this fashion lack a logical connection to expenses incurred or reasonably expected to be incurred during employment for the current employer and, therefore, fail to meet the business connection requirement. Continuing to pay as part of the hourly wage the amount previously designated and paid as tool reimbursement even though all purported expenses have been "reimbursed" illustrates that the amount is being paid without regard to whether the employee incurs or is reasonably expected to incur expenses for the employer.

- ***While an analysis of a Tool Plan under the substantiation and return of excess requirements is not necessary once the Tool Plan fails the business connection requirement, the following sections evaluate Tool Plans under the other accountable plan requirements as well.***

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

- ***Tool Plans also fail the substantiation requirement.***
- The majority of the tools covered under Tool Plans are not "listed property." The general substantiation requirement under Reg. Sec. 1.62-2(e)(3) requires the substantiation of the elements of the expense, which includes providing an expense account or other written statement showing the amount and business nature of each expense.
- While the Tool Plans vary on the level of information requested, Tool Plans fail the substantiation requirement because they fail to require substantiation of each element of an expenditure or use, including its business nature and proper reimbursable amount, in accordance with Reg. Secs. 1.62-2(e)(3) and 1.162-17(b)(4). Substantiation of these elements may require determining, in addition to original cost, information such as purchase dates, whether the tools have been used for any purpose other than the current employer's business, and whether any of the cost has been recovered through reimbursement or depreciation, or has otherwise been fully deducted or depreciated. The Tool Plans do not appear to require that the employee supply this information.
- To the extent the Tool Plans rely only on current value of inventory, expenses have not been substantiated because current value (rather than the unrecovered cost attributable to use of the tools in the employer's business) is not a proper reimbursable amount that satisfies the business connection requirement, as discussed above.
- To the extent the Tool Plans rely on cost estimates or totals for categories of tools without attempting to obtain information from the employee (such as cost, acquisition date, prior deduction, depreciation, or reimbursement) that would establish whether the employee has an expense and, if so, the amount of the expense, the Tool Plans do not determine the proper reimbursable amount of expenses attributable to an employer's business activities. (Note: Information regarding the acquisition date of tools or equipment is especially important both in establishing that there has been an expense incurred in performing services for that employer and in determining whether the employee has depreciation expenses that an employer could reimburse.)
- All the elements (i.e., amount, time, place, and business purpose) of the expenses incurred in performing services for the employer must be established, as required by Reg. Sec. 1.62-2(e)(3). Some of this information is essential to establish that the employee incurred an expense at all. An employee may have a tool or piece of equipment in inventory, but if the expense for the tool or equipment has previously been reimbursed or has been fully depreciated, then the expenses paid for the tool or equipment cannot be reimbursed through the current employer's accountable plan.
- If the employer cannot obtain accurate information from the employee to establish all the elements of the expenses paid or incurred in performing services for the employer, the employer may argue it may rely on a reasonable estimate to substantiate the expenses for tools not subject to Section 274(d). *Cohan v. Comm.*, 39 F.2d 540 (2nd Cir. 1930). However, there must be a reasonable evidentiary basis for the estimate. *Namyst v. Comm.*, T.C. Memo. 2004-263, affd 435 F.3d 910 (8th Cir. 2006). Of course, to the extent any of the tools or equipment constitute "listed property" requiring substantiation that satisfies Section 274(d) and the regulations, the Tool Plans do not appear to satisfy the more rigorous and specific requirements of that section.
- Substantiation must be made on a timely basis, and must establish what expenses were incurred for the employer. Fair tool and equipment rental or replacement value, without more, does not satisfy the substantiation requirement, as it does not take into account any information about the acquisition date and amount of, or the specific nature of, any expenses paid or incurred by the employee for the employer and not previously reimbursed.
- Furthermore, by taking into account the employee's entire existing inventory, whether determined by reference to value or cost, without taking into account the employee's prior history of depreciation or reimbursement for the expenses incurred for the tools listed, the Tool Plans fail to even reasonably estimate expenses actually incurred. Revenue Ruling 2005-52 emphasizes that there must be substantiation and provides that although reasonable expectations for expenses can be used to satisfy the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on expenses actually incurred.
- The Tool Plan's requirement for receipts for new expenses, 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.

