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A Periodic Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

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

#1. WHAT'S WORSE THAN GETTING A LETTER <u>FROM THE IRS</u>? That's an easy one ... If you're a dealership, getting a letter from one of the manufacturers in bankruptcy telling you that one of your franchises is being terminated or that you are soon to be out of business.

On April 30, Chrysler filed for protection under Chapter 11, and about 30 days later, General Motors did the same. Using the veil of the bankruptcy proceedings, both manufacturers have taken the opportunity to shed dealers right and left. Although recently there has been some efforts (hearings, even proposed legislation) to try to lessen the number of dealerships to be terminated, it will take a while before the results of those efforts become evident.

In previous issues of the *Dealer Tax Watch*, we have included summaries of presentations by Richard Sox, Esq. of Myers & Fuller, PA. In these presentations over the years, he has continually warned us that once the manufacturer files for bankruptcy protection, bankruptcy law will trump the dealer's agreement with the manufacturer, and it also trumps state laws that are designed to protect a dealer's rights.

The basic point is that a bankruptcy judge only has to consider whether the action urged or suggested by the manufacturer will enable it to emerge from bankruptcy as a (more) viable entity.

Right now, without a doubt ... although not a tax development story ... the big story is the collapse of our financial institutions, the economy and two major automobile manufacturer bankruptcies.

It was easy to see the manufacturer bankruptcies coming the moment you set foot in the door at the NADA Convention in January. See Watch Out Item #3 below.

WATCHING OUT FOR

#2. <u>8.8 ... MILLION</u>. That's my prediction for new vehicle sales for 2009. The manufacturers and NADA's economists are more optimistic. They're hoping sales for 2009 will be slightly more than 10 million new units. But, remember, it was not too long ago when those predicted numbers were 13 million, then shrunk to 12 million and shrunk again to 10 million.

I'm not a believer in the end-of-June/early-July articles in the *Wall Street Journal* and the more specific dealer-oriented press that "car makers see the end to sales slide." It's easy to increase sales if you're practically giving away cars or subsidizing credit-challenged customers to the point of forgiving substantial parts of their purchase-related indebtedness.

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Now that the government (i.e., we all) owns GM ... and indirectly - by less than a stretch of the imagination - we are all deeply "invested" in Chrysler ..., I seriously doubt that we will ever see again reasonable estimates for new vehicle unit sales. Forecasting agencies and individuals have too much invested in their own self-preservation to raise any further the specter of the sales drop-off to come.

It seems the plain fact is that, unless the government is stimulating new vehicle purchases directly or indirectly, growing numbers of unemployed workers simply will have to make do with the wheels they have. The "jobs created or saved" numbers are just myths ... with more spin on them than on a slice from Roddick, Federer or Nadal.

Increasing job layoffs, not to mention countless reductions in days or weeks worked per month (which somehow never gets factored in as a reduction of employment - although it results in a reduction of earned income), suggest that the ability of the public to buy new vehicles in the near future is slowly being strangled.

If my basic math is right, the economy now needs to create half-a-million jobs in July and another half-a-million in August if the most recent bullish jobs-employment predictions by the government are to be met. The President recently said/estimated that there would be 600,000 jobs saved or created over the next 3 months, meaning in June, July and August.

When the unemployment figures were released for June, the increase in the number of unemployed workers (jobs lost?) had gone up by over 400,000. So, to go from a -400,000 to a +600,000 (in July and August) would seem to require an average of a +500,000 figure for both months. Do you really think so?

My prediction (as an unschooled economist) is that unemployment rates (that should be) reported over the next several months will come scarily close to resembling the numbers in a *Fibonacci* series.

Where did I get the number "8.8 million" from? Well, I could have taken 50% of the 2008 sales figure of 13.2 million. But I thought that might be a little too drastic ... So, I took one-half of last year's sales and increased it by one-third.

I'll get around to our tax news in just a little bit, but let me next tie-in the NADA Convention, which was held while pre-bankruptcy euphoria was still in vogue.

#3. 2009 NADA DEALERSHIP CONVENTION. Again, this year, I attended the NADA Convention, held January 24-27 in New Orleans. Although I only stayed 3 days, skipping Tuesday, I had no problem covering the floor (several times) because it was like a ghost town at times ... Great for exhibitors since they were there in far greater numbers than were dealers/prospects.

"Catastrophic: You Can See It in Their Eyes." That was Saturday's page 1 lead in the *NADA Daily* which is published by *Automotive News* on each of the four Convention days. Let me continue the opening of that article ... "Catastrophic. That's the word for the day as America's auto dealers convene in this hobbled city: Catastrophic."

That pretty much set the tone for the Convention proceeding, despite the three or four-day "pretend" that everything would be OK. Dealers are an optimistic bunch. Vendors to dealers have to be even more optimistic. Ditto for most of the articles in the *Automotive News* and other related industry publications. But, it seems to me that nobody who was realistically thinking about the consequences of what was happening at the time (even back in January) thought the new vehicle sales forecasts for 2009 could even be remotely attained.

[And then, of course, two of the three Big 3 slid into their predictable bankruptcy spirals. The more familiar you are with the industry, the less surprised you should be by what's happened.]

But, let's go back to the Convention floor.

NADA regulatory outreach. I made my usual stop at the NADA regulatory outreach booth where the IRS was sharing space with NADA and several other Federal agencies. On the IRS literature rack were three new *Automotive Alerts*, as well as copies of the dreaded TAM 200736026 on cost cap and some other prior *Alerts*.

I did have the opportunity to talk with Ms. Terri Harris (the IRS Motor Vehicle Technical Advisor) and also with Mr. Paul Metrey (Director of Regulatory Affairs for NADA). I shared with them my views on how I thought the IRS should be applying the cost cap rules to dealerships and some of the problems that I foresee in upcoming guidance.

I saw many acquaintances and visited the booths of accounting firms and associations that were exhibiting at the Convention. Personally, one of the highlights of the Convention was the opportunity to attend a seminar presented by John Boggs on dealership human resources issues.

As many readers are aware, John is one of the country's leading employment attorneys, and he has written and developed *HotlinkHR*, an online "forced process" compliance system. This system is used by almost all of the dealerships in California and many more elsewhere, and its features and efficiency are

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a marvel to behold. For more information, contact John at jboggs@hotlinkhr.com or contact thotham@kpaonline.com.

#4. WHAT'S ON THE IRS' RADAR SCREEN THESE DAYS? At the NADA Convention, the workshop entitled *"News from the IRS - What You Should Know About Dealership Federal Tax Issues"* was again presented by Ms. Terri Harris, the IRS MVTA.

Her workshop comments are summarized beginning on page 8, along with some comments of my own. After thinking about what I should be covering in this Edition of the *Dealer Tax Watch*, it occurred to me that the theme for this issue closely related to one of her comments.

Ms. Harris said that she was beginning to develop some concern over the possibility that some dealerships may become sorely tempted to take (overly) aggressive positions in the income tax returns they will be filing for 2008 and 2009.

Perhaps her concern is heightened by the significant downturn in the industry, the greater flexibility in the ability to carry back net operating losses or just the many issues that are beneath the surface in just about every dealership audit. Although she did not give any real particulars... let's face it, the situations that Ms. Harris could be concerned about include just about every item she discussed.

Two further observations here. First, Ms. Harris did not discuss the significant penalties that could be assessed against both (1) dealerships and (2) their tax return preparers if aggressive positions in tax returns resulted in underpayments. Obviously, penalties are always a possibility.

Second, as a result of the heightened litigious environment that dealerships are now in, there will be more in the way of legal expenses and other payments that dealers will (be forced to) make which they will assume are fully deductible for tax purposes. In reality, some of those payments may be capitalizable, or otherwise non-deductible, or constructive dividends.

One of the Tax Court cases that Ms. Harris mentioned in her workshop involved a dealership, and the emphasis in her discussion of it was on the writedowns that the dealership had claimed for year-end used vehicles. It had claimed writedowns that were pretty much pulled out of mid-air ... or from somewhere else.

When I looked at this case late last year, the issues didn't seem that significant. Now, however, that case - *West Covina Motors, Inc.* - seems to warrant a second look and a more careful analysis because many dealers will undoubtedly be facing the same issues ... with some variation here or there.

Many dealerships will be faced with complex litigation with their manufacturers, suppliers, (former) credit sources and possibly others, as the shake-up and/or wind-down occurs in the industry. Going right along with negotiations and lawsuits are legal fees - some well beyond six figures - and payments to avoid litigation as well as payments resulting from litigation.

Some of these expenses and legal fees may be incurred in connection with bankruptcy proceedings ... and, the deductibility of similar legal fees was one of the issues in *West Covina Motors*. Therefore, the intricacies of deductibility under Section 162 versus alternative non-deductibility treatment under Section 263 warrant some type of review at this time, and I believe the *West Covina Motors* case provides a good background.

In order to survive, or suffer less damage, some dealerships may find it necessary to pay legal expenses or make payments to satisfy the obligations of others who are in financial difficulty. Or, they may have to acquire another franchise or dealership. Here again, the *West Covina Motors* case provides a good background because it also involved the (non)deductibility of expenditures to acquire a dealership.

And finally, as many surviving dealers ratchet up their used car operations, they should be expecting that the IRS will be looking closely at year-end inventory writedowns (as it was in the *West Covina* case). So, a little bit of a reminder on this subject also seems in order at this time. And, this reminder is peppered with some of the information from the recently-updated IRS Retail Industry *Audit Technique Guide* on determining cost of trade-ins and year-end lower-of-cost-or-market valuations.

Accordingly, you'll find an analysis of the *West Covina* case beginning on page 24. Supplementary materials include discussions of a few cases involving similar issues and two recent IRS publications.

#5. 6-MONTH TIMELINE. The ***Timeline*** on pages 6-7 gives you a quick overview of the major tax and other developments affecting dealerships over the past 6 months. Some of these developments are pretty cut-and-dry. Others are much more difficult to get a grasp of.

I recently had the opportunity to hear a presentation by Andrew Koblenz of the National Auto Dealers Association and was amazed at the amount of activity that NADA has been engaged in over the recent months.

I urge you to check NADA's web site (www.NADA.org) to follow up on its efforts in working

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with the manufacturers in bankruptcy and their representatives and the officials in the Government responsible for attempting to stabilize the economy and the financial markets. You'll be impressed at all of the activity that NADA has been involved with.

#6. WHAT'S GOING TO HAPPEN TO LIFO? ... IT'S ALL ABOUT THE MONEY. It certainly seems that LIFO will still be available for year-end 2009 inventory calculations. But, remember, anything can happen between now and the end of the year if the government says it needs to raise revenue - and lots of it - immediately.

After looking into the future with help from my somewhat cloudy (and pessimistic) crystal ball, I'm willing to bet that LIFO will still be around through the end of next year, 2010 ... Possibly, even a year or two after that.

Then, ***if*** LIFO should be repealed, one would hope that taxpayers will be given a few years to recover from their shock and pay the tax on the recapture of their LIFO reserves.

It seems cruelly ironic that the use of the LIFO method may be removed just at the time when greater inflation is about to spring forth and higher income tax rates seem inevitable.

In the 2009 Mid-Year Edition of the *LIFO Lookout*, I've devoted a dozen pages to answering this question. Therefore, I've only touched the surface in the Timeline on page 7.

#7. IT'S ACTUALLY BEEN A FAIRLY SLOW PERIOD AS FAR AS IRS GUIDANCE GOES. There haven't been any major Rulings, court cases or even non-precedential guidance issued by the IRS to report. Still nothing on Section 263A ... Not even any gossip right now.

In my own Mid-Year Dealer Tax Update seminar presentations, the general advice that I've been giving to dealers and dealerships is to start right now doing some year-end planning in terms of (1) projected changes in LIFO reserves, (2) eliminating trade discounts and local advertising fees from inventory costs and (3) looking carefully at the possibility of drawing out some dealership earnings as dividends subject to the 15% rate while it is still available.

#8. DEALERS RUNNING LOW ON INVENTORY AT YEAR-END MAY FACE STIFF LIFO RECAPTURE. If you have a dealership client facing this predicament, you might want to refer to an extensive article I wrote in the June 1998 *Dealer Tax Watch* at a time when GM dealers were facing reduced year-end inventories because of a possible strike. Of course, now there are many more reasons why a dealer might be anticipating lower inventories at year-end.

Dealers using LIFO with significantly lower year-end inventories will be hit differently depending on several variables, including (1) their LIFO layer structure, (2) the amount of base dollars in each years' LIFO increment layer and (3) the recapture potential that each layer built up over the years contributes to the overall LIFO reserve.

See *"GM Dealers Low on LIFO Inventory May Face Stiff Recapture ... Planning May Lessen the Blow,"* in the *Dealer Tax Watch*, June 1998, pages 18-27. Even though this article is over 10 years old, the principles discussed in it are timeless. If you don't have a copy of this article readily available, we'd be glad to send or e-mail it to you.

#9. DEALERSHIP INTERNET SELLING & THE IRS RETAIL INDUSTRY *ATG*. The IRS recently issued a revision to its Retail Industry *Audit Technique Guide (ATG)*, and it's definitely worth spending some time reviewing. The chapter contents are summarized on page 41.

Given the significant increase in activity that dealers are expending in the realm of e-commerce, web sites and all the trimmings, I've included on page 42-43 some material from the *ATG* that gives some indication of what to expect in the way of IRS audit techniques and interview questions where internet selling (e-commerce) is involved.

#10. RESURGENCE IN BUY-HERE, PAY-HERE ACTIVITY. I was able to catch up with Ken Shilson, the President and founder of the National Alliance of Buy-Here, Pay-Here Dealers (NABD), at the NADA Convention. Ken pointed out that many new car franchise dealers have recently become more interested and involved in expanding their used vehicle operations and getting into the Buy-Here, Pay-Here/dealer financing arena.

"Resurgence" probably isn't the right word because the BHPH industry has been going strong for some time now. Its vitality is evidenced by the increasing number of attendees at the annual NABD conventions of Buy-Here, Pay-Here dealers. This year's Convention was held in May in Las Vegas.

Ken mentioned a few considerations that make expanding to Buy-Here, Pay-Here activities a very attractive course of action for dealers who are stepping up their used vehicle operations.

First, store closings and consolidation will result in a serious excess of facilities and overcapacity. Many of these facilities are fairly new, very expensive and pretty much single-purpose structures. Dealers

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will want to utilize these facilities to recover some of their investment costs.

Second, even the most profitable franchise operators, in better times, struggle to generate bottom line profits equal to 3% of revenues. In comparison, successful Buy-Here, Pay-Here dealers have historically generated profits of 15% to 20% of revenues. These higher profits are attributable to higher gross margins on sales and financing profits realized from installment sales contracts.

Third, the diversification into BHPH operations should give dealers greater financial independence from the manufacturers.

Fourth, quality used vehicles are a essential to every BHPH transaction, and franchise dealers have access to the best inventory at favorable cost points. This gives them a tremendous competitive advantage which can translate into significant financing profits rather than necessitating the wholesaling of these vehicles for low or no gross margin.

Finally, negative equity and tougher credit approval standards mean that most customers no longer can qualify for new vehicle purchases. (Unless, of course, the government provides further customer, individualized credit bailouts.) Franchise dealers can retain these credit-impaired customers only if they are able to offer them a Buy-Here, Pay-Here financing alternative.

Ken advises dealers who are considering going into Buy-Here, Pay-Here operations to be sure to obtain proper training and "know-how" because there are important differences between a new car business and a sub-prime financing business.

In addition, dealers going into BHPH should develop a proper business model and have an accurate estimate of the (considerable) capital required to build a sub-prime installment portfolio. This includes having the ability to develop portfolio performance metrics to justify financial relationships.

To improve chances of success, a BHPH dealer should participate in a BHPH Dealer 20 Group. Participation in a 20 Group will provide discipline and help the dealer objectively evaluate whether his/her operation is being "run by the numbers."

Ken, his firm and NABD are all valuable resources and available to provide expert assistance in all phases of BHPH operations.

Tax considerations are also important, especially if the BHPH operation will be setting up a related finance company in order to obtain greater tax advantage. Prior issues of the *Dealer Tax Watch* include many articles on all of these tax aspects.

