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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. *THE PRACTITIONER'S NIGHTMARE:* Uncertainty & Dealership Tax Issues: Opportunities & Pitfalls Lurking in Current Critical Tax Issues ... *COPING WITH UNCERTAINTY WHEN IRS "GUIDANCE" IS NOT TOO HELPFUL.* That's the title of my presentation on tax issues at the AICPA National Auto Dealership Conference in Phoenix, Arizona in October.

I'll admit that this title is a bit lengthy ... but, it's less than the 50-word limit the AICPA put on presentation titles. Given the overall situations we're all facing in dealing with the IRS on so many issues trying to defend dealership clients ... I'll try to do justice to these subjects. Actually, more than a few are discussed in this Edition of the *DTW*.

If you're going to be at the Conference, let's look for the chance to say, "Hello."

#2. REPORTING UNCERTAIN TAX POSITIONS ... THIS NEW IRS INITIATIVE IS CAUSING CONSIDERABLE ANGST. Right now, the most talked-about recent tax development is the new reporting initiative that the IRS will be ***starting this year*** requiring self-disclosure of ***Uncertain Tax Positions***.

The keystone of the new self-reporting initiative that is being pushed by the IRS is a schedule that will have to be included with corporate Forms 1120 filed for the calendar year 2010 (and for fiscal years that begin in 2010).

This new schedule (Schedule UTP - *Uncertain Tax Position Statement*) will require the annual disclosure of uncertain tax positions in the form of a concise description of those positions and information about their magnitude ... a.k.a. the MTA (Maximum Tax Adjustment) amount.

For who must file and more on this important development, see page 8.

WATCHING OUT FOR

#3. DEALERSHIP SUCCESSFULLY SUES CPA FIRM FOR BAD TAX PLANNING ADVICE OVER BUILT-IN GAINS. In a recent case, a dealership in Massachusetts successfully sued its former CPA firm and one of its partners for bad tax planning advice.

Usually cases like this are settled before they ever go to court, and apparently, the CPA firm in this case did make a settlement offer. However, not only was there a District Court case, but there also was a review at Appeals in which all of the "dirty laundry" was out there on the line for everybody to see.