Analysis ... Requirement #3 ... Return of Excess Requirement

- ***Tool Plans also fail the return of excess requirement.***
- All amounts paid under the Tool Plans that are not properly substantiated are treated as excess reimbursements. Even if the Tool Plans make reference to a requirement to return "excess" tool allowances, since the Tool Plans do not substantiate the expenses, they also do not require employees to return any amounts paid in excess of substantiated expenses.
- Employees must be required to return to the payor within a reasonable period of time any amount paid in excess of expenses substantiated.
- Reg. Sec. 1.62-2(h)(2)(i)(B) and Revenue Ruling 2005-52 make clear that excess must be returned and cannot simply be reclassified as wages and taxed as such. The Regulation and the Ruling both provide that, with the exception of circumstances where the employee expenses are covered through a mileage or per diem allowance, an arrangement is not an accountable plan if it includes amounts paid in excess of substantiated expenses in wages rather than requiring that they be returned.

Additional Analysis ... Pattern of Abuse

- In addition to violating the basic requirements of an accountable plan, namely business connection, substantiation, and return of excess, Tool Plans may also evidence a pattern of abuse under Reg. Sec. 1.62-2(k), requiring the treatment of payments made under the plans as made under a nonaccountable plan.
- Generally, the failures are not isolated with regard to a particular employee or period of time. Rather, the failures appear to be routine and fundamental to the design of these Tool Plans, where the goals are to ensure that the gross pay of each employee remains the same, regardless of whether the employee incurs or is reasonably expected to incur expenses for the employer, while generating tax savings for both the employer and employee by "reimbursing" the employees with funds that would otherwise be payable to them as taxable wages and will again be paid to them as wages once the "reimbursements" are completed.
- The accountable plan rules were not meant to allow taxpayers to avoid paying taxes on 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 reimbursements until the employee's tool inventory value is zeroed out, only to reinstate the original wage amount at that point, evidence a pattern of abuse of the accountable plan rules.

IRS Coordinated Issue Paper ... *Employee Tool & Equipment Plans* ... LMSB-04-0608-037 ... July 2, 2008

I. *LIFO Inventory Matters - Everything Except Discussion of Rev. Proc. 2008-23 (Single LIFO Pool)*

A. *New Vehicles - Alternative LIFO Method (Rev. Proc. 97-36, formerly Rev. Proc. 92-79)*

1. Pool inflation indexes for calendar year 2007 LIFO computations for most makes and models reflected little, if any, overall inflation for the year.
   a. Pool #1 - *New* Automobiles ... Generally ... Around 1% inflation
   b. Pool #2 - *New* Light-Duty Trucks ... Generally the same ... Around 1% inflation
   c. IPIC indexes ... PPI ... Deflation of -0.2% cars and -1.6% light-duty trucks
2. Resolution of how crossover vehicles should be treated for LIFO purposes (Rev. Proc. 2008-23)
   a. Background
   b. Becomes moot if single LIFO pool is used for all new vehicles

B. *Used Vehicles - Alternative LIFO Method (Rev. Proc. 2001-23)*

1. Pool inflation indexes for calendar year 2007 LIFO computations
   a. Pool #1 - *Used* Automobiles ... Generally ... Around 2-3% deflation
   b. Pool #2 - *Used* Light-Duty Trucks ... Generally ... Around 1% inflation
2. Resolution of how used crossover vehicles should be treated for LIFO purposes
   a. Becomes moot if single LIFO pool is used for all used vehicles (Rev. Proc. 2008-23)

C. *Huffman, et al., v. Comm.*

1. Even though this case was decided in 2006, it is still very important in the context of automobile dealerships whose LIFO reserves have not been properly computed.
2. In this case, the taxpayer's LIFO computations omitted a major step that resulted in undervaluation of the inventory. In applying the link-chain, dollar-value method, the increments (expressed in base dollars) were not multiplied by the cumulative index at the end of the respective year. In other words, LIFO increments were not valued at current cost.
3. The accountant's error was not a mathematical error or a posting error within the meaning of Reg. Sec. 1.446-1(e)(2)(ii)(b).
4. The Tax Court held that IRS adjustments to correct the accountant's omissions constituted changes in a method of accounting. Therefore, the IRS' Section 481(a) adjustment was permitted and each shareholder of the dealership S corp. group was required to reflect his/her pro rata share.
5. ***Recent development ...*** March 4, 2008 - U.S. Court of Appeals for the 6th Circuit affirmed Tax Court decision on change in method, permitting the IRS to make Section 481(a) adjustment (rather than correction of error by taxpayer) in order to properly restate the LIFO valuations. (*Huffman*, 518 F3d 357 [6th Cir. 2008], affirming 126 T.C. 322 [2006])