#11. A CASE TO REMEMBER WHEN DEALERSHIP TIMES ARE BETTER. Back in the dealership hey-days, profitable dealerships that had not elected S treatment often had to worry about a challenge from the IRS that the amounts they were deducting for compensation paid to dealer-owners were "unreasonable" and, therefore, were dividends in disguise.

This has been far less of a problem recently for two reasons ... First, not much profit out there ... second, dividends are taxed at a fairly low 15% rate for the time being. So, taking a dividend, in lieu of compensation taxable at ordinary rates, might be a good tax strategy in some cases.

But, looking forward to better times ahead for dealerships, our economy and everybody in general, I thought I'd mention in the timeline a case that did not involve a dealership, but it did involve a stunning reversal of the IRS' and the Tax Court's disallowance of large amounts of compensation that was paid to a corporate officer/shareholder who seemingly "did it all."

If you have time over the summer, take a look at the recent U.S. Court of Appeals for the 7th Circuit reversal of the Tax Court decision in *Menard, Inc.* The Appeals Court decision is dated March 10, 2009. The Appeals Court held that the Tax Court committed clear error in ruling that John Menard's compensation/bonus was excessive.

One comment by Judge Posner bears repeating here ... "The Tax Court's opinion strangely remarks that because Mr. Menard owns the Company, he has all the incentive he needs to work hard, without the spur of a salary. In other words, reasonable compensation for Mr. Menard might be zero. How generous of the Tax Court nevertheless to allow Menard's to deduct $7.1 million from its 1998 income for salary for Menard!" The amount of compensation paid to Mr. Menard for the year included a $17.5 million bonus.

Oh, all right, if you insist ... Just one more juicy quote from the case... "The 5% bonus plan was in effect for a quarter of a century before the IRS pounced; was it just waiting for Menard to have such a great year [so] that the IRS would have a great-looking case?" [Delicious!]

EPILOGUE

I wanted to end this Watch Out on a happy, positive note. Had I not, I would have quoted at length a few passages from Aldous Huxley's *Brave New World* ... something about the government being involved with making cars. If you've read *Brave New World* during your school days or sometime thereafter, you'll know exactly what I mean.

Calendar	*TIMELINE … JANUARY 1, 2009 TO MID-YEAR 2009*
January	• IRS Motor Vehicle Technical Advisor issues three *Automotive Alerts*, all dated January 2009… ◆ ***Dealership Loaner Vehicle Fleets and Depreciation*** ◆ ***Tax Court Rules on Inventory Writedowns in*** *West Covina Motors, Inc.* ◆ ***Cash Reporting on Your Dealership*** *… Updated Questions & Answers on Form 8300*
Jan. 24-27	• At NADA Convention in New Orleans, LA, Ms. Terri Harris (IRS Motor Vehicle Technical Advisor - MVTA) presents a workshop on dealership Federal income tax issues. ◆ Ms. Harris discusses several technical issues, answers numerous questions for attendees. ◆ Ms. Harris expresses (major) concern that some dealerships may be taking "aggressive positions" in tax returns that will be filed for 2008 and 2009.
February 17	• ***American Recovery & Reinvestment Act of 2009 (ARRA)*** enacted. Includes significant provisions to reduce taxable income and expand ability of businesses to carryback net operating losses. Two major provisions affecting (some) dealerships… ◆ Net operating losses occurring in tax years beginning or ending in 2008 can be carried back for three, four or five years (instead of only two years) by election of the taxpayer. ▪ However, this applies only to businesses with average gross receipts of less than $15 million. ▪ Unfortunately, this beneficial provision excludes many, many dealerships, since they are "too big to be small," and are thus, ineligible. ◆ Section 179 expense/depreciation limits expanded and extended through 2009. ▪ Increase in Sec. 179 expense amount to $250,000 limit. ▪ Increase in phase-out threshold to $800,000.
March 10	• ***Reasonable compensation.*** U.S. Court of Appeals for the 7th Circuit reverses the Tax Court's decision in *Menard, Inc.* ◆ This reversal by the Appeals Court holds that the Tax Court committed clear error in ruling that John Menard's compensation was excessive in 1998. ◆ Although times right now are bad for many dealerships and the issue of "reasonable compensation" seems a dream of yesteryear, when things get better and dealerships are profitable (and there is no 15% preferential tax rate of dividends muddying the analysis of whether to pay salary or a dividend to a working shareholder), the language in this case should draw you like a magnet in defending dealer compensation as reasonable.
April 13	• ***Section 263A inventory cost capitalization rules.*** In Notice 2009-25, IRS invites public comments on how certain business practices in the retail industry have changed since Section 263A came into the Code. Specifically, it asks for comments (before July 13, 2009) concerning the following issues… ◆ How have changed retail business practices, including those resulting from technological advances and current trends, affected the application and administration of the existing Regulations under Section 263A to retailers that transact both on-site sales and sales that are not on-site sales from the same sales facility? ◆ How, if at all, should the definitions of *on-site sales*, a *retail customer*, a *retail sales facility*, a *dual-function storage facility*, etc., be modified to reflect current business practices of retailers that transact both on-site sales and sales that are not on-site sales from the same sales facility?
April 30	• ***Chrysler bankruptcy.*** Chrysler files for protection under Chapter 11 of the U.S. Bankruptcy Code in the Southern District of New York. ◆ Follow-up on May 14 … 789 Chrysler dealers received letters telling them that their franchises will be terminated. ◆ This impacts Chrysler, Jeep, Dodge and Dodge Truck dealers ◆ Initial filings indicate that Chrysler's bankruptcy proceedings are going to take the form of a sale of Chrysler's major assets under Section 363 of the Bankruptcy Code and a liquidation of a remainder of the Company. In a "Section 363 sale," an outside entity acquires the assets (in this case, brand-related assets) and theoretically takes those assets free and clear of associated liabilities. This entity could be a pre-existing company (such as Fiat) or it could be a newly created company with the United Auto Workers and the U.S. government as its primary shareholders. • See NADA web site (www.nada.org) for comprehensive information and a detailed timeline.

TIMELINE ... JANUARY 1, 2009 TO MID-YEAR 2009

May 11	• ***Proposal to repeal use of Last-In, First-Out (LIFO) method.*** The *President's Budget Green Book*, released May 11, 2009, includes, as a proposal for revenue increases, ◆ Full repeal of the LIFO method for all businesses, regardless of industry or size. ◆ Repeal would be effective in 2012. ◆ Spread period for repaying LIFO reserves would be over 8 years (presumably taking 1/8 of the amount of the LIFO reserve into income starting in year 2012 and 1/8 of the amount of the LIFO reserve in each of the 7 years thereafter). • According to the LIFO Coalition, ◆ "It is increasingly clear that LIFO repeal is simply all about the money - Congress needs new tax revenues to offset the spending and deficits they are proposing. There is little discussion of the merits of LIFO; it's just seen as a source of new tax dollars." ◆ "We absolutely ***MUST*** convince the members of the tax-writing committees that LIFO is an appropriate means of evaluating inventory which accomplishes the same purpose as FIFO, and the repeal of LIFO would cause great economic harm, and that voting for repeal of LIFO would be a potentially damaging anti-business vote." ◆ Source: *Memo to Members of the LIFO Coalition*, dated May 12, 2009. • Members of the Senate Finance Committee (SFC) have very explicitly asked for real data from companies on LIFO. ◆ They need to receive ***letters stating real life facts (not anecdotal evidence provided by trade groups) about how the repeal of LIFO would hurt their constituents.*** ◆ These letters can only come from businesses using LIFO, so direct contact from the companies using LIFO is necessary. ◆ CPAs and trade groups and associations cannot do this as effectively for them. • For a sample proforma letter that you can use for this purpose, I've reprinted the one from the *LIFO Lookout* on page 44.
May	• IRS publishes *Audit Technique Guide* for the Retail Industry. ◆ This includes significant discussions regarding audit considerations for used vehicle dealers and buy-here, pay-here operations.
June 1	• ***General Motors bankruptcy.*** General Motors files for protection under Chapter 11 of the U.S. Bankruptcy Code in U.S. Bankruptcy Court in Manhattan (New York). • GM notifies 1,124 dealers that their franchises will not be renewed when they expire in October 2010. ◆ GM intends to eliminate all Pontiac, Saab, Saturn and Hummer dealers. ◆ In addition, GM intends to eliminate more than 1,000 Chevrolet, Cadillac, Buick and GMC dealers. These dealers have received what are called "Wind-Down Agreements." • Those Chevrolet, Cadillac, Buick and GMC dealers that General Motors has determined it will allow to continue in operation will receive what are labeled "Participation Agreements." • See NADA web site (www.nada.org) for comprehensive information and a detailed timeline.
June 30	• IRS Business Plan Year ends ... with no action by the IRS on Section 263A cost cap guidance, either in the form of a Revenue Ruling or Revenue Procedure to adopt the IRS positions expressed in TAM 200736026.
Various	• De Filipps seminar ... *Mid-Year 2008 Dealer Tax Update Tax Strategies & IRS Activities ...* various dates & locations
August 1	• ***Red Flag Rules become effective after several suspensions.*** Previously, the Federal Trade Commission permitted a 6-month suspension of enforcement of the "Red Flags" rule(s) requiring creditors and financial institutions to have identity theft prevention programs in place. ◆ This delay in enforcement (which otherwise would have begun on November 1, 2008), was postponed to May 1, 2009, and it was subsequently postponed for another three months. ◆ Accordingly, the Red Flags rule is scheduled to become effective for dealerships on August 1.

News from the IRS ... What You Should Know about Dealership Federal Income Tax Issues

In January, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, presented a workshop on dealer tax issues at the National Automobile Dealers Association Convention in New Orleans.

In her capacity as an unofficial spokesperson for the IRS, Ms. Harris's comments covered six areas...

Essentially, Ms. Harris covered the same 5 major issues again at NADA in 2009, but in discussing "other issues," she added a few items not previously emphasized. Your special attention is called to these discussions on pages 7-8.

Cost Segregation Studies for Auto Dealerships

MVTA Comments	• IRS engineers ... not the on-site IRS auditors ... are the ones who actually review cost segregation studies. These engineers indicated to Ms. Harris that they were running into "unique" problems in reviewing cost segregation studies for automobile dealerships. • In referring to the existing IRS *Audit Technique Guide (ATG)* for cost segregation studies, these engineers were finding that many special areas unique to dealerships were not addressed. As a result, a special chapter on ***cost segregation studies for automobile dealerships*** was added to the IRS' Cost Segregation *Audit Technique Guide.* • This special chapter was added to the cost segregation *ATG* by the IRS LMSB Industry Director *Directive*. This kind of *Directive* is a document issued by the District Director who has responsibility for audits in a particular industry. In effect, such a *Directive* constitutes instructions to agents in the field. • The *Directive* states that it is not an official pronouncement of the law or the position of the IRS, and it cannot be used, cited or relied upon as such. However, IRS agents are required to follow it.
Analysis	• The finding reference for the *Directive* is *Field Directive on the Planning & Examination of Cost Segregation Issues in the Auto Dealership Industry*, LMSB Control No. 4-0208-006, dated February 25, 2008. • Essentially, this chapter on cost segregation for dealerships is in the form of a detailed matrix which recommends (to IRS agents) the categorization and general depreciation lives for dealership expenditures. • The *Directive* states that "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." • According to the IRS Cost Seg *Audit Guide*, the following "construction-related" expenditures by a dealership are not depreciable... ◆ "Landscaping & shrubbery" ◆ "Site preparation grading & excavation"
For More Info	• *"How Fast Can You Depreciate a Dealership's Fixed Assets? ... An Analysis of the New IRS Cost Segregation Audit Technique Guide for Automobile Dealerships,"* 2008 Mid-Year Edition of the *Dealer Tax Watch*, pages 22-47. ◆ This analysis includes several checklists that are more user-friendly than the IRS Matrix format. These checklists rearrange all possible dealership expenditures in terms of their potential depreciable lives (5-7-15-39 years) or non-depreciable status.

Termination of LIFO Elections

MVTA Comments	• Ms. Harris reviewed the history of how, over the years, LIFO technicians in the IRS National Office had been approaching the review of dealership requests to terminate LIFO elections. ◆ Unfortunately, the position of the National Office was that the change to terminate LIFO could not be made by a dealership filing Form 3115 after the intended year of termination was over. • The National Tax Office has now made it easier to terminate LIFO elections by allowing dealerships to use the ***automatic*** consent process and procedures. • The changes made by the IRS in Revenue Procedure 2008-52 updated (and simplified) the procedures for all taxpayers who want to voluntarily terminate their LIFO elections. • The problems that all dealers were faced with in "terminating" their LIFO elections under the "old" (i.e., pre-Rev. Proc. 2008-52) procedures were eliminated on a prospective basis.
Analysis	• ***"Catch-22."*** You'll note that the preceding sentence said that the "problems" were eliminated on a *prospective* basis. ◆ But, what about Forms 3115 that were incorrectly filed as "automatic" LIFO terminations before Rev. Proc. 2008-52 relaxed the requirements? Unfortunately, there are still many dealers who used the wrong procedure in previously filing to "request permission" to terminate their LIFO elections. • In other words, some dealers (CPAs?) thought they could use the automatic change filing procedure to terminate their LIFO elections before 2008, and they filed Form 3115 ***after*** the end of the year of change. As a result, they did not obtain permission from the IRS ***in advance*** to terminate their LIFO elections. • Revenue Procedure 2008-52 does not say anything about whether these dealers are still on LIFO, or are off LIFO or whether they should re-file another Form 3115 under the current automatic provisions. ◆ If dealerships are supposed to re-file Form 3115, will the year of change/termination be retroactive to the year "intended" by the dealer? Or will the year of change be the later year for which the subsequent Form 3115 is timely filed? For dealers in this quandary, this limbo state is theoretically a mess. • ***One situation where terminating a LIFO election for new vehicle inventories warrants consideration involves those (Chrysler or General Motors) dealers who have received letters from Chrysler or GM telling them that their franchises will be terminated.*** ◆ In some cases, the franchise being terminated is the only one the dealer has, and the dealer plans to stay in business selling used vehicles and providing other automotive-related services. ◆ For these dealers whose new vehicle inventories will likely be zero - or negligible, if demonstrators are still around - at the end of the year, in certain cases, terminating the LIFO election (if the tax return has not already been filed) may be considered as a preemptive strike to delay the full impact of having to repay all of the LIFO reserve in a single year. ◆ There may be other alternatives available to the dealership, and it is important to carefully consider the provisions in Section 5 of Rev. Proc. 2008-52. This Section prescribes certain events and situations that will accelerate or shorten the period of time over which the Section 481(a) adjustment, ordinarily 4 years, may be spread. However, be sure you read these provisions carefully.
For More Info	• *"Sample - Proforma Form 3115 Filing Package for Terminating a LIFO Election,"* 2009 Mid-Year Edition of the *LIFO Lookout*, pages 30-35.