see DEALER TAX WATCH OUT, page 3

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

Timeline	***JANUARY 1 TO MID-YEAR 2010***
Jan. 1, 2010	• The Federal ***Estate Tax is repealed*** for decedents dying on or after January 1, 2010. ◆ This "hiatus" lasts only throughout calendar year 2010, with the previous Estate Tax exemptions and rates coming back into effect as of Jan. 1, 2011 ... unless Congress enacts some legislation to the contrary. ◆ In lieu of "Estate Tax," survivors receiving property from the decedent are limited to "carryover basis" which is the lower of the (1) decedent's cost basis or (2) fair market value as of the date of death. • All Gift Tax provisions, however, still remain fully applicable.
Jan. 26	• ***Uncertain tax positions*** will have to be disclosed in ***Schedule UTP*** which is to be included in Form 1120 income tax returns ... as a result of the IRS' new reporting initiative (Announcement 2010-9). ◆ This impacts taxpayers with assets in excess of $10 million if they issue audited financial statements that reflect uncertain tax positions in connections with transactions reported in those financial statements. ◆ This initiative affects all Form 1120 filers, starting with returns filed for calendar year 2010.
Feb. 12-15	• ***Section 263A issues and the IRS' Directive issuing a temporary moratorium on the raising of these issues*** were thoroughly discussed at the NADA Convention in Orlando, FL. ◆ The NADA workshop was presented by Ms. Terri Harris (IRS Motor Vehicle Technical Advisor ... MVTA) and Mr. Robert Zwiers. ◆ The moratorium is effective from Sept. 15, 2009 and continues through Dec. 31, 2010. ◆ The IRS said that moratorium was declared *"in order to encourage compliance and to allow taxpayers in the auto dealership industry an opportunity to voluntarily change their methods of accounting to apply with the legal reasoning allowed in TAM 200736026."*
Deç. 1, 2009 Released Early 2010	• In Field Attorney Advice (FAA) 20100501F, the IRS held that a Closing Agreement with a taxpayer did not prevent the IRS from challenging the same LIFO methodology for defining inventory "items" when those definitions were used in later years.
Dec. 16, 2009 Released Early 2010	• ***The deduction for professional fees paid in the acquisition of a dealership was upheld*** by the Tax Court in its Supplemental Memorandum Opinion in *West Covina Motors, Inc. v. Comm.* • This case lays out a step-by-step approach for identifying and allocating such fees. ◆ *West Covina Motors, Inc.* was discussed in detail in the *DTW* last year ... This new development relates to only one of the three major issues in that case.
April 15	• More light was shed on the broad reach of Section 197 in creating intangibles (including covenants not to compete) to be amortized over a 15-year period. The Tax Court's decision in *Recovery Group, Inc.* was significantly based on its prior holdings in *Frontier Chevrolet, Inc.*
April 19	• Schedule UTP, *Uncertain Tax Positions*, and lengthy, detailed Instructions for completing the Schedule were released in Draft form by the IRS. (Announcement 2010-30)
April 20	• ***A Massachusetts dealership successfully sued its former CPA firm for bad tax planning advice.*** ◆ The CPA firm did not face up to the necessity of advising the dealer/dealership that it had became liable for a fairly large built-in gains tax, *and then the CPA firm did not reflect that tax liability on the Form 7004 that it prepared for the dealership to file with the IRS.* • The case of *Haddad Motor Group, Inc. v. Karp, Ackerman, Skabowski & Hogan, PC* was tried in both the District Court and the U.S. Court of Appeals for the 1st Circuit.
May 10	• ***The IRS revised Form 3115 and Instructions for Form 3115.*** (Announcement 2010-32) • New revision date for both is December 2009.
May 28	• Another suspension of the enforcement of the "Red Flags" Rule was announced by the Federal Trade Commission. This delay in enforcement will end on December 31, 2010. ◆ "Red Flags" require creditors and financial institutions to have identity theft prevention programs in place.
June	• Auto dealers were excluded from the sweeping legislation to overhaul the U.S. financial system by enacting new customer protection rules.
June 30	• ***IRS Business Plan Year ends*** ... with no action by the IRS on Section 263A inventory cost capitalization guidance, either in the form of a Revenue Ruling or a Revenue Procedure - or any other guidance, for that matter - to assist dealerships in evaluating whether they should file Forms 3115 before December 31, 2010 to adopt the IRS positions in TAM 200736026.
Various	• De Filipps seminars ... *Mid-Year 2010 Dealer Tax Update Tax Strategies & IRS Activities.*

At issue was the advice given to the dealership by the CPA firm partner regarding an unusual technique that the dealer employed to acquire another dealership. This technique involved a so-called "margin-against-the-box" transaction to finance the purchase of a second automobile dealership. At the same time, the dealership was contemplating changing from Subchapter C to Subchapter S status.

You guessed it ... The built-in gains tax reared its ugly head, and apparently, the CPA firm didn't handle things properly.

What really cooked the goose for the CPA firm was that it did not face up to the necessity of advising the dealer/dealership that, in fact, it became liable for a fairly large built-in gains tax ***and then it did not reflect that tax liability on the Form 7004 that it prepared for the dealership to file with the IRS.***

The case was originally tried in the U.S. District Court and then appealed to the U.S. Court of Appeals for the First Circuit. The Appeals Court decision is dated April 20, 2010.

The jury in the District Court found that the CPA firm had been negligent resulting in the dealership's failures to make timely payments, but the damages that the jury awarded to the dealership were solely for Federal and state interest and penalties incurred from March 15, 2000 (the date on which the dealership's tentative tax payments were due) until October 15, 2000 (the date on which the taxes were paid).

The jury awarded nothing for the other penalties that the IRS imposed on the dealership for failing to make quarterly installment payments in 1999.

The jury also awarded nothing to the dealership on its claim that the CPA firm negligently advised it on the Subchapter S conversion and closing the "margin-against-the-box" transaction.

In the Appeals Court, the dealership did not challenge the jury's verdict on these issues. What really raised the ante in this case was the mandatory add-on to the award against the CPA firm for $206,000 to cover the dealership's attorneys' fees and another $54,000 in other costs.

This case underscores a number of "lessons" for CPA firms providing tax advice to dealerships. I've analyzed this case and some of the "lessons" from it in the article beginning on page 14.

#4. MID-YEAR TIMELINE. The ***Timeline*** on the facing page gives you a quick overview of the major tax and other developments affecting dealerships over the first 6 months of 2010.