D. *Termination of LIFO elections by auto dealerships ... New uncertainties arise*

1. Question over what are "permitted methods" raises the issue of whether the termination of its LIFO election by a dealership can be made as an automatic change (in method) or if the termination requires IRS permission in advance.
2. Background ... All non-LIFO inventories must be using the same method for valuation and identification of inventories. If they are not, then termination of LIFO cannot be made using the Automatic Change in Method Procedures
   a. Because the replacement cost method is used for parts and accessories inventories, auto dealerships must obtain consent in advance to terminate LIFO election for new vehicles or for used vehicles.

I. *LIFO Inventory Matters - Everything Except Discussion of Rev. Proc. 2008-23 ... (continued)*

D. *Termination of LIFO elections by auto dealerships ... New uncertainties arise ... (continued)*

3. Current status ... The severe problems caused by the IRS' position is apparently receiving some attention in the National Office at this time. The implications for dealers caught in this catch-22 are nothing short of horrendous.

E. *When in doubt, file Form 970*

1. ***Recent development*** ... In LTR 200810010 (December 12, 2007), the IRS granted an extension of time under Reg. Sec. 301.9100-1(c) to file a Form 970 in connection with the restructuring of a corporate group.
   a. This involved the creation of a Single Member Limited Liability Company (SMLLC) which was a disregarded entity for Federal income tax purposes. The SMLLC subsequently elected to be treated as a corporation under Reg. Sec. 301.7701-3(a).
   b. A Form 970 should have been filed, but it wasn't in connection with this. The oversight of the first practitioner was caught by a second practitioner, and a request for an extension of time to file the Form 970 was granted by the IRS.

F. *Will use of the LIFO inventory method be legislated out of existence?*

1. Senate hearing on status of LIFO "viability" two years ago (June 13, 2006)
2. 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 (Section 3301) ...
   a. Proposed by Rep. Rangel (D, NY), Chairman of the House Ways and Means Committee
   b. The LIFO reserve income would be recognized (i.e., taken into income) over an 8-year spread period. This proposal was estimated to raise $106 billion over 10 years.
   c. Also included proposed repeal of the use of the Lower-of-Cost-or-Market Method for valuing inventories (Section 3302)
3. ***Recent development*** ... How important will developing International Financial Reporting Standards (IFRS) be in considering this matter? ... SEC does not want an exception for use of LIFO by U.S. companies.

II. *LIFO Inventory Matters - Revenue Procedure 2008-23 ... March 8, 2008 [Attachments #1-5]*

A. *Evaluating the "new & improved" Single, Combined LIFO Pool Method for New Vehicles*

B. *At a Glance summary of Rev. Proc. 2008-23*

C. *Proforma comparison of single pool result vs. separate pool result*

D. *What should you be telling your dealer clients?*

E. *Projections of change in LIFO reserve for 2008 ... Will calculations be based on using a single pool, or continuation of the standard 2-pool approach?*

1. There could be significant differences between the results, especially if there are major changes in composition of dealership inventories of car relative to light-duty trucks.
2. What if the dealer does or does not want to reflect the single pool result on the financial statement (even though the Vehicle-Pool Method will be elected)?
   a. What are the ramifications in terms of Revenue Ruling 97-42 which require certain disclosures in order to avoid a violation of the financial statement conformity requirements?

II. *LIFO Inventory Matters - Revenue Procedure 2008-23 ... March 8, 2008 ... (continued)*

F. ***Recent development ...*** IRS Chief Counsel's Office issues Memo No. 200825044 providing guidance in the form of two examples of calculations for combining the LIFO pools for dealerships adopting the new Vehicle-Pool Method.