Employment Tax Issues of Employer Tool (Reimbursement) Plans

MVTA Comments	• Ms. Harris said that she really had hoped not to have to bring up this subject again. ◆ However, the IRS has several promoter investigations underway, and as a result of these, the IRS has been able to obtain some lists of clients from promoters under investigation. • She reported that (unfortunately) many automobile dealership names were on these lists. • There is ample evidence that "promoters are still out there marketing (these plans) ... changing names ... changing plan structures," and their efforts seem to be successful because these plans look pretty good because the employment tax burdens are considerably lessened. She said ... "If something sounds too good to be true, it probably is." And, Ms. Harris left it at that. • Ms. Harris briefly recounted the chronology of events leading up to the IRS' most recent Coordinated Issue Paper on tool plans (issued July 2008), which was preceded by ILM 200745018, Revenue Rulings 2006-56 and 2005-52. ◆ She emphasized that under this guidance, all plans (intended to qualify under Section 62(c) fail to overcome the "wage recharacterization" requirement ... as well as usually at least one of the other three requirements under that Code Section. • She said that it's very difficult from the outside for the IRS to "spot the dealership's involvement" with these plans ... "until it is caught by the IRS" ... meaning, until that dealership's name shows up on a promoter's list as a result of the IRS' investigation of the promoter. • Ms. Harris reiterated her previous concerns ... Namely, that it is very difficult to get these plans right. "If these guys (i.e., promoters) walk through the door ... don't do it." • Also, there is no standard industry exception or other special rule that gives dealers entitlement to adopt these plans without adverse tax consequences.
Analysis	• In short, there are no new technical developments or IRS guidance to report here ... Just continuing concern by the IRS over the prevalence of marketing efforts selling these plans and potential dealer gullibility. • What really seemed to be perplexing to Ms. Harris is that current IRS promoter investigations which yield promoters' client lists are showing that many automobile dealerships have adopted (what they believe to be) accountable employee tool plans under Section 62(c).
For More Info	• *"IRS Revised Coordinated Issue Paper Hammers Tool Plans,"* 2008 Mid-Year Edition of the *Dealer Tax Watch*, pages 50-62. • *"Section 62(c) Accountable Plans for Technicians' Tool Reimbursements ... Update," Dealer Tax Watch*, December 2007, pages 34-52. ◆ This coverage includes detailed analyses of ILM 200745018 and Rev. Rul. 2006-56. • *"A Comprehensive Report on Technicians' Tool Reimbursement Plans Under Section 62(c)," Dealer Tax Watch*, June 2005, pages 4-48. ◆ This includes *Practice Guide* Checklist ... *"Considerations in Evaluating Exposure to Challenge by the IRS."*

LIFO Pooling ... Single, Combined LIFO Pool (i.e., the Vehicle-Pool Method & Rev. Proc. 2008-23) and Pooling for Crossover Vehicles under the Two-Pool Method

MVTA Comments	• ***Combining LIFO pools for all new vehicles.*** Ms. Harris discussed in some detail the Vehicle-Pool LIFO Method (i.e., the single, combined LIFO pool method for all new automobiles and all new light-duty trucks) which the IRS announced last year in Revenue Procedure 2008-23. ◆ This method could be adopted as early as 2007, although many dealers waited until 2008 to do so. • Ms. Harris emphasized the IRS's issuance of informal guidance on how dealerships implementing the change should go about combining their pools. ◆ This guidance from the IRS was contained in Chief Counsel Office Memo (CCM) No. 200825044, and it included two detailed examples. • Ms. Harris stressed that if a dealership combines its pools in the manner set forth in the CCM (i.e., Step 1: combine the pools, then Step 2: rebase the single pool after the two pools have been combined), it will have the certainty that the National Tax Office would approve that approach. • ***Classification of crossover vehicles for LIFO pooling.*** Ms. Harris also discussed the rules for classification of crossover vehicles if a dealership does not change to the Vehicle-Pool Method. ◆ The question of which LIFO pool a "crossover" vehicle should be placed in would be moot if the dealership elected to use the Vehicle-Pool Method. ▪ A dealership is not required to elect the Vehicle-Pool Method, and if it doesn't, then it must continue to maintain one pool for new automobiles and one pool for new light-duty trucks under the Alternative LIFO Method for New Vehicles. ◆ Rev. Proc. 2008-23 introduces a ***new***, different rule for classifying crossover vehicles for LIFO pooling purposes. This new rule is effective for taxable years ending on or after March 7, 2008. ▪ ***New rule.*** Each year, a facts and circumstances determination must be applied on a case-by-case basis to the crossover vehicle in question, and that crossover vehicle is to be assigned to whichever pool (i.e., either to the automobile pool or to the light-duty truck pool) is more reasonable under all the facts and circumstances. ▪ This new rule does not mandate that all crossover vehicles will always be placed in the same pool year after year ... that was the old rule under Rev. Proc. 2001-23 for used vehicles.
Analysis	• Regarding CCM 200825044, providing guidance on procedures for combining automobile and truck LIFO pools, the 2008 Year-End Edition of the *LIFO Lookout* analyzed the CCM and these examples, and it examined some very interesting consequences and results if the sequence of operations were reversed. • Three case studies are included in the 2009 Mid-Year Edition of the *LIFO Lookout* to show how much the contributions to the LIFO reserve have been shifted among LIFO layers (i.e., years having increments) when the combining process occurs. ◆ We have found that, depending on the facts and circumstances, these differences can be very significant, especially where (large) decrements are anticipated to be experienced in the pools in the year of change ... or, in fact, are experienced in the year of change. ◆ With some dealers on the verge of losing substantial portions of their inventories in 2009 and/or 2010 due to actions taken in manufacturer bankruptcies, the shifting of contributions to the LIFO reserve to the more recent years can take on added importance in situations where large decrements are experienced in the combined LIFO pool in the year of change or a succeeding year.
For More Info	• *"CCM 200825044 on Combining LIFO Pools,"* 2008 Year-End Edition, *Dealer Tax Watch*, pp. 46-47. • *"IRS Approves Single, Combined LIFO Pool Method for New Vehicles in Rev. Proc. 2008-23,"* 2008 Spring/Mid-Year Edition of the *LIFO Lookout.* ◆ The entire Edition (60 pages) is devoted to analyzing and implementing the Vehicle-Pool Method. • *"Combining LIFO Pools for All New Vehicles ... CCM Guidance Creates Problems ... A Step-by-Step Analysis of the CCM Examples,"* 2008 Year-End Edition of the *LIFO Lookout*, pages 33-47. • *"Three Case Studies on Combining Vehicle-LIFO Pools,"* 2009 Mid-Year Edition of the *LIFO Lookout*, pages 36-53.

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

MVTA Comments	• Basically, Ms. Harris reviewed all of the cost cap developments that have gone before, including the IRS' Business Plan Year expectations for issuing guidance. Major points were discussed... ◆ ***Should the auto dealership be treated as a "producer" or as a "reseller" under Sec. 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 Sec. 263A. ◆ *TAM 200736026 ...* Multiple issues involving how the Treasury Regulations under Section 263A should be interpreted in dealership situations for (1) production and handling activities, (2) retail sales facility and "dual function" issues and (3) identification and allocation of costs issues. • Where are we now ... as of January 2009 NADA workshop presentation? ◆ No new IRS "guidance" at this time. ◆ Ms. Harris expressed hopefulness that by the end of June (2009), the IRS might issue a Revenue Ruling. However, she indicated that she thought that if a Revenue Ruling were issued, it would address only the "producer" issue aspects of the TAM. (Note: The IRS' Business Plan Year is a fiscal year ending June 30.) • In terms of gauging the significance of a dealership's compliance with Sec. 263A, Ms. Harris indicated that the IRS Issue Management Team has assigned (relegated) Sec. 263A to be a "Tier III Issue." Issues assigned to Tier III classification are lower profile issues. Apparently, what this means is that (1) an agent is required to "consider the issue" but does not necessarily have to "raise" the issue and (2) agents are supposed to do a "risk analysis." • Ms. Harris did mention two new potential dynamics that the IRS may be considering in working towards resolution of Section 263A issues for automobile dealerships... ◆ ***Capitalization of labor costs (which include some capitalization of gross profit).*** Some dealers may already be capitalizing too much labor cost ... to the extent that there is a "gross profit element" in the cost of parts and labor that are being capitalized under Section 471. In other words, if the dealership is capitalizing labor at a flat rate or some other rate (say, $21 per hour), that rate may be (considerably?) in excess of the actual hourly rate paid to the technician (say, $14 per hour). ◆ ***Consideration of each dealership department as a "separate trade or business."*** Ms. Harris said that if different departments in the dealership were treated as separate trades or businesses, that could lessen the impact of the producer issues because, in some cases, there are very small ending inventories in the service department.
Analysis ... ***"Separate Trades or Businesses"***	• ***Consideration of each dealership department as a separate trade or business.*** With respect to this issue, readers of the *Dealer Tax Watch* are well aware that this is something (i.e., a tax return position) that I have advocated all along. In an informal discussion with Ms. Harris and Paul Metrey (of NADA), I repeated my advocacy of this approach for the following reasons... ◆ There is sound legal basis for this approach under Section 446. ◆ This approach would avoid many of the complex "producer" issues. ◆ With acceptable compromises, Section 263A computations could be pulled off directly from a dealer's financial statement. Some costs or expenses could be directly allocated to appropriate departmental columns based on predetermined ratios of either revenues (in the case of on-site vs. off-site sale determinations) or expenses/costs. ◆ Accepting the dealer's financial statement (sent to the manufacturer) as the basis for Section 263A computations would significantly lessen debates over the need for judgment on the part of the dealership, its CPA or controller, and/or an examining IRS agent. Whatever lack in precision this approach of computing Sec. 263A costs using the dealership financial statement might have, that would be offset by the concomitant certainty and administrative savings in resources.

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

Analysis ... Thoughts on Forthcoming Guidance from the IRS	• ***Possibility ... or inevitability ... of the issuance of guidance in the form of a Revenue Procedure or a Revenue Ruling by the IRS.*** With respect to this possibility, I also had the opportunity to informally discuss with Ms. Harris and Paul Metrey (of NADA) some of the key questions that I would hope the IRS would address in connection with whatever positions the Service takes in forthcoming guidance. ◆ ***A flood of 3115s?*** If dealers are required to (or voluntarily) change their Sec. 263A computations, will these changes in accounting method be automatic changes that can be made under the automatic change provisions of Rev. Proc. 2008-52 with the filing of Forms 3115 after the end of the year of change? ... Or will these changes in cost cap methods require advance consent from the IRS, with the payment of a user fee and the filing of Forms 3115 before the end of the year of change under Rev. Proc. 97-27? ◆ ***Section 481(a) adjustment?*** If dealers are required to (or voluntarily) change their Sec. 263A computations, how will the Section 481(a) adjustment be computed? Or, will a Section 481(a) adjustment be waived? (i.e., Will the cut-off method be permitted? Or will a full recomputation involving all prior years be required? And, if a computation of the Sec. 481(a) adjustment requires consideration of all prior years, will dealerships using LIFO have to adjust their LIFO layers, or be permitted to use a 3-year look-back shortcut approach?)
IRS Seeks More Input	• ***Notice 2009-25.*** Subsequent to Ms. Harris' presentation at NADA, in Notice 2009-25, the IRS invited public comments on how certain business practices in the retail industry have changed since Section 263A came into the Code. ◆ Specifically, the IRS asked for comments (before July 13, 2009) concerning the following issues... ◆ (1) How have changed retail business practices, including those resulting from technological advances and current trends, affected the application and administration of the existing Regulations under Section 263A to retailers that transact both on-site sales and sales that are not on-site sales from the same sales facility? ▪ Provide descriptions of common (and unique) retail business models, operations, and practices, where retailers conduct on-site sales as well as internet or fax sales at a sales facility. ▪ Also provide examples of other types of sales that do not meet the existing definition of on-site sales. ◆ (2) How, if at all, should the definitions of *on-site sales*, a *retail customer*, a *retail sales facility*, a *dual-function storage facility*, etc., be modified to reflect current business practices of retailers that transact both on-site sales and off-site sales from the same sales facility? • ***Application of Sec. 263A to dealership internet marketing departments.*** In recent years, many dealerships have set up internet selling modes; many have significant internet marketing departments and can trace substantial (some claim up to 30-40%) sales to this activity. ◆ Exactly how the principles of Section 263A will be interpreted in terms of these internet marketing activities remains to be seen.
Bottom Line	• *As of June 30, 2009*... we still do not know anything more or less than we knew before. and nothing ... one way or the other ... has been issued by the IRS.
For More Info	• *"Cost Cap for Auto Dealers: TAM 200736026," Dealer Tax Watch*, September 2007, pages 8-40. • *" Zero Cost Cap ... Are CPAs Oversimplifying the 'Simplified' Resale Method? Determining Amounts to Be Capitalized & Avoiding Capitalizing Unnecessary Amounts," Dealer Tax Watch*, December 2006, page 20. (See also page 19.) • *"Should Auto Dealerships Be Treated as 'Producers' or as 'Retailers' under Section 263A?" Dealer Tax Watch*, March 2006, pages 3-12.

Five Other Issues

- ***Importance of documenting used vehicle (lower-of-cost-or-market) writedowns***
- ***New vehicle writedowns.***
- ***"Free loaner" pool of vehicles ... Can dealership loaner vehicle fleets be depreciated?***
- ***Treatment of payments received for the discontinuation of a franchise ... Revenue Ruling 2007-37***
- ***Concern over aggressive tax return positions in dealership returns for 2008-2009***

#1. Used Vehicle Writedowns	• ***MVTA comments*** ◆ Ms. Harris discussed the importance of properly computing and documenting writedowns for used vehicles at year-end under the lower-of-cost-or-market method (LCM). ◆ This was basically a recitation of what should be already familiar rules (i.e., in making LCM adjustments at year-end, one must consider - among other things - model variations, mileage, condition, options, regional differences, seasonal differences and the lapse of time between the date of acquisition of the used vehicle by the dealership and the year-end). ◆ She said that subsequent gross profit on the sale of a vehicle should not be the only documentation of the amount of the writedown of a vehicle at year-end. ◆ Ms. Harris mentioned a recent case, *West Covina Motors, Inc.* in which the IRS and the Tax Court both disallowed a dealership's arbitrary valuations for used vehicles. She also referred to a recently-released *Automotive Alert* that discussed this dealership's writedowns. • ***Comment - Analysis*** ◆ The key precedential document is Revenue Ruling 67-107, and in the context of LCM writedowns, the IRS years ago informally announced that a used car is a *normal* (as distinguished from a *sub-normal*) good in the context of a used car market. ◆ As some dealers are forced to place a greater reliance on used vehicle operations (particularly if they have lost their franchises to sell new vehicles), proper computation of used vehicle writedowns and documentation could become much more important in the future as inventory levels increase ... even if these adjustments are only a one-year timing difference. ◆ The *West Covina Motors* case is analyzed in this Edition of the *Dealer Tax Watch.* Related materials include a copy of the IRS *Automotive Alert* and our sample *Year-End Writedown Documentation Worksheet* which is reproduced from December 2006 *Dealer Tax Watch.* • ***For more information*** ◆ *"Used Car LIFO Computations Take a Hit,"* Watch Out Item #7, *Dealer Tax Watch*, March 1999, page 2. This is a summary of LTR 9853003 which is discussed more fully in *"IRS National Office Tells How Used Vehicles Should Be Repriced (LTR 9853003)," LIFO Lookout*, March 1999, pages 15-18.
#2. New Vehicle Writedowns	• ***MVTA comments*** ◆ Ms. Harris talked about the renewed interest (due to economic conditions) in the possibility of writing down ***new*** vehicles (which are not on LIFO) at year-end. ◆ ***The current position of the IRS is that new vehicles are not eligible for writedowns.*** • ***Comment - Analysis*** ◆ This is a new development, but it is timely as many dealerships struggle with hard-to-move inventories of new vehicles. ◆ ***What about demonstrators?*** In Letter Ruling 9522002, the IRS expressed the position that a dealer may not write down the value of demonstrator vehicles at year-end by referring to the wholesale values of used vehicles in the *NADA Official Used Car Guide.* Ms. Harris did not mention this ruling in her presentation. • ***For more information*** ◆ *"Demonstrator Vehicle Writedowns at Year-End: The IRS Says ... 'No,' in LTR 9522002" Dealer Tax Watch*, June 1995, page 3.

Five Other Issues

(Continued...)