I suggest that you also periodically check out NADA's web site (www.NADA.org) to follow up on its many efforts including activities on behalf of dealerships who have lost their franchises and lobbying for various other dealership-favorable legislative changes.

#5. SECTION 263A UPDATE. The Year-End 2009 Edition of the *DTW* provided extensive coverage of the moratorium that the IRS announced on raising Section 263A issues in auto dealership examinations. This moratorium began mid-September 2009 and will end Dec. 31, 2010.

So far this year, there's not been much new to report. However, the entire IRS workshop at the NADA Convention in Orlando in February was devoted to a review of all of this by IRS Motor Vehicle Technical Advisor Terri Harris and by Robert Zwiers. For more on this, see page 19.

The lengthy article beginning on page 24 which discusses the revisions to Form 3115 places special emphasis on the concerns that dealerships ought to have if they are planning to file Form 3115 to make changes to the so-called "TAM 200736026" method for capitalizing Section 263A inventory costs. You'll want to read both of these together to get a better picture of the whole situation.

Boy, what a mess this is.

#6. IRS UPDATES FORM 3115 & INSTRUCTIONS FOR ACCOUNTING METHOD CHANGES ... NEW REVISIONS & NEW CONCERNS. Form 3115 is the form that taxpayers must file when they are changing most accounting methods. The IRS recently updated this Form and the Instructions to incorporate various developments. The new Form 3115 and Instructions are dated December 2009 and supersede the last revision of Form 3115 (December 2003) and the last revision of the Instructions (June 2006).

The Instructions have been updated to include all of the Automatic Changes that do not require advance permission from the IRS. The total is 149, but that includes 6 "automatics" that are now obsolete. The Automatic Change list will continue to grow over time. There is a list of frequently encountered Automatic Changes in dealership situations on page 25.

My analysis beginning on page 24 assumes that you are basically familiar with many aspects of Form 3115 and the underlying changes in methods being discussed. Accordingly, my comments are selective in nature, and they focus on areas that require new emphasis in light of more recent developments.

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Currently, the biggest problem relating to many dealership changes in accounting methods arises in connection with the (insufficient?) amounts that dealerships are capitalizing as additional inventory costs under Section 263A. (These technicalities have all been addressed thoroughly in many articles in previous Editions of the *Dealer Tax Watch.*)

In September 2009, auto dealerships were encouraged by the Director of the LMSB (in its issuance of a moratorium on pursuing Section 263A matters until January 1, 2011) to consider filing Forms 3115 to change to the Section 263A methodology espoused in TAM 200736026.

Dealerships and their CPAs are not living in the real world if they are not in a quandary over whether they should file Forms 3115 in connection with their Section 263A methods of accounting. And, this applies to one and all, regardless of whether or not the dealership is using LIFO. This affects everybody!

Some dealerships, or their CPAs, may be considering filing a Form 3115 - as suggested or inferred by the LMSB Directive - to change their Section 263A methods to comply with the so-called TAM 200736026 method. These dealerships should keep in mind that a taxpayer filing Form 3115 has a duty to reveal all material factors pertinent to its request for an accounting method change. And, that would include addressing both the (1) "producer" basket of issues and the (2) "reseller" basket of issues.

I've tried my best to incorporate these concerns into this article and in the proforma materials for Forms 3115 included with the article.

It is not the responsibility of the IRS National Office to try to pry all of the pertinent information out of the taxpayer who wants to make the change. This applies regardless of whether the taxpayer is filing a Form 3115 that requests advance permission from the Commissioner to change the method, or whether the Form 3115 simply supports an "automatic" change in method, to which the Commissioner is deemed to consent. And, it seems to be the consensus of practitioners with whom I've spoken that a Form 3115 filed to request permission to change to the so-called TAM 200736026 method would have to be filed under the ***advance consent*** procedures.

One other note of caution: On top of all the other disclaimers that the IRS has made recently in connection with Sec. 263A matters, the IRS also disclaims responsibility for the accuracy or reliability of its own forms and instructions. Letter Ruling 200328001 states that "Generally, forms and instructions do not bind the Service and are not intended to replace the law or change its meaning. The sources of authoritative law in the tax field are the statutes and regulations and not the informal publications and tax forms that are published by the Service. Therefore, taxpayers who rely solely on IRS forms and instructions are at risk." Not very comforting, is it?