1. Example where both LIFO pools have the same base year. This is pretty straight-forward.
2. Example where LIFO pools do not have the same base year.
   a. Chief Counsel Memo follows format used in the example in the Regulations.
   b. This approach may be problematic in many cases where the result is to shift the amount of the LIFO reserve allocable to a particular year's LIFO layer to a different year's LIFO layer.

III. *Section 263A ... Application of Inventory Cost Capitalization Rules to Auto Dealerships*

A. ***General background***

1. Section 263A issues have been raised in only a few dealer audits. These dealers are located principally in the Northeast and in the Midwest. The adjustments proposed by the IRS agents involve significant dollar amounts.
2. Sec. 263A technical issues are being coordinated by a IRS Issues Specialist (headquartered in a Midwest IRS office) who has been heavily involved in developing the Section 263A issues.
3. IRS Motor Vehicle Technical Advisor issued *Automotive Alert* ... "IRC Section 263A Auto Dealership Questions & Answers" ... dated January 2007.
   a. The *Alert* consists of 4 pages of questions and answers which basically repeat portions of the Regulations under Section 263A with little, if any, further guidance for dealerships.
   b. Because of the lack of any significant guidance over the last 12-18 months, the introduction to the *Automotive Alert* which expresses the IRS' "current audit posture" on Sec. 263A issues is still relevant ...

"Section 263A's recently elevated profile is likely due to a number of factors ***including an increase in dealership examinations***. (Emphasis added.)

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

"The Producer Issue has not been previously considered an issue at dealerships by the IRS and there is no specific guidance. In order to clarify the issue and to provide guidance to the industry, we have requested a Generic Legal Advice Memorandum (GLA).

"In addition to the Producer Issue, we have asked for industry specific guidance on several other Section 263A issues. Although normally the GLA process does not contemplate involvement from external customers, in this case NADA was invited to submit a white paper expressing the industry view of the issues.

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

III. Section 263A ... Application of Inventory Cost Capitalization Rules to Auto Dealerships ... (continued)

A. General background ... (continued)

3. IRS MVTA *Automotive Alert ... (continued)*

   c. ***Recent development ...*** The IRS recently indicated that it will not be issuing the Generic Legal Advice Memorandum referenced above. Instead, it will deal with ***some*** of the Section 263A issues ... "in the future," under its IIR Program. NADA is strenuously attempting to persuade the IRS to "stand down" on all Section 263A issues (not just the producer issue).

4. ***Recent development ...*** On March 26, 2008, NADA sent a letter to the IRS requesting that non-producer dealership cost capitalization issues be considered for guidance under the IIR program. This contains a very good discussion of the current state of uncertainty over unresolved issues.

B. TAM 200736026 (Sept. 7, 2007)

1. Currently, this TAM is still the only available information or guidance that the IRS (National Office) has issued.

   a. The dealership facts in this TAM must be carefully studied ... and distinguished, if possible, from your own dealership's fact pattern.

   b. This TAM does not have precedential value. However, everyone - including IRS agents - seems to be treating it as if it does.

2. Basic technical issue ... ***Should the auto dealership be treated as a "producer" or as a "reseller" under Section 263A?*** Whether the repair services provided by a typical dealership meet(s) the definition of "providing services" under Reg. Sec. 1.263A-1(b)(11). This would put the dealership either ... directly under the "producer" rules of Section 263A, ... or result in treating the dealership as a "reseller with production activities" under the "reseller" portion of the rules of Section 263A.

3. TAM divides into 3 major parts. Although 12 issues are listed, many have multiple subparts.

   a. ***Part 1*** ... *Production & Handling Activities* ... 6 issues ***[Attachment #6]***

   b. ***Part 2*** ... *Retail Sales Facility Issues* ... 3 issues ***[Attachment #7]***. Note carefully the specifics of Taxpayer's facilities in connection with these on-site / off-site sales issues

   c. ***Part 3*** ... *Identification & Allocation of Costs*... 3 issues ***[Attachment #8]***

4. Selected definitions, allocation rules & de minimis exceptions ***[Attachment #9]***

5. In January 2008, the IRS Motor Vehicle Technical Advisor issued a 3-page *Automotive Alert* which briefly discusses TAM 200736026.