#3. Depreciation of "Free Loaner" Vehicles	• ***MVTA comments*** ◆ This is an issue that has more recently come to Ms. Harris' attention ... Some dealerships that have vehicle loaner fleets are trying to avoid the limits that Section 280F places on the depreciation rates for luxury automobiles. These limitations under Section 280F stretch out the depreciable life much longer than 5 years. ◆ Dealerships try to justify avoiding the Sec. 280F limitations by classifying their loaner vehicle fleets as being used for the transportation of persons or property for compensation or hire. ◆ Section 280F limits the depreciation deduction allowed for any passenger automobile in any taxable year. A passenger automobile is generally defined as a vehicle intended primarily for use on public streets, roads, and highways with a gross vehicle weight of 6,000 pounds or less. ◆ ***The position of the IRS is that "loaner vehicles" are subject to the limitations of Section 280F(a) because these vehicles are fixed assets, rather than inventory.*** ▪ The "loaner vehicles" are "passenger vehicles" as defined by Sec. 280F(d). They do not qualify for the passenger vehicle exception provided for "any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire." ▪ Loaner vehicles do not qualify for another exception that exists for the treatment of property leased or held for leasing under Sec. 280F(c). • ***Comment - Analysis*** ◆ The depreciation limitations on luxury vehicles change annually (because each year they are adjusted upward slightly for inflation). However, depreciation for the first 3 years generally totals about $10,000, and each year thereafter, it is about $1,500 or $1,600 until all basis for the vehicle has been recovered. Each year, the instructions for Form 4562 contain the applicable limitation amounts. ◆ Obviously, the inability to use a 5-year life significantly diminishes the depreciation deduction. • ***For more information*** ◆ The IRS *Automotive Alert* on this subject is included on the immediately following pages.
#4. Payments Received for Discontinuation of Franchise	• ***MVTA comments*** ◆ With respect to payments that dealers or their dealerships might receive from the manufacturers in connection with the termination of their franchises, Ms. Harris briefly referred to Revenue Ruling 2007-37 as the source of guidance for the treatment of these payments. ◆ In response to a question, Ms. Harris also discussed the tax treatment of payments made by dealerships to assist the manufacturer in buying out other/competing dealerships in their area. • ***Comment - Analysis*** ◆ Keep in mind that Form 982 (revised January 2009) should be attached to the dealership's tax return where certain payments received are being treated as reductions in basis of other assets. • ***For more information*** ◆ *"Treatment of Payments Received by Dealerships for the Cancellation of Distributor Agreements," Dealer Tax Watch*, June 2007, pages 13-19. ◆ *"In LTR 200218034, the IRS Rules Favorably for Some Oldsmobile Dealers ... But Be Careful if You Are Going to Rely on this Ruling," Dealer Tax Watch*, March 2002, pages 12-21.
#5. Concern Over Aggressive Tax Return Positions	• ***MVTA comments*** ◆ Ms. Harris said that she was beginning to develop some concern over the possibility that some dealerships may become sorely tempted to take (overly) aggressive positions in the income tax returns they will be filing for 2008 and 2009. ***Comment - Analysis*** ◆ Perhaps Ms. Harris' concern is heightened by the significant downturn in the industry, the greater flexibility in the ability to carry back net operating losses, or just the many issues that are beneath the surface in just about every dealership audit. ◆ Ms. Harris did not discuss the potential that significant penalties could be assessed. ◆ Situations that Ms. Harris could be referring to include just about any of the items she discussed.

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Dealership Loaner Vehicle Fleets and Depreciation

Automotive Alert

Motor Vehicle Technical Advisor

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Introduction:

Many dealerships accommodate service customers by providing loaner vehicles for use while the customer vehicle is being serviced. Frequently, the dealership provides the customer with an identified demonstrator vehicle, used vehicle, or other vehicle from the dealer's inventory. In other situations, the manufacturer requires the dealership to maintain a fleet of loaner or rental vehicles that can be provided to customers. Demonstrator vehicles and used vehicles are included in the dealer's inventory, available for sale to customers and not subject to depreciation. The loaner/rental fleet vehicles typically are removed from inventory and may be titled in the dealership's name. In these circumstances, the dealership may be entitled to depreciation on those vehicles.

ISSUE:

Recently, the MVTA has been made aware of situations in which dealerships seek to avoid the depreciation limits of Internal Revenue Code (IRC) Section 280F by classifying the loaner fleet as used for transportation of persons or property for compensation or hire. IRC 280F limits the depreciation deduction allowed for any passenger automobile in any taxable year. A passenger automobile is generally defined as a vehicle intended primarily for use on public streets, roads, and highways with a gross vehicle weight of 6,000 pounds or less.

CONCLUSION:

The "Loaner Vehicles" are subject to the limitations of §280F(a), because they are fixed assets rather than inventory. They are "passenger vehicles" as defined by §280F(d) since they do not qualify for the passenger vehicle exception provided for vehicles used directly in the trade or business of transporting persons or property for compensation or hire and they do not qualify for the treatment of property leased or held for leasing under §280F(c).

FACTS

Dealerships typically sell and lease new and used vehicles, and provide automotive maintenance and repair services. Some dealerships maintain a fleet of "loaner vehicles" that they provide to customers of the service department and body shop without charge while the vehicle is being serviced. Customers are not offered a discount for service if a loaner vehicle is not

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provided. If none of the dealerships' "loaner vehicles" are available, the dealerships may provide their customers with a rental vehicle from a local rental service instead.

Dealerships generally obtain title to a vehicle prior to placing it in service as a loaner vehicle. The dealerships' customers are usually responsible for the cost of any gasoline used and for any damages to the loaner vehicle while it is in their possession. Major items of repair are generally covered under the manufacturer's warranty. The dealerships bear the other costs of ownership of the loaner vehicles. Dealerships will typically reclassify the loaner vehicle as used vehicle inventory between 6 and 12 months after placing it in service.

LAW AND ANALYSIS

I.R.C. §167 provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or of property held for the production of income. I.R.C. §168 provides the method for determination of the §167(a) depreciation deduction for tangible property such as automobiles.

I.R.C. §280F(a) provides limitations on the amount of the depreciation deduction allowed for any "passenger automobile" any taxable year. Section 280F(d)(5) defines "passenger automobile" as any 4-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways, and which is rated at 6,000 pounds unloaded gross vehicle weight or less. §280F(d)(5)(B)(ii) states that the term "passenger automobile" shall not include any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

I.R.C. §280F(c) provides that §280F shall not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing such property. According to §280F(d)(4)(A)(i), listed property includes any passenger automobile as defined by §280F(d)(5).

I.R.C. §179 provides that a taxpayer may elect to treat the cost of any section 179 property as an expense which is not chargeable to capital account. Any cost so treated is allowed as a deduction for the taxable year in which the section 179 property is placed in service, and reduces the amount which is allowed as a depreciation deduction under §167.

I.R.C. §280F(d)(1) provides that any deduction allowable under section 179 with respect to any listed property shall be subject to the limitations of [§280F(a)] in the same manner as if it were a depreciation deduction allowable under section 168.

Dealerships loaner vehicles clearly meet the definition of "passenger automobiles." Dealerships may potentially argue that the loaner vehicles are not passenger vehicles under §280F(A) because they fall within the exception to the definition of "passenger automobiles" under §280F(d)(5)(B)(ii) for vehicles used directly in the trade or business of transporting persons or property for compensation or hire. As such, dealerships may argue, the limitations on depreciation in §280F(a)(1) do not apply to the loaner vehicles.

The loaner vehicles held by dealerships do not qualify for the exception in §280F(d)(5)(B)(ii) because dealerships are not engaged in the "trade or business" of providing loaner vehicles. Furthermore, the provision of complementary loaner vehicles is not "the transportation of persons or property for compensation or hire."

If the dealership is not engaged in the "trade or business" of providing loaner vehicles, then its loaner vehicles cannot be used directly in such trade or business. The term "trade or business" generally refers to "holding one's self out to others as engaged in the selling of goods or services." *Deputy v. DuPont*, 308 U.S. 488 at 499 (1940). The "trade or business" of providing loaner vehicles is therefore *the holding one's self out to others as engaged in the service* of providing loaner vehicles. This description does not align with the business practices of a typical dealership. Customers do not solicit dealerships for the purpose of obtaining a loaner vehicle; they come to the dealership to have their vehicle services or repaired instead.

In at least one instance, the use of this term in the code has been interpreted more broadly to include activities for which the taxpayer had not yet engaged in the sale of goods or services, but merely had a profit motive. *See Snow v. C.I.R.*, 416 U.S. 500 (1974). In *Snow*, the Supreme Court held that in the context of research expenditures, the term "trade or business" for purposes of section 174 deductions merely requires a profit motive. However, the stated purpose for broadening this term in the context of research expenditures was to "stimulate the search for new products and new inventions upon which the future economic and military strength of our Nation depends," by accommodating small businesses which do not as yet sell goods or services but which devote their resources to research. *Id.* at 503.

No such policy incentive exists for broadening the definition of "trade or business" in the context of depreciation limitations on passenger automobiles. In *Snow*, the definition of "trade or business" was broadened because the taxpayer's primary economic activity was motivated by the promise of future profit. Even if dealerships build the cost of the loaner vehicles into the cost of the repair service, they still derive their economic benefit from the repairs and maintenance, not from the offering of loaner vehicles. Therefore, we believe dealerships are in the trade or business of selling and maintenance of vehicles, not the trade or business of providing loaner vehicles.

Furthermore, the provision of complementary loaner vehicles is not "the transportation of persons or property for compensation or hire." Dealerships neither charge customers for this service, nor does a customer who declines the service receive a discount for the repair bill. Moreover, the legislative history of I.R.C. §4001(c), which created an exception from the excise tax imposed by §4001(a) for vehicles used by the purchaser exclusively in the trade or business of transporting persons or property for compensation or hire, states that "[t]he trade or business of transporting persons or property for compensation or hire does not include the leasing or rental of an automobile without a hired driver." H.R. Rep. 101-881. The provision of loaner vehicles is more analogous to an automobile rental agency than a transportation service, such as a taxicab or limousine service.

CONCLUSION

Taxpayer's "loaner vehicles" are "passenger automobiles within the definition of §280F(d)(5). They do not qualify for the exception for vehicles used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire. Therefore, the loaner vehicles are subject to the limitations on depreciation in §280F(a).

If you have any questions or comments, you may contact the Motor Vehicle Technical Advisor at 616-365-4601 or at Terri.S.Harris@irs.gov.

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Cost Segregation at Auto Dealerships

Automotive Alert

Motor Vehicle Technical Advisor

March 2008

Introduction:

On February 25, 2008, The Heavy Manufacturing and Transportation Industry Director signed industry directive # LMSB-4-0208-006 which provides technical guidance to field agents. This directive is intended to serve as a tool to reduce audit cycle time and taxpayer burden. It should be noted that while this document has been drafted following current guidance, it is not an official pronouncement of law and is not intended to be relied on as such. The Directive can be found in Chapter 7 Section 5 of the Cost Segregation Guide at www.irs.gov

This directive and the attached asset matrix represent a new Chapter in the Cost Segregation Audit Technique Guide. The Guide was written by the Capitalization Technical Advisor with the assistance of IRS engineers, IRS counsel attorneys and input from internal and external stakeholders. This new Chapter for Auto Dealerships is not a stand alone product and the content of the Audit Technique Guide should be considered as a whole.

Background:

As stated in the Industry Directive, the crux of cost segregation is determining whether an asset is I.R.C. §1245 property (shorter cost recovery period property, 5 or 7 years) or §1250 property (longer cost recovery period property, 39, 31.5 or 15 years). The most common example of §1245 property is depreciable personal property, such as equipment. The most common examples of §1250 property are buildings and building components, which generally are not §1245 property.

The determination of real or personal property treatment for MACRS purposes are to be based on the **facts and circumstances** surrounding each individual item claimed as personal property. These facts and circumstances must be viewed in the light of the criterion set forth not only by the courts, but the historical statutes set by Congress, the Internal Revenue Code and Regulations, Revenue Rulings, Revenue Procedures and other directives from the Commissioner of the IRS. The Tax Court and other Courts' findings and determinations as to specific items should also be considered.

History of Cost Segregation:

Definition of Building and Structural Components in general:

Reg. 1-48 (e) states that the term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores.

Section 1.48-1 (e) (2) provides that the term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefore such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

Definition of Personal Property in general:

Section 1.48-1 (c) defines tangible personal property as including all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property

Class Life Asset Depreciation Range:

Revenue Procedure 87-56 provides the most current version of the Class Life Asset Depreciation Range (CLADR). This CLADR sets forth the lives of property that are necessary to compute the depreciation allowances under Section 168. Activity Class 57.0 - DISTRIBUTIVE TRADES AND SERVICES applies to assets used in wholesale and retail trade, and personal and professional services, and includes section 1245 assets used in marketing petroleum and petroleum products. These assets qualify for a MACRS life of 5 years.

Hospital Corporation of America v. Commissioner:

In a landmark decision, Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997), provided the legal support to use cost segregation studies for computing depreciation. In effect, this decision has reinstated a form of component depreciation for certain building support systems, such as electrical and plumbing systems that directly serve tangible personal property. This decision changed the way in which allocations between tangible personal property and real property are viewed by the courts.

Chief Counsel Guidance:

Chief Counsel issued further guidance to the field in the form of an advice memorandum dated May 28, 1999. It made the following observations and recommendations for field agents examining cost segregation studies:

- The determination of whether an asset is a structural component or tangible personal property is a facts-and-circumstances assessment.
- The use of cost segregation studies must be specifically applied by the taxpayer.
- Allocations must be based on a "logical and objective measure" of the portion of the equipment that constitutes § 1245 property.
- An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records.
- Cost segregation studies should be closely scrutinized by the field.
- A change in depreciation method is a change in method of accounting, requiring the consent of the Secretary or his delegate.

Whiteco Factors:

Revenue Ruling 75-178, 1975-1 C.B. 9 outlined several criteria to determine § 1245 property classification. These criteria included:

- whether the asset is movable or removable;
- how the asset is attached to real property;
- the design of the asset; and
- whether the asset bears a load.

Cost Segregation at Auto Dealerships

The classic pronouncement addressing inherent permanency was Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664, 672-673 (1975). The Tax Court, based on an analysis of judicial precedent, developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the "Whiteco Factors," are:

1. Can the property be moved and has it been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that show that the property may or will have to be moved?
4. Is the property readily movable?
5. How much damage will the property sustain when it is removed?
6. How is the property affixed to land?

It should also be noted, however, that moveability is not the only determinative factor in measuring inherent permanency. In L.L. Bean, Inc. v. Comm., T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), it was determined that, even though the structure could be moved, it was designed to remain permanently in place. Thus, it was determined to be an inherently permanent structure.

Other factors that should be considered when addressing the Whiteco factors include:

- The manner in which an item is attached to a building or to the land,
- The weight and size of the item,
- The time and costs required to move the components,
- The number of personnel required in planning and executing a move,
- The type and quantity of equipment required for a move,
  The history of the item or similar items being moved,
- The time, cost, manpower and equipment required to reconfigure the existing space if the item is removed,
- Any intentions regarding the removal,
- Whether the item is designed to be moved, and
- Whether the item is readily usable in another location.

<u>Summary:</u>

To determine an asset that is constructed with and is integral to a building facility as personal property eligible for the MACRS recovery period and bonus depreciation is a complicated task.

The historical guidance set by the Code, Regulations and Revenue Procedures through the CLADR show that an asset that is a structural component of a building should be depreciated with the building. However, the Courts over the years, have found that in certain instances items that are a part of a building can still qualify as personal property if they meet certain tests, or their use is integral to the taxpayer business activity.

The IRS assumes an item built as an integral part of a building structure is a structural component of the building placed for the operation and maintenance of the building and should be allowed depreciation with the underlying building - unless substantially proven otherwise.

The Cost Segregation Audit Technique Guide, and the specific chapter of Auto Dealerships, is based on current published guidance. Any questions can be directed to the Motor Vehicle Technical Advisor Terri Harris (616) 365-4601.