Finally, because of the continuing strong interest in considering, or actually initiating, terminations of LIFO elections by many dealerships and the more recent emphasis by the IRS on the alleged improper application of Section 263A by many auto dealers, I have included some discussion of the problematic interrelationship of these two issues on pages 36-37.

#7. THE BEST SUGGESTION I CAN MAKE ... OBTAIN A SIGNED ENGAGEMENT LETTER WHEN YOU ARE INVOLVED WITH FORM 3115 FILINGS. In my opinion, you should consider obtaining a signed engagement letter from the client before embarking on most, if not all, change in accounting method request filings.

The letter should describe the responsibility for the accumulation of information, the computation of the transitional adjustments, if any, and the representation services to be rendered before the IRS in connection with the Form 3115 accounting method change request. See page 32 for details and pages 38-39 for some other suggestions.

#8. BUSINESS ACQUISITIONS & THE BROAD REACH OF SECTION 197. A recent Tax Court decision in *Recovery Group, Inc.* sheds more light on amortization of Section 197 intangibles (including covenants not to compete). Although this case does not involve an automobile dealership, the Tax Court opinion discusses in some detail the defenses that the company tried to make by distinguishing itself from *Frontier Chevrolet, Co.* - a case that has been discussed in several articles in the *Dealer Tax Watch.*

Accordingly, *Recovery Group* indirectly relates to the topics of writing off franchise costs and dealership goodwill and other intangibles that have been discussed periodically in the *DTW.*

Also, in this case, the Tax Court declined to impose accuracy-related penalties against the company because it had reasonably relied on its accountants. In the opinion of the Court, the CPAs for the company were found to be "competent, fully-informed professionals" who were able to prepare its tax returns. These levels of proficiency (i.e., competency and full knowledge of the pertinent facts) allowed the company to avoid liability for the penalties.

The *Recovery Group* decision is discussed on page 41, and the company's escape from penalties is discussed on pages 43-45.

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#9. ALLOCATION OF PROFESSIONAL FEES PAID IN THE ACQUISITION OF A DEALERSHIP ... A STEP-BY-STEP ANALYSIS. In the Mid-Year 2009 Edition of the *Dealer Tax Watch*, we discussed the importance of the Tax Court's decision in *West Covina Motors, Inc.* Under the by-line *"Aggressive Dealership Deductions Disallowed ... A Good Refresher for Some Basic Principles,"* the article discussed several major issues, two of which involved the deductibility of legal fees.

In one instance, the deductibility question involved legal expenses that the dealership had paid in connection with the bankruptcy of its landlord. In the other instance, the deductibility of the legal and other fees it had paid related to the purchase of another dealership, Clippinger Chevrolet. The Tax Court agreed with the IRS in disallowing the deductions for all of these fees.

Recently, in a Supplemental Memorandum Opinion, the Tax Court held that all of the legal and other fees paid in connection with the purchase of another dealership were deductible. However, these fees had to be allocated pro rata among the various classes of dealership assets that were acquired and written off over several years.

As a *Practice Guide*, I've reduced the Tax Court's analysis to a series of step-by-step calculations, and these appear on pages 50-52. This approach may help you in going back and reviewing what you have done in similar situations for dealership clients who made similar acquisitions.

#10. ESTATE TAX REPEAL FOR 2010 AND UNCERTAINTY FOR SURVIVORS & PRACTITIONERS. For dealers ... or for anyone else ... who died on or after January 1, 2010, there is no Federal Estate Tax or Generation-Skipping Transfer (GST) tax. This situation is temporary; it will only last until January 1, 2011 at which time the Estate Tax (and the GST) will revert back to their previous levels, rates and exemptions.

For the survivors of decedents who died in 2010, although there is no Federal Estate Tax or GST, there is a somewhat corresponding downside. That downside is the imposition of a carryover basis regime to compensate for the absence of the Estate Tax.

Section 1022 provides for the treatment of property acquired from a decedent dying after December 31, 2009. It prevents heirs from receiving the benefit of any step-up in basis for the appreciation in the assets transferred by death to the date-of-death value or to the alternative valuation date (6 months later if that were elected by the executor).