C. Related questions and ramifications

1. ***"Clear reflection of income" ...*** Overall standard for acceptability of Section 263A methodologies ... But, what does this "standard" (i.e., *clear reflection of income*) really mean?

2. ***"Separate trades or businesses."*** How should the tax principles relating to "separate trades or businesses" be applied in the dealership context? Is there some way to separate and distinguish certain activities of a dealership (namely, the Parts, Service and Body Shop activities) from the dealership's other activities which involve the purchase and sale of new and used vehicles? ***[Attachment #10]***

3. ***Corrections ... changes in accounting methods.*** If a dealership previously has been considering itself to be ***a reseller*** under Section 263A, how should the IRS correct the dealership's erroneous interpretation / method of accounting in that regard?

III. *Section 263A ... Application of Inventory Cost Capitalization Rules to Auto Dealerships ... (continued)*

C. *Related questions and ramifications ... (continued)*

4. ***Forms 3115 filings.*** There will be confusion over how dealers (and many other retailers) should correct the errors of their ways in the past. Will there be countless Forms 3115 to be filed? Will these be automatic changes in accounting method? What about Section 481(a) adjustments?
5. ***LIFO ramifications.*** There will be confusion over the ramifications for auto dealers using LIFO. How will the Section 481(a) adjustments be handled in this situation? Embedded in LIFO layers, etc.?
6. Can your dealership get a better cost cap. result (than what the TAM seems to provide for)?
   a. In many respects, this TAM evidences how a lack of information can hurt the taxpayer. The taxpayer probably could have been provided the IRS with more information ... But it didn't. In many instances, no information is provided concerning what the taxpayer did or did not do in its computations. Remember the adage, "Bad facts make bad law."
7. What's next? ... Depends on who you talk to and what you believe.
   a. Possible guidance in the form of Industry Issue Resolution consideration ... But, this would address only the *"producer issue"* and not any of the other Sec. 263A interpretation issues
      (1) As previously indicated, NADA recently (March 26, 2008) sent a letter to the IRS requesting that non-producer dealership cost capitalization issues be considered for guidance under the IIR program.
   b. Possible Revenue Ruling or other relief available under Rev. Proc. 2002-18 (Involuntary Change of Accounting Methods)
   c. Possible Revenue Procedure / settlement agreement (... possibly similar to Rev. Proc. 97-44 when many dealerships faced LIFO terminations because of conformity requirement violations)
   d. NADA intervention and possible intervention by other trade associations whose members will be significantly and adversely affected

IV. *Other Dealer Tax Practice Issues & Developments*

A. *In 2008, to date, there have been a few major developments.*

1. May 9, 2008 ... Memo from White House Chief of Staff to Federal Agencies that instructed them, absent "extraordinary circumstances," to refrain from proposing Regulations after June 1 and directed them to finalize Regulations before November 1.
   a. This directive is not intended to slow down the flow of issuance of tax Regulations and (business plan) guidance.

B. *Recent presentation by Terri Harris (sponsored by NADA) on May 8, 2008*

1. "Recent Federal Tax Issues Affecting Auto Dealerships" ... a 2-hour web-based audio seminar
2. General comments on expectations concerning Section 263A guidance
3. Other topics covered
   a. Employee tool & equipment plans ... accountable / nonaccountable plans under Sec. 62(c)
   b. Cost segregation *Audit Technique Guide*
   c. LIFO pooling ... IIR & Rev. Proc. 2008-23
   d. IRS policy on automatic termination of LIFO elections & "permitted method" issues
   e. Alternative Motor Vehicle Credits