CASH REPORTING AND YOUR DEALERSHIP

Questions and Answers on Form 8300

IRS

26.	**If a dealership receives a bank check drawn on the funds of the bank (not a personal checking account check or a check drawn on a personal account of the customer) with the customer's personal account number and customer name on it, is this considered cash or a cash equivalent?**	• Bank checks (drawn on the bank's account, not the account of the customer) of $10,000 or less are cash under the expanded definition of cash, unless they are loan proceeds. • The fact that there are notations on the check or even that the check is made payable to the dealership does not negate this. • **Update:** The definition of cash does not include a check drawn on an individual's personal account. A bank check drawn on the customer's personal account with the customer's personal account number and customer name noted may not be considered cash.
27.	**A customer purchases a vehicle for $15,000 and pays for it with $9,000 in cash and puts the remaining $6,000 on a personal credit card. Should a Form 8300 be filed?** **Update: A customer purchases a vehicle for $12,000 and provides the business with a $10,000 cashier's check and pays the remaining $2,000 with his ATM card. Is the ATM amount considered cash or a cash equivalent that makes the total amount received over $10,000 and thus reportable on Form 8300?** **Would the answer differ if the customer had used a credit card instead of a debit card for the $2,000 portion?**	• No Form 8300 is required. • Less than $10,000 in cash was received. A credit/debit card is not cash. • **Update:** The ATM card works the same as a credit card in this instance. The only difference is that the account will be charged with a debit against existing funds instead of charged for a debit to non-existing funds, but a promise to repay later. • An ATM transaction is not given the consideration of cash, therefore, the $10,000.00 cashier's check in itself is not cash greater then $10,000.00 so it is not reportable.
32.	**Update: A dealership receives monthly ACH payments [automatic payments from a customer bank account] If the payments total in excess of $10,000, should the payments be treated as cash?**	• ACH payments are not considered cash for the purpose of reporting on Form 8300.
33.	**Update: A related finance company provides financing to customers of multiple related used vehicle dealerships. The finance company purchases contracts from the used car lot and a check is issued to the car lot for the amount of the car deal. Would the definition of cash to include cashier's checks and money orders apply to the finance company?**	• Update: The dealership's sale of the vehicle constitutes a retail sale of a consumer durable requiring reporting of monetary instruments if the face amount was $10,000 or less and there is no financing involved. • When the finance company purchases the "finance contract" they do not have a designated reporting transaction. The finance contract is not a consumer durable, collectible or travel or entertainment and it is not a consumer durable because it is not tangible personal property. Thus monetary instruments with a face amount of $10,000 or less received to pay off the finance contract would under normal situations not be reportable.
34.	**Update: What type of records might an examiner request during an 8300 examination?** **Motor Vehicle Technical Advisor** **Updated** **January 2009** Terri.S.Harris@irs.gov	• **Update:** Records requested may vary by examiner but typically the following records are requested: • Checking, savings and/or other financial account statements and deposit slips • An electronic bank deposit reconociitate in Excel format extracted from the dealer's DMS system. The requested report generally requests all receipts of the business from any sourceincluding the amount, date received, method of payment (cash, check, credit card number, etc.), payer name, and receipt number. Receipt sources should include new and used vehicle sales, leases, service, parts, body shops, and any non-customer receipts. • Deale jackets for leases and sales during the examination period. • Sales journals, cash receipts journals, accounts/notes receivable, sales invoices • Copies of Forms 8300 filed, notification statements provided to customers, and any correspondence from the IRS related to forms 8300

Automotive Alert - Updated January 2009

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Overview

WEST COVINA MOTORS, INC. ...
AGGRESSIVE DEALERSHIP DEDUCTIONS DISALLOWED
A GOOD REFRESHER FOR SOME BASIC PRINCIPLES

The Importance of *West Covina Motors, Inc.*

In October 2008, the Tax Court handed down a decision in *West Covina Motors, Inc.* (T.C. Memo 2008-237, date of decision - Oct. 27, 2008) that involved a variety of issues that this dealership had with the IRS. These were seemingly minor and unimportant issues, as evidenced by the Tax Court relegating its opinion to a Memorandum Decision.

The issues involved the deductibility of legal fees paid by the dealership - they were all held to be non-deductible - and writedowns for year-end used vehicle inventories were pretty much pulled out of mid-air ... or somewhere else.

In addition, the IRS tacked on accuracy-related penalties under Section 6662. These penalties were upheld by the Tax Court.

At the time, *West Covina Motors* didn't really make a strong impression on me. After all, there's nothing unusual about non-deductible legal fees and uncorroborated used car writedowns. I had read this case in December and decided not to analyze it for the Year-End 2008 Edition of the *Dealer Tax Watch.* Terri Harris, the IRS Motor Vehicle Technical Advisor, commented on disallowance of the used vehicle writedowns in her NADA workshop presentation on Dealer Tax Issues in January. Her office also issued an *Automotive Alert* on the disallowance of the writedowns.

Greater interest value now due to the upheaval in the auto dealership industry ... particularly all that has transpired since January 1 ... caused me to re-read this case. Several thoughts struck me suggesting that this case merits attention at this time in the *Dealer Tax Watch.*

Many dealerships will be faced with complex litigation with their manufacturers, and possibly others, as the shake-up and/or wind-down occurs in the industry. Going right along with negotiations and lawsuits are legal fees - some well beyond six figures.

Some of these expenses and legal fees may be incurred in connection with bankruptcy proceedings ... and, the deductibility of similar legal fees was one of the issues in *West Covina Motors.* Therefore, the intricacies of deductibility under Section 162 versus alternative non-deductibility treatment under Section 263 warrant some type of review at this time, and the *West Covina Motors* case provides a good background.

In order to survive, or suffer less damage, some dealerships may find it necessary to pay legal expenses or make payments to satisfy the obligations of others who are in financial difficulty. Or, they may have to acquire another franchise or dealership. Here again, the *West Covina Motors* case provides familiar background because it involved the (non)deductibility of dealership acquisition expenditures.

Greater focus on used car operations and, of course, LCM inventory writedowns at year-end. Many dealerships have recently received letters terminating their franchises from Chrysler and/or General Motors in connection with their manufacturer's bankruptcies. Many of these dealers have indicated that, rather than just throwing in the towel and going out of business, they plan to continue operations by expanding the pre-owned or used car sales side of their business activities. Many are looking into Buy-Here, Pay-Here aspects of the business also.

Assuming an enlarged scale of used vehicle operations by many of these dealerships, and thus enlarged year-end used vehicle inventories (and assuming that the Last-In, First-Out (LIFO) inventory method will not be used), a review of the basic rules concerning used vehicle writedowns seems to be in order. Here again, *West Covina Motors* comes to mind as the most recent poster-child for bad practices.

Coincidentally, and perhaps intentionally (?), the recent release by the IRS of an *Audit Technique Guide (ATG)* for the retail industry includes a rather lengthy chapter devoted exclusively to the audit of independent used automobile dealerships.

Accordingly, our analysis of *West Covina Motors, Inc.* incorporates the review of another similar case, some additional supplementary materials and the IRS' recent *Automotive Alert* emphasizing the inventory writedown issue, which is reproduced on pages 36-37.

WEST COVINA MOTORS, INC. ...
AGGRESSIVE DEALERSHIP DEDUCTIONS DISALLOWED
A GOOD REFRESHER FOR SOME BASIC PRINCIPLES

Contents

Case Discussion & Related Materials

Facts

- West Covina Motors operated a Dodge dealership and was 100% owned by Mr. Alhassen (the dealer).
- Mr. Alhassen and his two brothers owned 100% of Hassen Holding Co., the parent and owner of Hassen Imports Inc.
  - Hassen Imports, Inc. was a 1% general partner of HIP, petitioner's landlord, which owned and leased to petitioner the site of the Dodge dealership (West Covina property).
- ***Dollars involved ...***
  - For year 1999 ... \$380,652 deficiency ... \$54,880 accuracy-related penalty under Sec. 6662.
  - For year 2000 ... \$415,073 deficiency ... \$63,548 accuracy-related penalty under Sec. 6662.

Issues & Holdings

- ***Issue #1*** ... May the dealership deduct legal expenses it incurred in connection with the bankruptcy of its landlord, Hassen Imports Partnership (HIP) for 1999 and 2000?
- ***Issue #2*** ... May the dealership deduct legal expenses related to the purchase of Clippinger Chevrolet?
- ***Issue #3*** ... May the dealership deduct assorted other miscellaneous legal expenses? This is really a non-issue because West Covina Motors, Inc. was unable to provide the Court with any information regarding these miscellaneous legal fees.
- ***Issue #4*** ... Is the dealership entitled to deduct year-end write-offs of used vehicle inventory?
- ***Issue #5*** ... Is the dealership liable for accuracy-related penalties under Section 6662(a)?
- ***Holdings ...***
  - Dealership may not deduct any legal expenses involved in Issues #1, 2 and 3.
  - Dealership may not deduct any of the writedowns as part of cost of goods sold expense.
  - Dealership is liable for accuracy-related penalties for both years.

Tax Court Analysis ... Character of Legal Fees in General

- The question is whether the dealership is entitled to deduct various legal expenses as ordinary and necessary business expenses under Sec. 162 or must it capitalize these legal fees under Sec. 263.
  - It is well established that attorney's fees that are paid as ordinary and necessary expenses may be deductible. (*Bagley v. Comm.*, 8 T.C. 130, 134 (1947))
  - No deduction is allowed, however, for attorney's fees that are considered capital expenditures. [Citations omitted]
- ***Origin of claim doctrine.*** The legal expenses at issue in this case must be analyzed under the "origin of the claim" doctrine. (*Mosby v. Comm.*, 86 T.C. 190 (1986))
  - Courts apply the origin of the claim test to determine whether expenses are deductible under Section 162 or subject to capitalization under Section 263. [Citations omitted]
  - The substance of the underlying claim or the nature of the transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the payor's motives or the consequences resulting from the failure to defeat the claim. [Citations omitted]
  - This test requires examination of all the facts and events underlying the claim, and each case turns on its special facts. (*Boagni v. Comm.*, 59 T.C. 708, 713 (1973))

WEST COVINA MOTORS, INC. ... AGGRESSIVE DEALERSHIP DEDUCTIONS DISALLOWED A GOOD REFRESHER FOR SOME BASIC PRINCIPLES

Legal Expenses Paid in Connection with Bankruptcy of Landlord	• Hassen Imports Partnership (HIP) filed for Chapter 11 bankruptcy in April 1998 to prevent foreclosure on the West Covina property. • The mortgagor bank expressed its intent to "toss out" the dealership/taxpayer/tenant from the property during the bankruptcy proceeding. • The leases between the dealership and the lessor provide, however, that a foreclosing mortgagor is deemed to have assumed and agreed to carry out the covenants and obligations of the leases. • Mr. Alhassen (the dealer) had signed these leases as the representative for both the dealership and the lessor. • The dealership participated in lessor's bankruptcy reorganization and was able to expand its business to two additional parcels of land that the lessor acquired as a result of the reorganization. • The dealership directly paid \$46,897 of bankruptcy-related fees in 1999 and \$194,802 in 2000. • The dealership reimbursed the lessor \$21,192 for bankruptcy-related fees in 1999 and \$52,833 in 2000. • The dealership deducted all of these legal fees, totaling \$315,724 as ordinary and necessary business expenses in its income tax returns.

Tax Court Analysis ...
 	
Legal Fees Incurred in the HIP Bankruptcy
	• ***IRS position ...*** The bankruptcy-related legal fees were ordinary and necessary expenses of the dealership. However, they were not deductible because they were rooted in the defense of title.
	• ***Dealership position ...*** These bankruptcy-related legal fees were paid to stave off its (i.e., the dealership's) extinction, and therefore, the dealership should be entitled to deduct them.
	• Legal expenses incurred to defend claims that would injure or destroy a business are ordinary and necessary expenses. *Comm. v. Heininger*, 320 U.S. 467, 471-472 (1943).
	  ◆ The expenses incurred in defending legal title, however, are not deductible and must be capitalized. *Duntley v. Comm.*, T.C. Memo. 1987-579; Reg. Sec. 1.263(a)-2(c).
	  ◆ The Tax Court has held that legal expenses incurred in defending or postponing foreclosure actions must be capitalized because they are actions in defense of title. *Flint v. Comm., supra*; *Boyajian v. Comm.*, T.C. Memo. 1970-78.
	• In this case, the Tax Court could see no difference where a tenant (i.e., West Covina Motors, Inc.) took the highly unusual action of paying expenses to defend its landlord's title.
	• As a general rule, a taxpayer may not deduct the expenses of another. See *Deputy v. du Pont*, 308 U.S. 488 (1940).
	  ◆ The Tax Court has recognized a narrow exception where the original obligor is unable to make payment and the taxpayer satisfies the obligation to protect its own business interests. (*Hood v. Comm.*, 115 T.C. 172, 180-181 (2000) and cases cited thereat; *Lohrke v. Comm.*, 48 T.C. 679 (1967))
	  ◆ **The adverse consequences for the payor taxpayer's business must be direct and proximate, however, as demonstrated by the impact on the payor's business of an obligor's inability to meet its obligations.** (*Hood v. Comm.*)
	  ◆ Note: See pages 32-35 for a discussion of the *Hood* case.
	• In this case, there is no suggestion that HIP (i.e., the dealership's landlord) was unable to pay the bankruptcy-related legal fees.
	  ◆ In fact, HIP had paid some of the fees, and the dealership reimbursed HIP for a portion.
	• ***Tax Court conclusion ...*** The dealership may not deduct these expenses because the benefits to it (i.e., the dealership) are not as direct and proximate as required for the narrow exception set out in *Lohrke*.

West Covina Motors, Inc. ... Aggressive Dealership Deductions Disallowed A Good Refresher for Some Basic Principles

Legal Expenses Paid in Connection with Acquisition of Clippinger Chevrolet

- In an unrelated transaction, Mr. Alhassen (the dealer) entered into an agreement to purchase (purchase agreement) the assets of Clippinger, an established new car dealership in Covina, CA.
- Mr. Alhassen assigned the purchase rights to West Covina Motors, Inc., who consummated the purchase agreement with Clippinger in November 1999.
- West Covina Motors, Inc. acquired Clippinger's inventory of new and used automobiles, automobile parts and accessories, new automobile deposits, fixed assets including shop equipment and machinery, and intangible assets including goodwill and trademark rights.
- Escrow documents list the Clippinger purchase price as roughly $6.2 million.
  - The purchase agreement assigned specific dollar values to the assets as follows:
    - To fixed assets ... $250,000,
    - To miscellaneous assets ... $1, and
    - To goodwill and other intangible assets ... $3,500,000.
- Clippinger also required the purchaser to assume Clippinger's legal fees for structuring a seller-financing arrangement when the purchaser was unable to proceed with the transaction on a cash basis.
- West Covina Motors, Inc. paid $100,000 in fees to Clippinger's counsel in 1999 for preparing multiple loan documents and lease agreements, and it incurred $19,251 of legal fees in 1999 and $19,214 in 2000 for its own representation in the Clippinger acquisition.
- West Covina Motors, Inc. deducted all of these fees, including those paid to Clippinger's counsel, on its tax returns for the respective years

T.C. Opinion

Legal Fees Incurred in the Clippinger Acquisition

- ***IRS position ...*** The legal expenses in 1999 and in 2000 are capital expenditures because the dealership incurred them while acquiring a capital asset.
  - It is well settled that legal expenses incurred in the acquisition or disposition of a capital asset are capital expenditures. (*Woodward v. Comm.*, 397 U.S. at 574)
- ***Dealership position ...*** These legal fees are deductible because they relate to inventory, which turns over every 90 to 150 days and does not provide significant benefit beyond a taxable year.
  - In addition, these fees were either directly linked to physical inventory and inventory financing or were related to the Clippinger purchase in which 74% to 90% of the purchase price was attributable to inventory.
- The Tax Court found that the dealership's argument that most of the Clippinger purchase price represented automobile inventory conflicts with the evidence in the record.
  - Escrow documents list the Clippinger purchase price at $6,206,814, and removing the amounts allocated in the purchase agreement to non-inventory items leaves less than $2,400,000 (i.e., less than 40%) of the purchase price allocated to Clippinger's inventory and other assets.
    - The amount representing non-inventory items includes $100,000 for legal fees paid to Clippinger's counsel, $250,000 for fixed assets, $1 for miscellaneous assets, and $3,500,000 for goodwill and intangible assets.
- The Tax Court also found that the testimony given by Mr. Alhassen (the dealer) regarding the portion of the purchase price allocated to inventory was uncorroborated and insufficient to overcome the information contained in the escrow documents and in the purchase agreement.
    - The dealership failed to provide invoices or records for the acquisition-related legal services, indicating that these services related specifically to physical inventory or inventory financing.
    - The Tax Court held that the accountant's testimony on this issue was not credible.
    - The dealership's records contradicted its position that inventory turned over every 90 to 150 days as 35 of the 96 automobiles included in the 2000 year-end inventory were also listed in the 1999 year-end inventory.
- The Tax Court said that it is not required to (nor would it in this case) accept the self-serving testimony of interested parties without probative corroboration. [Citations omitted]
- ***Tax Court conclusion ...*** The expenses incurred in the Clippinger acquisition are not deductible as ordinary and necessary business expenses because they constitute capital expenditures.