Survivors (including estates) who inherit property from a decedent who died in 2010 will now have a "carryover" tax basis in that property equal to the ***lower*** of (1) the adjusted basis of the property in the hands of the decedent or (2) the fair market value of the property on the date of the decedent's death.

The carryover basis regime involves complex rules that may result in an increase in the basis of inherited property, and the carryover basis (for the property in the hands of the survivor) cannot be increased above the fair market value of the property at the date of the decedent's death.

The carryover basis provisions apply only for property transferred by death during calendar year 2010 ... The provision becomes unnecessary when the Estate Tax is reinstated on January 1, 2011.

For almost 10 years, Congress knew all of this was going to happen, but it failed to take any action to prevent the problems that have been created. In short, there still has been no "fix" for this mess.

Speculation about a "fix" includes the possibility that Congress might try to reinstate the Federal Estate Tax and GST retroactive to January 1, 2010. Some attorneys have said that if such legislation were passed, they would challenge the Constitutionality of the law.

Another possibility is that Congress may allow executors for the estate to make an election. This election would be to either (1) use the carryover basis provisions or (2) apply the levels, rates and exemptions that were available before 2010.

The real problems for many executors and practitioners are hidden in the reporting requirements that are associated with the carryover basis provisions for estates in excess of $1.3 million.

#11. ILM ON TRADE DISCOUNTS INDIRECTLY EMPHASIZES THAT THE PROPER TREATMENT FOR FLOORPLAN ASSISTANCE PAYMENTS IS TO EXCLUDE THEM FROM INVENTORY COSTS. In Internal Revenue Service Legal Memorandum (ILM 200945034), the IRS recently discussed the proper treatment of "member satisfaction merchandise allowances." Essentially, these were discounts given to purchasers for merchandise that was discovered either sooner or later to be defective.

The relevant issue was ... should these allowances be treated as trade discounts? The answer to this question was, "Yes," they should be. The IRS concluded that these were "akin to [a] trade discount[s]."

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If the allowances were properly treated as trade discounts, the next questions were whether the allowances should reduce (1) the cost of ***all*** merchandise purchased from the vendor, or (2) only the portion of the cost of the merchandise that was subsequently determined to be defective. The answers here were, "Yes," to the former and "No," to the latter.

All automobile dealerships selling new vehicles receive trade discounts in the form of floorplan assistance payments and other similar allowances or adjustments from the manufacturers.

The IRS recognizes these floorplan assistance payments as trade discounts which are required to be eliminated from inventory costs and deducted currently, rather than capitalized as part of the inventory cost. Although the internal accounting procedures for some dealers expense these amounts as part of their initial entry to record the cost of the inventory, many dealerships do not do this.

Many dealers in recent years have filed Forms 3115 to change their method of accounting for treating these payments. Originally, these change requests required advance approval from the IRS, the payment of the user fee and the patience to wait for a fairly long time until the IRS responded. When the IRS responded, it granted these requests.

After years of reviewing virtually identical Form 3115 applications for the same type of requested change in method, the IRS made life easier for everyone by designating this type of change as one which could be made under the automatic filing procedures (most recently set forth in Rev. Proc. 2008-52). Accordingly, such a change can be made as automatic change Number 53.

Auto dealerships may also make a similar automatic change in accounting method for the treatment of certain invoice advertising association costs under Section 21.13 of the Appendix to Rev. Proc. 2008-52. This is automatic change Number 139, and it is applicable only to advertising "in the dealership's market area" (i.e., this change includes only costs for local and regional advertising campaigns that promote the dealer's brand of vehicles in the dealership's specific market area ... it excludes costs for advertising on a national level).

In the ILM, the taxpayer was using FIFO to value some of its inventory and LIFO to value the rest. The import of this ILM is that if dealerships are not eliminating trade discounts from their new vehicle inventory costs, (1) they are using an improper method of accounting (and therefore, should correct it by filing Form 3115) and (2) they may be overlooking a tax savings / deferral opportunity, since these costs tend to average around 2% of the inventory.

If dealerships are not eliminating trade discounts from their new vehicle inventory costs and they are using LIFO, not only are they using an improper method of accounting (which they should correct by filing Form 3115) and overlooking a tax savings / deferral opportunity. ***Worse yet...*** They may be risking their LIFO election by violating one of the LIFO eligibility requirements. (The LIFO implications are discussed more fully in the Mid-Year 2010 Edition of the *LIFO Lookout*.)