IV. *Other Dealer Tax Practice Issues & Developments ... (continued)*

C. *Depreciable lives for dealership fixed assets - Cost segregation matters [Attachment #12]*

1. Cost segregation studies are intended to determine whether an asset is ***Section 1245 property*** (***shorter*** cost recovery period property - depreciable personal property, such as equipment) or ***Section 1250 property*** (***longer*** cost recovery period property - such as buildings and building components, which generally are not Section 1245 property).
2. This difference in the 5, 7, 15 or 39-year recovery periods can be significant in most dealership situations, and it usually places the IRS and the dealership in adversarial positions.
3. In April of 2004, the IRS released a *Cost Segregation Audit Technique Guide (ATG)* to assist its auditors in reviewing and examining cost segregation studies. The original 2004 *ATG* did not specifically refer to automobile dealerships
4. For some time, the IRS Motor Vehicle Technical Advisor has been circulating a "draft" copy of a fixed asset depreciation matrix that might become the basis for a "new chapter" in the *ATG.*
5. ***Recent development ...*** In February of 2008, the IRS released the final version of the new *Audit Technique Guide* chapter specifically devoted to dealerships. This came in the form of a detailed matrix which recommends (to IRS agents) the categorization and general depreciation lives for dealership expenditures.
   a. The final (Feb. 2008) version differs somewhat from the draft of the matrix that was previously circulating.
   b. This LMSB Directive is not an official pronouncement of the law or the position of the IRS. It cannot be used, cited or relied upon as such.

D. *Section 62(c) employee tool & equipment accountable plans*

1. This area continues to be discussed by Terri Harris in every presentation with continuing repetition of negative attitude toward plans. ***[Attachment 11]***
2. ***Recent development ...*** ILM 200745018
   a. The plan in this ILM was held to be a nonaccountable plan which evidenced a consistent pattern of abuse and (adverse) promoter involvement. All payments under the plan were held to be fully taxable. The "facts" in this case are particularly unfavorable to the taxpayer.
   b. This ILM is significant because it contains the most recent ... and comprehensive ... analysis of all of the Section 62(c) issues that the IRS might be expected to raise.
   c. This ILM was the subject of extensive analysis in the December 2007 *Dealer Tax Watch.*
3. ***Recent development ... Employee Tool & Equipment Alert*** (dated January 30, 2008). This advises that the IRS has set up a coordinated task force to deal with continuing concerns in this area.
4. ***Recent development ...*** Revised Coordinated Issue Paper (CIP) on tool and equipment plans was issued July 2, 2008.
   a. The CIP concludes ... "As the IRS has seen them to date, employee tool and equipment plans, under which amounts are paid to employees for the use of their tools and equipment, do not meet the accountable plan requirements."
   b. The CIP does not discuss ...
      (1) The possibility of the IRS imposing Section 6662 accuracy penalties
      (2) The potential imposition of Section 6694 tax return preparer penalties.
      (3) The ramifications if the IRS were to become concerned about promoter involvement in employee tool and equipment plans

IV. Other Dealer Tax Practice Issues & Developments ... (continued)

E. Dealership & dealer sales of goodwill / customer lists, non-compete agreements

1. Update and general discussion
2. Possible impact of recent (non-dealership) cases
   a. *Solomon v. Commissioner* ... April 16, 2008 (T.C. Memo 2008-102) ... allocation of sales proceeds to customer lists and non-compete agreements
      (1) Payments received by the individual sellers on the sale of a division of their company were attributable to their covenants not to compete (and thus, taxed as ordinary income) instead of the sale of customer lists (which would have been taxed as long-term capital gain.
   b. *Irwin Muskat v. U.S.A.* ... April 2, 2008 (U.S. District Court for the District of New Hampshire [Docket No. 1:06-cv-00030]) ... capital gain vs. ordinary income treatment
      (1) Taxpayers were unable to show that $1 million paid under a non-compete agreement as part of the sale of their business was for goodwill. Therefore, the taxpayers should treat the payment as ordinary income.

F. Dealer PORCs ...

1. IRS is applying multi-national pricing law (transfer pricing under Section 482) to many dealers' common producer and reinsurance transactions ... i.e., credit insurance, property, extended service agreements, gap insurance.
2. IRS is using a "dashboard" approach which compares commissions at the dealer level with industry averages to determine if too much income is being allocated to the reinsurer.
3. IRS' position is based on a recent study which is very negative towards the industry.
4. One can expect that the position of the IRS (particularly if it is based in part on the recent study) will receive significant resistance from the advisors to dealers with PORCs.
5. It appears that some dealers may end up going to the Tax Court over these transfer pricing issues.