West Covina Motors, Inc. ... Aggressive Dealership Deductions Disallowed A Good Refresher for Some Basic Principles

Used Vehicle Inventory Writedowns... Facts

- The IRS and the taxpayer stipulated that it is industry custom to use the lower-of-cost-or-market method of inventory valuation under which items are valued at the lower of cost or market value.
  - This method usually results in an adjustment to inventory, by means of a write-down of inventory to market value.
  - However, the IRS disagreed with the dealership's method of writing down inventory
- The dealership assigned a stock number to each new and used automobile in its inventory.
  - It referenced the stock number in records comparing the cost and the market value of each automobile for purposes of determining the proper writedown, if any.
- ***Insufficient records.*** The dealership's records were lacking in two respects.
  - They did not include complete information concerning the year, make, and model for ***several*** automobiles in these records.
  - They did not indicate the condition, mileage, or equipment options of ***any*** of the automobiles.
- ***Flawed valuations.*** The dealership's accountants estimated market value based on the *Kelley Blue Book* average wholesale prices ***without reference to*** the actual condition, mileage, or equipment options of any of the automobiles.
- The dealership's writedown calculations show that the inventory writedowns should have been $309,172 for 1999 and $344,208 for 2000.
- ***Use of reserve account.*** The dealership used an inventory valuation reserve account, and it recorded the inventory writedown adjustment for the years at issue, as a trial balance sheet item titled "UV Res for Writedown." *[Presumably, "Used Vehicle Reserve for Writedown."]*
  - In other words, the dealership offset $340,181 against a reserve for each of the years at issue, rather than using the writedown amounts that had been determined from its vehicle-by-vehicle analysis.
- ***Slow moving / Non-moving inventory.*** The dealership's ending inventory for 2000 consisted of 96 automobiles, 35 of which had been listed in its ending inventory for 1999.
  - The dealership did not adjust the cost of these automobiles at the beginning of 2000 by the writedown taken at the end of 1999, resulting in a $79,8245 overstatement of inventory writedown in 2000.

IRS Audit Technique Guide Used Vehicle Operations

Trade-In Valuation & LCM Adjustments

(Continued)

Year-end LCM writedowns ... (Continued from Page 39). Reg. Sec. 1.446-1(a)(2) states in part that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. Reg. Sec. 1.471-2(d) provides that the method must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business. There is a lack of consistency if more than one official valuation guide is used simultaneously.

Section 471 provides that inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income. These Regulations under Section 471 prescribe two instances where inventory may be written down below cost to market.

The first instance allows a taxpayer to write down purchased goods to replacement cost (Reg. Sec. 1.471-4(a)).

The second instance is contained in Reg. Sec. 1.471-4(b) which states in part that inventory may be valued at lower than replacement cost with correctness determined by actual sales for a reasonable period before and after the date of inventory.

Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market. (See also *Thor Power Tool Co. v. Comm.*, 439 U.S. 522 (1979) and *Pearl v. Comm.*, T.C. Memo 1977- 262.)

WEST COVINA MOTORS, INC. ...
AGGRESSIVE DEALERSHIP DEDUCTIONS DISALLOWED
A GOOD REFRESHER FOR SOME BASIC PRINCIPLES

Year-End Writedown of Used Vehicle Inventories...

Tax Court Analysis

- The position of the IRS in disallowing the year-end used vehicle inventory writedowns was that the dealership both (1) failed to substantiate the writedowns and (2) violated the Regulations under Section 471 by using a reserve amount.
- The position of the dealership was that its accounting complied with industry standards, and therefore, the writedowns should be allowed.
    - Apparently, the dealership also argued that the inventory writedowns "had no taxable effect" (i.e., that the net result was just a shift of income between years?), and the Tax Court basically dismissed this argument as having no merit.
- ***Basic principles...***
    - A taxpayer is required to use a method of accounting for inventory that clearly reflects the taxpayer's income. (*Best Auto Sales, Inc. v. Comm.*, T.C. Memo. 2002-297, affd. 90 Fed. Appx. 388 (11th Cir. 2004))
    - A taxpayer has a heavy burden of proving that the Commissioner's determination is plainly arbitrary and constitutes an abuse of discretion if the Commissioner determines that the taxpayer's method of accounting for inventory under Section 471 is improper. (*Thor Power Tool Co. v. Comm.*, 439 U.S. 522, 532-533 (1979))
    - ***"Inventory writedown."*** A taxpayer using the lower-of-cost-or-market method of valuing inventory may writedown a decline in the value of merchandise from its cost to a lower market value in the year in which the decline occurs, even though the goods have not been sold. (Reg. Sec. 1.471-2(c))
        - If the market value of the inventory at the end of the year is lower than its cost, the taxpayer writes down the basis of the inventory to the lower market value, thereby reducing gross income. (*Thor Power Tool Co. v. Comm.* and Reg. Sec. 1.471-4(c))
        - ***However, deducting a reserve for price changes from the inventory or writing down inventory based on mere estimates is not allowable.*** (Reg. Sec. 1.471-2(f)(1))
    - The Tax Court will not disturb the Commissioner's determination disallowing a taxpayer's writedowns without objective evidence substantiating an item-by-item comparison of cost-to-market value. [Citations omitted]
    - An official guide for used automobiles may be used to determine the market value for write-down purposes. (*Brooks-Massey Dodge, Inc. v. Comm.*, 60 T.C. 884, 895 (1973))
- The dealership's accountant determined the market value for writedown purposes as the wholesale *Kelley Blue Book* value with the assumption that the automobiles were in average condition.
    - However, in his Tax Court testimony, the dealership's accountant said that it is necessary to know the make, model and year of the automobile, as well as the automobile's condition, mileage and equipment options in order to determine the *Kelley Blue Book* value.
- ***Dealership's records for identifying vehicles were incomplete.***
    - The records did not show the make, model and year of ***several*** automobiles
    - The records did not include the mileage, condition or options of ***any*** automobiles.
- The dealership argued that this method is the industry standard and any differences between the method used and a more detailed analysis would have been immaterial.
    - The Tax Court was not persuaded given the incomplete writedown records and the absence of any corroborating evidence to support the estimated *Kelley Blue Book* values.
- ***Use of a writedown reserve account.*** In addition to the problems created by its incomplete records for vehicle descriptions, the dealership caused further problems for itself because it did not use the total amounts of its writedown calculations of $309,172 in 1999 and $344,208 in 2000 to determine its cost of goods sold.
    - Therefore, the dealership violated the Regulations when it substituted a reserve amount of $340,181 as the writedown amount for both years.
- ***Tax Court conclusions upholding the IRS...***
    - The dealership did not adequately substantiate the inventory writedowns and relied on a reserve in violation of the Section 471 Regulations.
    - The dealership failed to prove that the Commissioner's determination (disallowing the writedowns) was arbitrary and an abuse of discretion.

WEST COVINA MOTORS, INC. ...
AGGRESSIVE DEALERSHIP DEDUCTIONS DISALLOWED
A GOOD REFRESHER FOR SOME BASIC PRINCIPLES

Accuracy-Related Penalties

In General

Sec. 6662(c)

Tax Court Analysis

- The IRS has the burden of production (i.e., the burden of proof) under Section 7491(c) and must come forward with sufficient evidence that it is appropriate to impose a penalty.
- A taxpayer is liable for an accuracy-related penalty of 20% of any part of an underpayment attributable to, among other things, a substantial understatement of income tax. (Sec. 6662(a) and (b)(2) and Reg. Sec. 1.6662-2(a)(2))
  - There is a substantial understatement of income tax if the understatement amount exceeds the greater of 10% of the tax required to be shown on the return, or $10,000. (Sec. 6662(d)(1)(B) and Reg. Sec. 1.6662-4(b)(1))
- The dealership reported income tax of zero for the years at issue and reported negative taxable income of $258,427 for taxable year 1999 and zero taxable income for 2000.
  - The IRS met its burden of proof because the adjustments related to the conceded issues alone were sufficient to meet the threshold amounts under Section 6662(d)(1).
- West Covina Motors argued that Section 6662(a) penalties should be waived for three reasons...
  - There was ***substantial authority*** for the positions taken on its tax returns.
  - The dealership provided ***adequate disclosure*** of the relevant facts affecting its tax treatment of the items on the returns.
  - Dealership had ***reasonable cause*** for its positions on the returns.
- While the IRS bears the burden of production/proof under Sec. 7491(c), the taxpayer bears the burden of proof with regard to issues of reasonable cause, substantial authority, or similar provisions.

#1. Substantial Authority For Positions Taken

Sec. 6662(c)

- Substantial authority for the tax treatment of an item exists only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions. [Citations omitted]
- The weight of an authority depends on its source, persuasiveness and relevance. (Reg. Sec. 1.6662-4(d)(3)(ii))
- The Tax Court found that the weight of authority consistently favored the IRS.
  - The Court found no merit in the dealership's arguments concerning the deductibility of the attorney's fees.
  - The dealership's position regarding the inventory writedown explicitly contradicts the relevant income tax regulations. (Reg. Sec. 1.471-2(f)(1))
- The Tax Court concluded that the substantial authority exception did not apply.

#2. Disclosure Of a Position & Reasonable Basis for Treatment

Sec. 6662(c)

- No accuracy-related penalty may be imposed for a substantial understatement of income tax when the taxpayer adequately discloses the relevant facts affecting the tax treatment of an item and there existed a reasonable basis for the treatment of that item. (Sec. 6662(d)(2)(B))
  - A return position generally has a reasonable basis if it is reasonably based on one or more of the following authorities, among others: The Internal Revenue Code and other statutory provisions; proposed, temporary and final Regulations construing the statutes; court cases; and Congressional intent as reflected in committee reports. Reg. Sec. 1.6662-4(d)(3)(iii).
    - The reasonable basis standard is not satisfied by a return position that is merely arguable or is merely a colorable claim. (Reg. Sec. 1.6662-3(b)(3))
- A taxpayer may make adequate disclosure if the taxpayer provides sufficient information on the return to enable the Commissioner to identify the potential controversy. (*Schirmer v. Comm.*, 89 T.C. 277, 285-286 (1987))
- Merely claiming the loss without further explanation, however, is insufficient to alert the Commissioner to the controversial nature of a loss claimed on the tax return. (*McConnell v. Comm.*, T.C. Memo. 2008-167 (citing *Robnett v. Comm.*, T.C. Memo. 2001-17))
- The Tax Court held that the dealership did not provide sufficient facts to supply the IRS with actual or constructive knowledge of the tax treatment of the disputed items.
  - The income tax returns did not mention the dealership's inventory writedown method or that the dealership deducted legal fees related to HIP's bankruptcy and the acquisition of the Clippinger dealership.
- The Tax Court concluded that the dealership did not adequately disclose its position(s), and the adequate disclosure exception did not apply.

West Covina Motors, Inc. ...
Aggressive Dealership Deductions Disallowed
A Good Refresher for Some Basic Principles

#3. Reasonable Cause ***Reliance on Advice of "Accountant"*** ***Sec. 6662(c)***	• The accuracy-related penalty under Section 6662(a) does not apply to any portion of an underpayment if it is shown that there was reasonable cause for, and that the taxpayer acted in good faith with respect to, that portion. (Sec. 6664(c)(1) and Reg. Sec. 1.6664-4(a)) ◆ The determination of whether the taxpayer acted with reasonable cause and in good faith depends on the pertinent facts and circumstances, including the taxpayer's efforts to assess his or her proper tax liability, the knowledge and experience of the taxpayer, and the taxpayer's reliance on the advice of a professional. (Reg. Sec. 1.6664-4(b)(1)) • West Covina Motors argued that it should not be liable for the accuracy-related penalties because it relied upon the advice of its accountant concerning the tax treatment of the disputed items. • Reliance on the advice of a competent adviser can be a defense to the accuracy-related penalty. (Reg. Sec. 1.6664-4(b)(1), case citations omitted) ◆ Reliance must be reasonable, in good faith, and based upon full disclosure. [Citations omitted] • The Tax Court held that the dealership had not shown that ... ◆ It supplied its accountant with all the correct and necessary information needed to establish its position, ◆ Its error in underreporting was the result of the preparer's mistake, or ◆ It discussed the tax treatment of the legal fee deductions with its accountant before filing the returns. • After considering all of the facts and circumstances, the Tax Court held that the dealership had not established that it had reasonable cause and acted in good faith with respect to the substantial understatements of income tax.
Tax Court Holding on Penalties	• After discussing each of the taxpayer's arguments, the Tax Court sustained the IRS' determination regarding the accuracy-related penalties for the years at issue because the dealership had not satisfied any of the conditions that would waive the imposition of the penalties.
Another Case re: ***Reliance on Advice of "Tax Professional"***	• A recent case (*January Transport, Inc. v. Comm.*, T.C. Memo 2008-268) contains a discussion more specific to a situation where a taxpayer relies upon advice of a tax professional. ◆ The *West Covina* case involved the dealership's reliance on its accountant(s). ◆ In *January Transport*, the taxpayer ignored its CPA's advice and claimed a deduction in the corporate return based upon information in a newspaper article. ◆ A Corporate Officer reviewed the tax return before it was filed and, therefore, was clearly aware that this deduction was being claimed (which was found to be erroneous) in the income tax return filed. • Major discussion points from the *January Transport* case follow, with citations omitted ... • Reliance upon the advice of a tax professional may establish reasonable cause and good faith for the purpose of avoiding liability for the Section 6662(a) penalty. • Reliance on a tax professional is not an "absolute defense", but merely "a factor to be considered." • Whether reasonable cause exists when a taxpayer has relied on a tax professional to prepare a return must be determined on the basis of all of the facts and circumstances. • ***The taxpayer claiming reliance on a tax professional must prove by a preponderance of evidence each prong of the following test:*** ◆ The adviser was a competent professional who had sufficient expertise to justify reliance, ◆ The taxpayer provided necessary and accurate information to the adviser, ***and*** ◆ The taxpayer actually relied in good faith on the adviser's judgment. • Reliance on a return preparer is not reasonable where even a cursory review of the return would reveal inaccurate entries.

HOOD V. COMM. ... MORE ON THE DEDUCTIBILITY OF LEGAL FEES & EXPENSES PAID FOR ANOTHER PARTY

More Insight into the Tax Court's Analysis of the Deductibility Issues

In some situations, a dealership may be involved with another party who is, or may be, in financial difficulty. The dealership may be called upon to make payments that arise under a number of different circumstances such as the payment of debts assumed with respect to creditors of controlled corporations, payments to compromise debts and, thus, avoid bankruptcy, or payments to indemnify creditors or to maintain a favorable credit rating.

If the dealership has paid either (1) legal fees or (2) other amounts paid for the benefit of that party, the dealership will want to deduct those payments as ordinary and necessary business expenses under Section 162. Typically, the position taken by the IRS in disallowing the deductibility of those payments would be that the payments made by the dealership/ corporation are nondeductible to the corporation and should be added to the basis of some property or added to the basis of the investment in stock. That was the general context for the payments at issue in *West Covina Motors, Inc.*

In *West Covina*, the Tax Court held that the dealership could not deduct the expenses of its landlord because the benefits to the dealership were not sufficiently "direct and proximate." On the other related expense issue, the Clippinger dealership-acquisition-related expenses were required to be capitalized.

The Tax Court said that as a general rule, a taxpayer may not deduct the expenses of another. The Court did, however, recognize that there was a "narrow exception" to that general rule where the original obligor is unable to make payment and the taxpayer satisfies the obligation to protect its own business interests.

There are two tests or conditions to be satisfied in order to satisfy this narrow exception. First, there must be direct and proximate adverse consequences on the taxpayer's business. Second, these consequences must be demonstrated by the impact on the payor's business of an obligor's inability to meet its obligations.

In *West Covina*, the Tax Court cited two cases ... *Lohrke v. Comm.* (48 T.C. 679 (1967) and *Hood v. Comm.* The *Hood* case will be analyzed to examine more closely the "narrow exception" and what may be more "direct and proximate" consequences to the payor in these circumstances.