The bottom line is that this ILM suggests that perhaps some dealerships should take a closer look at their accounting method for handling floorplan assistance payments.

#12. DEALERSHIP FACILITY RENT PAYMENTS & SECTION 467. Real estate market conditions in many parts of the country have been depressed for a long time, and some still are not in a recovery mode. In addition, there is considerable uncertainty over valuations of dealership real estate. As a result of depressed market conditions, some lessors are offering inducements ... such as "rent holidays" or deferred rents ... in order to facilitate the rental of their properties.

If a dealership is involved in situations where its rental payments are (significantly) accelerated or deferred, the CPA should not overlook the potential application of Section 467 to these payments if they exceed the $250,000 threshold amount.

The provisions of Section 467 could provide a planning opportunity, or they might contain a potential trap or two.

If a dealership is making rental payments for its facilities under a long-term lease, its tax deduction for its rent payments may be subject to being recast under the straight-line, present value accrual method described in Section 467. For this purpose, "long-term" means a lease with a term of more than 14¼ years for real property.

Section 467 basically operates to treat cash basis lessors as if they were on the accrual basis for rents. It is also intended to apply the time value of money principles comparable to those found in Section 1274.

The provisions of Section 467 are extremely complex. They are not easy reading, by any means. One further caution is that when Sec. 467 is applicable, it includes concomitant recapture provisions that have the effect of converting a portion of the lessor's gain on the disposition on leased property →

from (the desired) long-term capital gain status to (the much less favorable) status of ordinary income, taxable at higher income tax rates.

Finally, certain changes in accounting method for the treatment of rental income or expense payments may be made as automatic changes in accounting method. These are described in the Appendix to Revenue Procedure 2008-52 at Section 20.01 and described as Designated Automatic Change Number 136 in the Instructions to Form 3115.

#13. WHAT'S GOING TO HAPPEN TO LIFO? I am now feeling more confident that LIFO for our closely-held dealerships and other businesses will survive all efforts to make it extinct - whether these efforts might come from Congress by legislation to repeal LIFO, or indirectly from the much-discussed and anticipated adoption of International Financial Reporting Standards by U.S. companies when global accounting principles or standards are adopted here in the U.S.

I've included a very long article in the Mid-Year 2010 Edition of the *LIFO Lookout* explaining the more recent shift in my own thinking from a more tentative "I-wonder-if-LIFO-will-be-around-much-longer" frame of mind. As part of that article, I also reported on the results of a survey which reflected the 2008 and 2009 LIFO reserve results for approximately 100 dealerships for whom we provide LIFO calculations.

If you're not a subscriber to that publication, but would like a copy of that article, just drop me an e-mail and ask for it.

#14. UPDATED, IMPROVED INDEX OF *DEALER TAX WATCH* ARTICLES THROUGH DEC. 31, 2009. We have completely revised and expanded our *Index* of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December 2009.

The updated *Index of Articles* on our web site (www.defilipps.com) is now electronically ***searchable*** to make it more user-friendly for your reference purposes. In other words, you can search the *Index* by keyword(s). You can also save the 64-page *Index* on your own computer for handy reference and printing.

This *Index of Articles* is divided into ten sections, each of which is further sub-divided by key topic or subject. It also includes (1) a separate list of what I consider the best of our *Practice Guides* over the years, and (2) *Finding Lists* for all tax cases, Revenue Rulings and Procedures, Letter Rulings (including TAMs), and other precedential and/or non-precedential IRS guidance.

We've included the ten sections of our *Index of Articles* below.

Major Sections

DEALER TAX WATCH ... INDEX OF ARTICLES

June, 1994 - December, 2009

DISCLOSURE OF UNCERTAIN TAX POSITIONS ... THE IRS' NEW REPORTING INITIATIVE FOR 2010

INTRODUCTION

The keystone of a new self-reporting initiative that is being pushed by the IRS is a schedule to be included with tax returns filed for the calendar year 2010 (and for fiscal years that begin in 2010).

This new schedule (Schedule UTP - *Uncertain Tax Position Statement*) will require the annual disclosure of uncertain tax positions. This disclosure will take the form of a concise description of those positions and information about their magnitude. The only bright spot in all of this is that taxpayers will not be required to disclose their risk assessments or tax reserve amounts. However, the IRS could always compel the production of that information by issuing a summons.