G. Previous major topics for which, right now, there are no new developments to report

1. Trade discounts & elimination from inventory costs ... Apparently not required for LIFO calculations.
   a. Everyone (except me) seems to be relying on informal opinion expressed by IRS National Office. No official or authoritative sources, citations or explanations given
   b. But note, if IRS technicians have recently become very picky over the matter of "permitted methods of accounting" in connection with the termination of LIFO elections, might they not some day become equally picky over compliance with Reg. Sec. 1.471-3(b) and Rev. Rul. 84-481?
2. Electronic recordkeeping requirements & Rev. Proc. 98-25
3. Cash reporting & Form 8300 developments

V. Other Dealer Tax Practice Issues & Discussion Topics ... Some Still Viable as Carryovers from 2007

A. Major tax planning opportunity is still available for many dealers (with C Corporations)

1. 15% preferential tax rate for qualified dividends and long-term capital gains under prior *JGTRRA* and *TIPRA* legislation has been extended to 2010.
2. Effective rate of tax, considering AMT interplay, is slightly more than 15% and less than 20%.
3. C Corp. distributions of property as dividends will require payment of tax at corporate level also.
4. These lower rates present tax planning opportunities for dealers and their dealerships.

V. *Other Dealer Tax Practice Issues & Discussion Topics ... (continued)*

B. *Tax return preparers ... Higher standard for avoidance of penalties ... Section 6694*

1. *Small Business and Work Opportunity Act* of 2007, amended Section 6694 to increase first tier and second tier penalty amounts and also to alter the standards of conduct required to avoid the imposition of ***preparer*** penalties in connection with positions taken on the tax return.
   a. Applies to all returns prepared after May 25, 2007, subject to certain transitional relief rules.
   b. Notice 2007-54 (2007-27 I.R.B. 12) provides transitional relief for the standards of conduct for all tax returns due before January 1, 2008.
2. ***"Unreasonable position."*** Penalty for return with tax liability understatement due to an "unreasonable position" is 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.
3. ***"Willful or reckless conduct."*** Penalty for return with tax liability understatement due to an "willful or reckless conduct" is 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.
4. ***Penalties now apply to all types of returns.*** Penalties extended to tax return preparers of tax returns for estate, gift, employment and excise tax returns and exempt organization returns.
5. ***Raising the bar for avoidance of preparer penalties***
   a. ***"More likely than not."*** Under the new rules, a penalty for a 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 ... ***over 50% chance.***
   b. ***"Realistic possibility."*** Under prior law, a penalty for taking a tax return position could be avoided if there was a "realistic possibility" that the position taken could be sustained on its merits ... ***one-in-three or 33⅓% chance.***

C. *FIN 48 ... Accounting for uncertainty in income taxes & uncertain tax positions*

1. Effective date ... Generally, effective as of January 1, 2007.
2. Employs a two-step approach to *recognition threshold* and *measurement attribute* ...
   a. ***Recognition threshold*** ... Management evaluates each tax position as to whether, based on the position's technical merits, it is *"more likely than not"* that the position will be sustained upon examination by the taxing authority.
      (1) The term *"more likely than not"* means that there is a probability of more than 50% that the tax position will be sustained upon examination.
      (2) Each tax position must be evaluated independently of all other tax positions without offset or aggregation at each reporting date based on the individual facts, circumstances and information that is available at that reporting date.
      (3) Tax positions recognized in previous periods as having met the "more likely than not" standard at that time, but which no longer meet the "more likely than not" standard at a later date, are to be reversed (i.e., "derecognized") in the first period in which that standard is no longer met.
   b. ***Measurement attribute*** ... If a tax position meets the *recognition threshold*, it is subject to measurement to determine the amount to recognize in the financial statements.

D. *Supplementary discussion materials (i.e., all [Attachments]) have been omitted from this outline.*

MAJOR INCOME TAX PLANNING OPPORTUNITY IS STILL AVAILABLE FOR DEALERS

15-18% RATES

The *Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)* enacted significantly lower tax rates for individuals on income from investments, including so-called ***"qualified dividends"*** and long-term capital gains. Before this change, individuals were taxed on all dividend income at their highest marginal tax rates, and long-term capital gains were generally taxed at a flat 20%.