The Hood Case	• The *"Hood"* case actually involves one individual (*Lenward Hood*) and his solely-owned corporation (*Hood's Institutional Foods, Inc.*). The two taxpayers were combined in the Tax Court proceeding (collectively, *"Hood"*) [115 T.C. 172 (decided Aug. 25, 2000)]. • The Corporation (Hood's Institutional Foods [HIF]), as well as its predecessor sole proprietorship, was engaged in the sale of food, paper and plastic goods and related products to institutional customers ... primarily governmental entities. ◆ Mr. Hood supervised and managed all aspects of the business conducted through the sole proprietorship and later by the Corporation. He was solely responsible for computing bid amounts, negotiating bid amounts and deciding whether or not to bid for particular jobs. His assistants made no important decisions without consulting him. When he took vacations, he spoke frequently with his assistants by telephone. ◆ One important finding of fact was that Mr. Hood was indispensable to the continued successful operation of the Corporation. • In its 1991 income tax return, Mr. Hood's corporation had deducted the payment it made for all of the legal fees that Mr. Hood had incurred in defending himself against criminal tax evasion and false declaration charges. ◆ These charges related to alleged unreported income from the sole proprietorship that preceded the Corporation. Mr. Hood was acquitted on all accounts when his case was tried in 1991.
Tax Court Holdings	• ***The Tax Court held that the payment of the legal fees was not deductible*** because... ◆ The payment was a constructive dividend to Mr. Hood. Therefore, it was nondeductible by the Corporation. ◆ The legal fees paid by the Corporation were the expense of another, and the Corporation did not show that the payment was made to protect or promote its own trade or business under the standard of the *Lohrke* decision. • The constructive dividend (i.e., the legal fees paid) should be included in income by Mr. Hood. • Accuracy-related penalties were not assessed against the Corporation because its reporting position was found to be consistent with the Tax Court's holding in another case.

	Hood v. Comm. ... More on the Deductibility of Legal Fees & Expenses Paid for Another Party
Taxpayer & IRS Positions	• In *Hood*, the central issue is whether the Corporation may deduct the legal fees it paid for Mr. Hood's defense against criminal tax evasion and false declaration charges arising from Mr. Hood's reporting of the Schedule C income of a predecessor sole proprietorship. • In a previous case involving virtually identical circumstances - *Jack's Maintenance Contractors, Inc. v. Comm.* [citations omitted], the Court of Appeals for the Fifth Circuit held that the payment of legal fees constituted a constructive dividend to the shareholder. ◆ This Circuit Court decision reversed the Tax Court's holding that the corporation was entitled to deduct the legal fees. • In *Hood*, the IRS argued that the Circuit Court's position in reversing *Jack's Maintenance* was correct, and therefore, the Corporation (HIF) may not deduct the legal fees because the payment of these fees constituted a constructive dividend to Mr. Hood. As such, they would not qualify as ordinary and necessary business expenses of the Corporation under Section 162. • In *Hood*, the taxpayers contended that the legal fees were deductible by the Corporation as an ordinary and necessary business expense, and consequently, their payment was not a constructive dividend to Mr. Hood.
The Saga of Jack's Maintenance	• In the Tax Court's opinion in *Jack's Maintenance Contractors, Inc.*, it had allowed the corporate taxpayer a deduction for the legal expenses. The IRS had argued that under the "origin-of-the-claim" test established in *United States v. Gilmore* (372 U.S. 39 (1963)), the legal fees were not deductible by the corporation. The Tax Court found, however, that the origin-of the-claim test in *Gilmore* addressed only whether the legal fees were nondeductible "personal" expenses or deductible "business" expenses. • In *Jack's Maintenance*, the Tax Court concluded (as the IRS had conceded) that the fees were *business* rather than *personal* in origin, and the Court had reasoned that ***the "real issue" in the case was whether one taxpayer may deduct the expenses of another.*** ◆ The Tax Court had relied on the exception (in *Lohrke*) to the general rule that a taxpayer may not deduct the expenses of another. ◆ The Tax Court held that the legal fees were deductible by the corporation because the corporation had a sufficient business purpose in paying what were concededly the expenses of another (its shareholder/employee)... namely, that the corporation was ensuring its own continued operations because the shareholder/employee was an indispensable employee. ◆ The Tax Court had also relied on *Holdcroft Transp. Co. v. Comm.* [citations omitted] in which a corporate successor to a partnership was allowed to deduct legal fees it had paid with respect to the settlement of outstanding claims against the partnership. • In *Jack's Maintenance*, the appropriate treatment by the shareholder/ employee of the legal fees was not an issue in the case. The Tax Court did not address the question of whether the corporation's payment of the fees might be a constructive dividend. • The Court of Appeals gave two reasons for reversing the Tax Court's holding that the fees were deductible by the corporation. ◆ ***First,*** the legal fees were not deductible because they constituted a constructive dividend. The Court of Appeals applied the test of whether the payment primarily benefited the shareholder or the corporation, and the Court concluded that the shareholder was the primary beneficiary. ◆ ***Second,*** the Court of Appeals held that in any event the legal fees were the personal expenses of the shareholder and not an ordinary and necessary business expense of the corporation under Section 162. • The Court of Appeals analogized the legal expenses to the shareholder's medical expenses, both of which were personal in its view, and concluded that ***any rule which permitted a corporate deduction of a shareholder's personal expenses on the grounds that the corporation's payment ensured the continued availability of an indispensable employee "would be far too broad."*** ◆ Therefore, the corporation's deduction was disallowed.

HOOD v. COMM. ... MORE ON THE DEDUCTIBILITY OF LEGAL FEES & EXPENSES PAID FOR ANOTHER PARTY

(Avoiding) Constructive Dividend Treatment	• The Tax Court said that there was no question that the payment of Mr. Hood's legal fees was an economic benefit conferred without the expectation of repayment. Therefore, this raised the question of whether the payment was a constructive dividend. ◆ However, not every corporate expenditure which incidentally confers economic benefit on a shareholder is a constructive dividend. In determining the existence of a constructive dividend, ***the crucial test is whether the distribution was primarily for the benefit of the shareholder.*** • The existence of some benefit to the Corporation is not enough to permit a corporate deduction; the Court must weigh the benefit to the shareholder and the Corporation, and "where the business justifications put forward are not of sufficient substance to disturb a conclusion that the distribution was primarily for shareholder benefit," a constructive dividend will be found. *Sammons v. Comm.* [citations omitted]. • The determination of whether the shareholder or the Corporation primarily benefits is a question of fact. The line between primarily for shareholder benefit and primarily for corporate benefit is often difficult to draw. • To avoid constructive dividend treatment, the taxpayer must show that the corporation primarily benefited from the payment of the shareholder's expenses. • The Tax Court said that it is absolutely essential to make a ***strong showing of the benefit to the Corporation*** in dealing with (1) the primary benefit test and (2) the standards under which a taxpayer may deduct the expenses it has paid for another.
Which Party Benefitted "Primarily" from the Payment? *Was the Benefit to the Corporation Direct & Proximate?*	• The Court did not believe the taxpayers had shown that the Corporation primarily benefited from the payment of Mr. Hood's legal expenses. • One factor to be considered in the overall picture was the "indispensability" of the owner-employee to the Corporation. ◆ There was no evidence that, in deciding to pay the legal fees, genuine consideration was given to the corporate interests identified by the taxpayers ... namely, loss of an indispensable employee if his legal expenses were not paid. ▪ It was established as a finding of fact that Mr. Hood was clearly indispensible to (the continued, successful operation of) the Corporation. ▪ Although the indispensability of Mr. Hood to the Corporation was a factor, that factor was too broad and subjective to be the decisive or controlling factor. • The evidence did not show that the Corporation would have ceased operations or gone out of business if it did not pay the legal fees. This casts doubt on the claim that the primary purpose of the expenditure was to forestall this result. ◆ There was no evidence that corporate interests would be harmed by Mr. Hood's inability to pay his own legal fees. • The taxpayers had not shown that Mr. Hood was experiencing financial difficulty or was otherwise unable to pay his legal fees. ◆ Thus, while the incarceration of Mr. Hood might have caused the Corporation to cease operations, the taxpayers did not show that the Corporation's failure to pay the legal fees would have led to Mr. Hood's incarceration. ◆ Mr. Hood, in fact, paid the deficiencies and civil fraud additions to tax for which he was indicted, strongly suggesting that he had the wherewithal to pay the legal fees associated with his criminal defense. There was no showing that he could not afford to pay these fees. • The benefits to Mr. Hood were obvious: free legal representation for which he would otherwise have to pay to avoid incarceration and/or a felony conviction. This left Mr. Hood as the primary beneficiary of the payment of his legal fees by his Corporation. • The benefits to the Corporation's business of paying Mr. Hood's legal fees are not as direct and proximate as the connection demonstrated in *Lohrke*, where the corporation's inability to compensate purchasers of its defective fabric prompted its shareholder, who collected royalties from the fabric's production process, to make the compensatory payments. • Accordingly, the Tax Court held that Mr. Hood ... not the Corporation ... was the primary beneficiary of the payment of his legal fees. The business justifications put forward were not of sufficient substance to disturb that conclusion.

	Hood v. Comm. ... More on the Deductibility of Legal Fees & Expenses Paid for Another Party **Page 4 of 4**
"Expenses Paid for Another Party"	• The alternative rule that would allow the Corporation in *Hood* to deduct the payments is referred to as the "standards under which a taxpayer may deduct the expenses it has paid for another." ◆ In this respect, there was no proof that Mr. Hood could not pay for his own legal expenses. ◆ Also, there was no showing that the Corporation had explicitly assumed the liability for the payment of these expenses. • The *Lohrke* case is cited by the Tax Court as the basis for its determinations under the "expenses paid for another" party standard. ◆ Note: Unfortunately, the *Lohrke* case does not provide much help in analyzing some of the more current general dealership situations.
The Facts in Lohrke	• In *Lohrke v. Comm.*, the taxpayer had shown that the expenses he paid to protect his own business were those of a corporation unable to make payment. ◆ The taxpayer in *Lohrke* held a majority interest in a corporation that had provided defective synthetic fiber to a customer. The taxpayer individually carried on a separate trade or business of licensing the process to produce the synthetic fiber, from which he derived substantial royalty income. ◆ The customer suffered losses as a result of receiving the defective fiber, but the corporation, which was in serious financial difficulty, was unable to compensate the customer. • Because the corporation was unable to pay, the taxpayer guaranteed, and ultimately paid, the customer's losses because he was concerned that otherwise his reputation in the industry, and that of his patented process, would be damaged. • ***In Lohrke, the Tax Court held that a narrow exception existed to the general rule that a taxpayer may not deduct the expenses of another.*** ◆ The cases relied on in *Lohrke* likewise involved the taxpayers' payment of the obligations of others in financial difficulty. ▪ *Lutz v. Comm.* (282 F.2d 614 (5th Cir. 1960), revg. & remanding T.C. Memo. 1959-32) ... Although 50 years old, this case is extremely rich in detail. ▪ *Pepper v. Comm.* (36 T.C. 886 (1961)) ▪ *Snow v. Comm.* (31 T.C. 585 (1958)) ▪ *Dinardo v. Comm.* (22 T.C. 430 (1954)) ◆ To fit within the narrow exception under the *Lohrke* line of cases, ***the adverse consequences for the payor taxpayer's business must be direct and proximate***, as is demonstrated in the above cases by the impact on a payor's business of an obligor's inability to meet his obligations. Other cases cited ... ▪ *AMW Invs., Inc. v. Comm.* (T.C. Memo. 1996-235 [adverse effect on payor's business must be "clear, direct, and proximate"]) ▪ *Concord Instruments Corp. v. Comm.* (T.C. Memo. 1994-248)
Hood Fails the Lohrke Test	• The Tax Court did not think that the facts in *Hood* came within the terms of the narrow exception in *Lohrke* to the general rule that a taxpayer may not deduct the expenses of another. • The Tax Court found *Lohrke* to be distinguishable from *Hood* for two reasons... ◆ *Lohrke* involved the payment by an individual of a corporation's expenses. ◆ In *Lohrke*, the taxpayer provided valid reasons for its paying another party's expenses ... the taxpayer paid the expenses of another party that was unable to do so. (In *Hood*, there was no such showing.) • Where a corporation pays expenses incurred by its sole or controlling shareholder, as in *Hood*, an additional issue not considered in *Lohrke* is presented... namely, whether the corporation's payment should be treated as, in substance, a distribution of earnings. (In this regard, see Page 3 of 4 for "constructive dividend" discussion.) • Note: Because the Tax Court concluded that the Corporation did not come within the terms of the exception provided in *Lohrke*, it did not have to consider the impact of the origin-of-the-claim doctrine announced in *United States v. Gilmore* on the deduction of the legal expenses of another by a taxpayer meeting the terms of the exception provided in *Lohrke*.

IRS

TAX COURT RULES ON INVENTORY WRITE DOWNS

West Covina Motors, Inc.

TC Memo 2008-237

Automotive Alert

Motor Vehicle Technical Advisor

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Introduction

In October 2008, the Tax Court released its ruling in West Covina Motors, Inc., TC Memo 2008-237. The ruling addresses many issues including deductibility of several types of legal expenses, applicability of penalties, and the appropriateness of the dealership's inventory write down. While much of the opinion in this case is focused on the legal expense issue, for purposes of this Alert, we will limit our discussion to the inventory write down issue.

Statement of the Issue

The Internal Revenue Service (IRS) determined that the taxpayer had failed to substantiate its inventory write down and violated the regulations under IRC 471 by using an inventory reserve account. The Taxpayer argued that its accounting method complied with industry standards and that the write down should be allowed.

Tax Court Ruling

The Tax Court concluded that the taxpayer bore the heavy burden of proving that the IRS conclusion was arbitrary and incorrect. Furthermore, the Court ruled that the taxpayer did not adequately substantiate the inventory write downs and additionally relied on a reserve in violation of the IRC 471 requirements.

Discussion

A taxpayer using the lower of cost or market method of valuing inventory may write down a decline in the value of merchandise from its cost in the year in which the decline occurs even though the goods have not been sold. However, deducting a write down reserve or estimated amount is not allowable.

Citing Best Auto Sales, Inc, TC Memo 2002-297, the Court noted that a taxpayer is required to use a method of accounting that clearly reflects income. In this case, the IRS determined that the taxpayer's method did not clearly reflect income as the inventory write down amounts were unsubstantiated and the taxpayer used an unauthorized write down reserve. The Court also noted that the dealership failed to provide objective evidence substantiating an item-by-item comparison of cost-to-market value.

In this case, the dealership's accountant determined vehicle market value for write down purposes by reference to a commonly used wholesale guide assuming that all vehicles were in average condition. However, the accountant testified that it is necessary to know the make, model, and year of the vehicle as well as the vehicle's condition, mileage and optional equipment in order to properly apply the wholesale guide. In this case, the dealership's records lacked the necessary detail to enable a write down calculation using all of the required comparisons. For some vehicles, the dealership's records did not include the make, model, or year of the vehicle subject to write down. For other vehicles, the records did not include mileage, condition, or options.

The Court was not persuaded by the taxpayer's argument that their method of inventory write down valuation was the industry standard and that any differences determined by a more detailed analysis would be immaterial.

Conclusion

Many dealerships have elected the lower of cost or market method to value used vehicle inventories. Analysis of the West Covina Motors, Inc. decision should alert dealers to review their record keeping and ensure that the dealership maintains adequate, detailed records. The records must enable an item-by-item vehicle comparison in order to ensure a proper and substantiated inventory write down computation.

A footnote in the decision acknowledges that an official guide for used automobiles may be used to determine market value for write down purposes (Brooks-Massey Dodge, Inc. 60 T.C. 884). However, in order to make a proper comparison, dealership records should include sufficient detail to enable a comparison of similarly equipped vehicles in similar condition. The following items are required to make a complete comparison:

- Make, model, and year of the vehicle
- Vehicle condition, mileage, and optional equipment

It should also be noted that the official used vehicle guide selected by the dealership must be used consistently and that the proper guide corresponding to the dealership location and time period must be used. Any change in the official guide used is considered to be a change in method of accounting.

If you have any questions or comments on this issue, you may contact the Motor Vehicle Technical Advisor at 616-365-4601 or Terri.S.Harris@irs.gov

Determining the Cost Basis for Trade-Ins

The starting point for determining the cost of a car taken in trade is the Actual Cash Value (ACV). It is a common industry practice to determine the ACV by the following steps ...

- Refer to a valuation guideline. While the *Kelley Blue Book* and *NADA Used Car Guide* are two of the more common valuation guidelines, any guideline approved by the Department of Transportation is acceptable, including Auction guidelines.
- However, these books serve only as the starting point, as a guideline for the value of the car. Even the valuation guidelines point out that adjustments must be made for the actual condition of the car, since the guideline assumes an average condition.

Many dealers may not follow proper tax procedures through the use of a published guideline. Instead, they base their determination on the actual market conditions existing at that time in their location. The dealer will then adjust the value to take into account specific features of the car that add to or subtract from the guideline value. Some of these factors include ...