This new disclosure requirement could create friction or disagreement not only between taxpayers and the IRS, but also between taxpayers and their "independent" tax return preparers over just what, or how much, should be disclosed.

JANUARY 2010 - FIRST DESCRIPTION OF THE NEW INITIATIVE

In January 2010, the IRS issued Announcement 2010-9 in which it first described the changes it was proposing to the reporting requirements regarding business taxpayers' uncertain tax positions.

IRS Commissioner Douglas Shulman coordinated the release of Announcement 2010-9 with a speech he gave to the New York State Bar Association on January 26, 2010. In his speech, the Commissioner referred to the recent efforts of the IRS to study (1) transparency regarding business tax issues and (2) the changes that have occurred in the practices of auditing firms in their review of materials used to make decisions on tax reserves that are reflected in a taxpayer's financial statements.

Goals of the new initiative. As context for the reporting initiatives being introduced, Commissioner Shulman said, "Today, we spend up to 25 percent of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues. It would add efficiency to the process if we had access to more complete information earlier in the process regarding the nature and materiality of a taxpayer's uncertain tax positions. The goals of our proposal are simple: to cut down the time it takes to find issues and complete an audit ... ensure that both the IRS and taxpayer spend time discussing the law as it applies to their facts, rather than looking for information ... and to help us prioritize selection of issues and taxpayers for examination."

The Commissioner made two other points. In referring to the "concise" description of an uncertain tax position that the taxpayer will be required to provide, he said: "By concise, we mean a few sentences that inform us of the nature of the issue, and not pages of actual description or legal analysis."

He added that since taxpayers are already required to establish tax reserves for uncertain tax positions in their financial statements under either U.S. or international accounting standards, this work is already being done. Accordingly, he said, ***all the IRS is asking for is "more transparency."***

The second point that the Commissioner emphasized was that the reporting requirements would not require the taxpayers to disclose how strong or weak they regard their tax positions. Nor would these reporting requirements ask for disclosure of the dollar amounts that had been reserved in the financial statements with respect to these uncertain tax positions.

FASB, FIN 48 & UNCERTAIN TAX POSITIONS

Many taxpayers are required by FASB Interpretation No. 48, Accounting for Uncertainty in *Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48) to identify and quantify uncertain tax positions taken in the return for financial accounting purposes. That is, taxpayers must identify and quantify for financial accounting purposes a tax position relating to a specific federal tax return for which a taxpayer is required to reserve an amount under FIN 48.

FIN 48, which became effective January 1, 2007, employs a two-step approach to *recognition threshold* and *measurement attribute*.

Recognition threshold. Management evaluates each tax position as to whether, based on the position's technical merits, it is *"more likely than not"* that the position will be sustained upon examination by the taxing authority. The term *"more likely than not"* means that there is a probability of more than 50% that the tax position will be sustained upon examination.

Each tax position must be evaluated independently of all other tax positions without offset or aggregation at each reporting date based on the

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individual facts, circumstances and information that is available at that reporting date.

Tax positions recognized in previous periods as having met the "more likely than not" standard at that time, but which no longer meet the "more likely than not" standard at a later date, are to be reversed (i.e., "derecognized") in the first period in which that standard is no longer met.

Measurement attribute. If a tax position meets the *recognition threshold*, it is subject to measurement to determine the amount to recognize in the financial statements.

Under the codification of accounting standards, the relevant portions of FIN 48 are now contained in Accounting Standards Codification Subtopic 740-10, *Income Taxes*.

A taxpayer's tax reserves and reporting regarding its uncertain tax positions may be reflected in its own books and records or financial statements, or in the books and records or financial statements of a related domestic or foreign entity. Taxpayers not subject to FIN 48 may be subject to other requirements regarding accounting for uncertain tax positions. For example, taxpayers may be subject to other generally accepted accounting standards, including International Financial Reporting Standards (IFRS) and country-specific generally accepted accounting standards.

The information developed in the course of complying with FIN 48 or other accounting standards is highly relevant to understanding the taxpayer's tax positions and assessing how those positions affect the taxpayer's tax liability. That information also would aid the Internal Revenue Service in focusing its examination resources on returns that contain specific uncertain tax positions that are of particular interest or of sufficient magnitude to warrant Service inquiry.