For an individual, these preferential lower tax rates for qualified dividends and long-term capital gain were applied as follows ...

(1) ***A flat 5% tax rate*** is applied to that portion of the qualified dividend income and long-term capital gain that would otherwise be taxed in either the 10% or in the 15% tax rate brackets.

(2) ***A flat 15% tax rate*** is applied to the remaining portion of any such income that would otherwise be taxed in the higher-than-15% tax rate brackets (i.e., that would have fallen into the 25%, 28%, 33% or 35% tax brackets).

(3) The beneficial tax treatment for both qualified dividends and long-term capital gains is also available in computing an individual's income tax liability under the Alternative Minimum Tax.

Planning & projections. In connection with planning for a large dividend distribution, it is necessary to project the taxes resulting from both (1) the regular income rates and (2) the Alternative Minimum Tax (AMT) rates. Although the flat rate of tax on the qualifying income will be 15%, the ***effective rate of tax*** probably will be a little higher because of the interplay with the AMT on Form 6251.

Before year-end, there are many variables to be estimated. This prevents knowing exactly what the effective tax rate on the contemplated dividend will be. After yearend, the effective rate of tax on that dividend can be easily be computed. In several cases in the past, the effective rate has been between 17.5% and 18%. Although this is slightly more than 15%, it is still low enough to be attractive as the tax cost for taking out a large dividend.

Proactive Planning for the Lower Rates. Many planners have seen opportunities to take advantage of the seemingly "too-good-to-be-true" low rates on investment income and gains which are effectively ***slightly more than 15% and less than 20%.***

Some dealers have built up accumulated *earnings and profits* (somewhat similar - but for tax purposes, not technically the same as - *retained earnings*) in their regular C corporations or in years before their C Corporations switched over from being taxed as C Corps. to S Corps.

Even now, in 2008, the lower tax rates are still considered by some to be a "take-it-while-you-can-get-it" invitation to withdraw earnings accumulated in their C Corporations at minimum tax cost. After all, who knows how long these lower tax rates are going to remain in effect?

This planning scenario could be especially attractive to individuals whose C Corporations have accumulated assets that are not really needed in the business operations (toys - not necessarily cash) and who now want to take some of that accumulation out of the corporation at minimal tax rates. In business continuity planning situations, relieving the corporation of these unneeded assets may also make it easier for the next generation of successors to pay for the stock they are acquiring in the dealership/ business.

In this case, when a C Corporation distributes this property as a (non-liquidating) dividend, it will have to pay tax at the corporate level because that distribution is treated as if it were a sale of the property by the corporation.

However, if the amount of tax at the corporate tax level on the distribution will not be significant (because the property being distributed has a depressed value or a high tax basis relative to its fair market value), then the payment of a small amount of tax at the corporate rates will be worth it to "simplify" things and reduce exposure to the IRS questioning the ownership and use of these assets by the corporation.

In this case, the shareholder benefits from the low rates on qualified dividend income since the property distribution is pulling out accumulated earnings and profits. And, after the distribution, the corporation's balance sheet will be a lot "cleaner."

Borrow funds to pay the dividend? In some cases, the C Corporation may have earnings and profits, but it may not have adequate cash on hand to pay out a large dividend to take advantage of these lower rates. As a final thought ... The corporation might consider borrowing the money to fund the dividend payment.

ORDER FORM

LIFO Lookout ... Special Edition - Spring 2008

Devoted Entirely to Revenue Procedure 2008-23 ...
Emphasizing How Auto Dealer LIFO Inventories Can Benefit by Using the new Single, Combined LIFO Pool Method

My check is enclosed for: $ ___________________

_______ copies @ **$320 per copy**

Name: ____

Firm Name: ____

Address: ____

City: ______________________ *State:* _____ *Zip Code:* _______

E-Mail: ____________________ *Phone:* ______________________

TOTAL PAYMENT MUST ACCOMPANY ORDER

Please make your check payable to *Willard J. De Filipps, CPA, PC,* and send a copy of your completed Order Form along with your check to...

Willard J. De Filipps, CPA, PC
317 West Prospect Avenue
Mount Prospect, Illinois 60056
cpawjd@aol.com *847-577-3977*

Thank you.

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

First-class