- Actual wear and tear on the car,
- Mileage,
- Accessories,
- Any hidden damage such as frame damage,
- The cost of complying with Environmental Protection Agency (EPA) requirements,
- Whether the car has been in an accident.

The dealer will also consider another intangible factor, the market conditions ...

- This is a factor to carefully examine because it deviates from valuations provided in the published guidelines. For example, a convertible offered as a trade in November may have less value than one offered as a trade in April or July, since the opportunity to quickly resell the convertible depends on the season. (Clearly it is harder to sell a convertible when snow is falling than it is on a warm spring or summer day).
- There are three problems with this type of writedown ...
  - The actual cash value of the convertible will not change dramatically between November and December.
  - The car can be sold in a warmer climate for what it is worth, or more, because of greater demand for convertibles in warmer climates.
  - Tax law will not allow a write down of a vehicle when the facts show it will be worth substantially more only 4 or 5 months later.
- Other conditions can all impact the value of a car include ...
  - The overall market for the particular car being offered for sale
  - Safety recalls
  - Changes in the automobile industry.

The value of the car is then adjusted for reconditioning costs and other expected expenditures that the dealer will have to make to get the car ready for resale. Some common expenditures include:

- Cleaning the car
- Mechanical repairs
- Body damage repairs
- Interior and upholstery repairs
- Safety inspection
- Required state inspection
- Emissions control inspection
- Painting
- Tires
- Finder's Fees

Actual Cash Value - Definition. The wholesale value assigned to a trade-in or purchase. The ACV will usually differ from trade-in allowance (the credit allowed customer on purchase of vehicle). ACV becomes cost adjusted by reconditioning costs and other costs. The ACV is determined by the dealer at the time of purchase or trade, based on valuation guides and adjusted for the specifics of each vehicle. ACV can be higher or lower than the trade-in allowance.

Source: *IRS' Retail Industry Audit Technique Guide* ... Chapter 3 ... Training 10247-001 (Rev. 02-2009)

TRADE-IN VALUATION & LCM ADJUSTMENTS

Trade-in valuation. The valuation of a trade-in is an art, not a science. This outline of the valuation process may or may not be followed by a particular dealer. Many dealers, for example, rely more on experience and personal judgment than on a valuation guide. Others may rely solely on their professional judgment of the value of the car in that area at that time.

However, every dealer values a car for the sole purpose of making a profit on both the cars in inventory and the trade-in, when it is ultimately sold.

Revenue Ruling 67-107 (1967-1 C.B. 115) states that used cars taken in trade as part payment on the sales of cars by a car dealer may be valued, for inventory purposes, at valuations comparable to those listed in an official used car guide (as the average wholesale prices for comparable cars). Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market.

Some dealerships may undervalue their year-end inventory to overstate the cost of goods sold by using unacceptable methods of valuation. For example, it is common for dealers to use personal knowledge and year-end auction prices for similar cars as the means of valuing inventory.

The reason given for using auction value is that this is the price one could get for their cars if forced to sell the inventory at auction and close the business. However, this may not be the dealer's primary market and would be an unacceptable valuation method.

Dealers may also try to use loan values to determine inventory value. The dealer may state he could get better loans from the bank by using the loan value of the cars as the inventory value. This too would be an unacceptable valuation method.

While the industry may recognize the use of experience and personal judgment to value inventory, the Internal Revenue Service and the courts do not accept such methods of valuation. Valuations must be comparable to those listed in an official used car guide. Courts have ruled that an officially recognized valuation guide would be accepted for tax purposes.

Once the ACV of the trade-in is determined, then the trade-in allowance that will appear on the sales contract must be negotiated with the buyer. These negotiations often result in an over-allowance, for various reasons. As indicated earlier, the sales price is usually adjusted to take the over-allowance into account.

Properly determining the ACV of a trade-in is critical to the dealer's success since the profit on sale of both the inventory and traded vehicles will ultimately be determined by how accurate a value is placed on the trade-in. A problem may arise when there is a loan outstanding on the trade-in. Some transactions will be upside down, with the outstanding loan amount greater than the ACV of the car.

In those cases, the dealer will give the buyer a trade-in allowance equal to the loan balance. The excess of the loan amount over the vehicle's ACV is an over-allowance which, in the industry, is treated as a discount to the sales price. The dealer will pay off the outstanding loan balance.

Year-end LCM writedowns. A majority of dealers will take a periodic inventory, usually at the end of the year, and adjust the purchase, inventory and cost of goods sold accounts at that time. When dealer uses the periodic inventory method, a physical inventory is taken at year-end.

The dealer may write the inventory down at this time and make one entry to record the inventory value less the writedown. In such instances, that will be the only entry at year-end to establish inventory at the lower of cost or market. The dealer should maintain a record of the writedown taken on each vehicle in inventory.

Year-end writedowns on used vehicles are allowable when certain requirements are met. Revenue Ruling 67-107 allows a car dealer to value his or her used cars for inventory purposes at valuations comparable to those listed in an official used car guide adjusted to conform to the average wholesale price listed at that time. (See also *Brooks-Massey Dodge, Inc.*, 60 T.C. 884 (1973). Although this is a practice recommended by the industry and used by nearly all car dealers, there are some additional requirements.

(Continued at bottom of Page 28...)

Source: ***IRS' Retail Industry Audit Technique Guide*** **... Chapter 3 ... Training 10247-001 (Rev. 02-2009)**

XYZ DEALERSHIP

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

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

NOTES

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

ATG At a Glance	***RETAIL INDUSTRY AUDIT TECHNIQUE GUIDE***
Overview	• There are essentially 4 chapters in the *Audit Technique Guide (ATG)* for the retail industry. • The chapter headings and contents are below. • There is a fifth chapter which contains *Code, Regulations and Revenue Rulings, Procedures, Court Cases and Internal Revenue Manual* Citations. • This *ATG* is identified as Training 10247-001 (Rev. 02-2009) on the IRS web site.
Description of the Retailer Industry ***Chapter 1 … Contents***	• ***Purpose of the ATG …*** "The purpose of this *Audit Technique Guide* is to provide guidance on conducting income tax examinations in the retail industry. It incorporates procedures and techniques that have been shown to be practical or unique to the retail industry that will be combined with the examiner's good judgment, skill and experience to complete the examination within the shortest possible time with the least burden possible to the taxpayer. Use of these techniques does not imply that the object of the examination is to find a deficiency, but rather to determine whether the reported income and expenses has been accurately reported. "Because the facts and circumstances of each taxpayer are unique, the procedures applied will be slightly different in every examination, and the strategy will remain dynamic. The examiner will combine the techniques that apply to each specific case and apply his or her basic knowledge to the practical situation at hand." • *Description of a Retailer* • *What Retailers Do* • *Demographics of Retail Industry* • *Retail Entities* • *Useful Retail Web Sites* • *Unique General Retail Industry Terminology* … A glossary of terms
General Issues in Retail ***Chapter 2 … Contents***	• *Initial Interview* • *Information Document Request* • *Books and Records* • *Income Issues* ◆ *Cash Records* ◆ *Indirect Methods* ◆ *Sources of Receipts* ◆ *Other Retail Income Sources* • *Cost of Goods Sold* ◆ *Inventory & Inventory Methods* • *Purchases* • *Expenses*
Examination Techniques for Specific Industries ***Chapter 3 … Contents***	• *E-Commerce …* ***"Inspection of the taxpayer's website is every bit as important as the inspection of the place of business."*** • *Video / DVD* • *Gasoline Service Stations* • *Independent Automobile Dealerships* (i.e., used auto dealers) ◆ Includes *Related Finance Companies* and *Non-Prime or Sub-Prime Finance Contracts* • *Direct Sellers* (i.e., basically the Avon, Tupperware, cottage industries, etc.) ◆ Direct selling companies market their products through person to person contact away from a fixed retail location through a network of independent sellers. Frequently these sales presentations are in the home, in the form of a sales "party," or through door to door solicitations, or sometimes, as part of a get-together - one person to one person. These approaches are all considered direct sales. • *Auto Body/Repair Industry* (i.e., auto body shops)
Food & Beverages Industries ***Chapter 4 … Contents***	• *Retail Liquor Stores* • *Mobile Food Vendors* • *Pizza Restaurants* • *Restaurants and Bars* • *Grocery Stores*

DEALERSHIP E-COMMERCE ... IRS INTERNET INVESTIGATIVE TOOLS

Suggested audit techniques to help determine if the taxpayer is involved in e-business or has a web site

1. Ask the taxpayer if he/she has a web site. Use a search engine.
2. Most businesses want high visibility to reach customers and will register their site with the major search engines.
3. Look in the yellow pages to see if the taxpayer advertises a website.
4. Business cards will often have the name of a website on it or an e-mail address. If the domain name included in the e-mail address is similar to the taxpayer's business name, then it is very likely the taxpayer has a business web site.
5. Look for deductions that are common for e-business:
   - Website development costs paid for software used to create a website or to an application service provider.
   - Larger than normal depreciation deductions for web servers, networking equipment and payments to Internet access providers.

The examiner of a retail business should always consult the Internet for possible websites or links to the business under examination or to unknown businesses belonging to the taxpayer. ***Inspection of the taxpayer's website is every bit as important as the inspection of the place of business.***

Internet Investigative Tools are available to assist examiners in their examinations. What can these tools do for the Revenue Agent? After the agent has determined that an Internet presence exists for the business or promotion, the agent will be able to identify possible third-party contacts to be made and related websites and other possible businesses and relationships.

- **Ask** the taxpayer. This question must be asked during the Initial Interview.
- Perform Google searches for the Domain Name based on the business and individual names.
- Save the current website content using **Internet Explorer**. Saving the website content before the taxpayer closes it down or places security on it such as "members only" registration is important to the development of an unreported income case involving online retail sales.
- Perform a **LinkPopularity** search to determine linked websites, related websites and other websites under the control of the taxpayer to determine other possible sources of income for summons action.
- Use **Whois** to locate the Registrar and summons records.
- Use **Whois** to locate the Responsible Party and summons records
- Search the Internet Archives Wayback Machine.*

*The Internet Archive is a database of archived web pages dating back to 1996. The search interface for the Internet Archive is the Wayback Machine. Using the Wayback Machine, it is possible to search for the taxpayer's website. The results displayed will show all archived copies of the website available. This search will allow the examiner to determine what the web site contained during the year of examination as well as historical information. Information derived might yield answers to questions such as
- Did the online business really start in year 200x or was there activity prior to that year?
- What were the product lines that were being sold online during the year of audit?
- Are those product sales included in income?

Source: *IRS' Retail Industry Audit Technique Guide* ... Chapter 3 ... Training 10247-001 (Rev. 02-2009)

Dealership E-Commerce ...
IRS Interview Questions & Audit Techniques

1. Do you have an Internet presence? (web site, web page, e-mail, banner for business purposes)
2. Do you conduct business transactions over the Internet? (Accept orders and/or payments over the Internet?) (What types of records are maintained for these transactions? All electronic? Paper documents?)
3. What products, services or memberships may be purchased on your web site or through the use of email?
4. When was the web site "opened" for business? Did the business exist prior to creation of the web site? Is the business conducted over the Internet separate or distinct from the taxpayer's historic line of business?
5. What domain names have been registered either by you or on your behalf? What domain names do you have control over? Please include the date of registration and the name of the registrant.
6. How is the fee for Internet connection services determined?
7. How was your Internet web site developed, i.e. outside consultant, internal staff, web site design software? Details regarding all consulting fees, employee salaries, design software, etc. should be requested.
8. How many employees are engaged in the Internet-based business activity? Secure a list of the employees, job titles, compensation, etc., responsible for web site design and web site hosting.
9. How much has the taxpayer paid to outside vendors including non-employee compensation, for web site development and web site hosting?
10. What type of credit cards does your financial institution(s) accommodate?
11. What is the name of the financial institution(s) that clears your credit card receipts? Was an application or merchant services sign-up form completed for the credit card clearing services?
12. Does your ISP or the entity that is providing you server space process your credit card transactions?
13. Have you used any other financial institutions in conjunction with your web site?
14. Does your financial institution(s) provide: charge authorization, transaction capture, settlement, charge-back handling, reconciliation, reporting or prepaid card issuance and acceptance?
15. What type of purchase payment enabling software do you use? Make note of the vendor name and address. If the taxpayer does not know the name of the software, ask if the ISP hosting the web site is providing the software.
16. How are credit sales handled and how are they recorded in gross receipts?
17. How are non-credit sales handled and how are they recorded in gross receipts?
18. How is information for approved or authorized credit card product purchases processed?
19. What is the sequence from order entry to shipment?
20. How are products shipped and which shippers are used?
21. Who are your major suppliers and vendors?
22. From where are shipments made?
23. Do you have any paid referral or advertising contracts with other Internet web sites? If the answer is yes, obtain copies of the contracts.
24. Do you swap (barter) links, banner space and server space with any other businesses?
25. Do you have any foreign operations?
26. Do you have direct or indirect control over any foreign corporations, foreign partnerships, foreign trusts or any other foreign business enterprises?
27. Do you have any direct or indirect control over foreign bank or other offshore accounts?

Source: *IRS' Retail Industry Audit Technique Guide* ... Chapter 3 ... Training 10247-001 (Rev. 02-2009)

Proforma Letter

PLEASE DON'T REPEAL LIFO

(To Be Tailored to Your Specific Situation)

Date__________, 2009

Honorable (Senator's Name)
U.S. Senate
Address
Washington, DC 20510

Dear Senator ____________:

We are the owner of a [business - state nature of business, i.e., auto dealership, manufacturer of ________]. We have been in business in [list locations - city, state, etc.] since [indicate year].

For filing our income tax returns, we made the election to use the Last-In, First-Out (LIFO) inventory method to value our inventories [X number of years ago _____] or starting in [year _____].

LIFO was accepted in the Internal Revenue Code as a legitimate method for valuing inventories when we started our business. We adopted this method because of the inflationary costs of goods, products and materials used in our business, and because LIFO allowed us to defer the payment of tax on inflationary profits, when we had to replace our inventory goods.

Over the years, we have built up a LIFO reserve of [$____ indicate amount] as of the end of [indicate year-end _____].

If LIFO is repealed, and we are required to pay tax on the LIFO reserve, we will have to pay [$_____ indicate amount computed as 33% or 35% or 40%, whichever is applicable, of the LIFO reserve amount].

We want to stay in business (and be able to pass it along to our children). But, we are fearful that if LIFO is repealed and we have to pay the tax on our LIFO reserves, we will not have cash in the bank (or a line of credit that we would be able to draw upon) to do so.

The impact of repealing the LIFO method on our business will be devastating.

We have [_____ number] employees and, undoubtedly, many - if not the majority of them - would have to be let go if we lose LIFO and have to repay our LIFO reserves.

[Be as specific as possible here ... refer to some of the talking points regarding reduction in operations, number of employees that might have to be terminated, impact on existing personal business loan guarantees and covenants, etc.]

Furthermore, even if there is only a little inflation over the next few years, LIFO will continue to allow us to defer the payment of tax on the impact of inflation that will be part of the cost of replacement goods in future year-end inventories. We would be extremely thankful for that, also, as we need all the help we can get.

As we said, without going out of business, if LIFO is repealed, it would be (almost) impossible for us to come up with the money to pay the tax on our LIFO reserves. And, that's true even if part of the repeal would allow us to make that repayment over several years. Many banks and other lenders are reluctant to loan money to finance year-end inventories. They will be even more reluctant to loan money to pay the tax on LIFO reserves. ***Until we go out of business, funds to pay the tax on LIFO reserves simply will not be available.***

Accordingly, the repeal of LIFO, even with some grace period, would place a terrible, if not fatal, financial strain on our business. It would do the same to many of our friends who also use LIFO in their businesses.

Therefore, we are asking you to please expend all efforts you possibly can to keep LIFO in the Tax Code. Please don't force us to give up this life support method for our business.

Sincerely,

____
/S/ Business Owners

- Note: If this letter is being sent to a U.S. Representative or to a Senator who is not a member of the Senate Finance Committee, you'll need to modify it accordingly. You might add the following...
  "Please give this letter to [one of the members of the Senate Finance Committee] with your personal recommendation that he/she fight against the repeal of LIFO on your constituent's behalf."

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De Filipps' DEALER TAX WATCH

First-class

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