APRIL 2010 - IRS COMMISSIONER SPEECH

A few months later, on April 12, 2010, a second speech by IRS Commissioner Shulman was coordinated with the unveiling by the IRS of the new form to be used by taxpayers in complying with the new reporting initiative.

In his remarks, Commissioner Shulman said, "As I have said before, I believe we have taken a reasonable approach. We could have asked for more ... but chose not to. We believe we have crafted a proposal that gives us the information we need to do our job without asking taxpayers to divulge the strengths or weaknesses of their uncertain tax positions. And, we are maintaining our current policy of restraint concerning tax accrual workpapers.

"While I believe our approach is reasonable, let me be clear - I also understand that it is a 'game-changer' with respect to our relationships with and responsibility to our large corporate taxpayers. We are moving away from what I would describe as a contentious relationship where we spend too much time identifying issues, to one where we know the issues from the outset and spend our time engaging on appropriate issues."

Commissioner Shulman explained that it is obvious that some positions taken in income tax returns are "uncertain" for a number of reasons, including ambiguity in the law and a lack of published guidance (Regulations, Revenue Procedures, Revenue Rulings, etc.). He added that "as a result, we need to engage with taxpayers early ... in pre-filing venues, if possible ... to eliminate uncertainty as quickly as possible, whenever possible."

To the extent the Service is enabled by the new reporting procedures to do so, the IRS will be able to focus on the critical areas of (1) eliminating uncertainty as quickly as possible, (2) evolving its approach to auditing, and (3) providing training to its examining agents.

SIX BENEFITS (for the IRS)

The Commissioner said these changes were needed for at least six reasons. When fully engaged, these changes would (1) create certainty sooner for taxpayers, (2) reduce the time it takes the IRS to find issues and complete an audit, (3) ensure that both the IRS and the taxpayer spend time discussing the law as it applies to their facts - rather than looking for information, (4) help the IRS ***prioritize*** taxpayers for examination, (5) help the IRS prioritize selection of issues during an audit, and (6) help the IRS obtain key information regarding uncertain tax positions "without getting into the heads of the taxpayers or their advisors, as it relates to quantifying risk."

Apparently, some of the IRS' "issue resolution tools" (pre-filing agreements, the so-called "fast-track" appeals process and/or early referrals to Appeals) are not working satisfactorily enough.

In implementing the new disclosure policy, Commissioner Shulman said that the IRS was "determined to honor the policy of restraint. Therefore, we chose not to ask for a risk percentage or a reserve number." He added "We understand that a $100 million issue with low risk to the company is less interesting to the IRS than a $100 million issue that has a high risk to the company where the taxpayer

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believed that the IRS was more likely than not to win if the issue was [were] litigated. We also understand that, if there is no adjustment for risk, both issues would appear to be the same size on the schedule. ... Given these self-imposed restraints, we came up with a maximum number so we have something to use for return selection, while recognizing that the maximum number does not reflect the precise value of the issue." It should be noted in this regard that the IRS may ask that the information disclosed include a "estimation of range" in order to assist the IRS in determining "materiality."

APRIL 19, 2010 ... IRS RELEASES DRAFT OF SCHEDULE UTP & INSTRUCTIONS

In Announcement 2010-30 the IRS introduced in draft form the schedule and related instructions that taxpayers would be required to use beginning with their 2010 income tax returns.

Schedule UTP, *Uncertain Tax Position Statement*, is a three-page schedule consisting of three parts, each Part having its own page.

Who must file Schedule UTP. In general, Schedule UTP must be filed by all corporations filing Form 1120 and related parties with assets greater than $10 million who issue audited financial statements and who have uncertain tax positions in connection with transactions reported in those financial statements.

Specifically, a corporation must file Schedule UTP with its 2010 income tax return if ... (1) the corporation files Form 1120, *U.S. Corporation Income Tax Return*, (2) the corporation has assets equal to or exceeding $10 million, (3) the corporation or a related party issued an audited financial statement and the audited financial statement covers all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and (4) the corporation has one or more tax positions that must be reported on Schedule UTP.

With respect to the $10 million asset threshold, a corporation's assets equal or exceed $10 million if the amount reported on Part I, Box D of Form 1120 (i.e., the total assets at the end of the year) is at least $10 million.

In addition, others required to use Schedule UTP if they meet the conditions above are taxpayers filing (1) Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, (2) Form 1120-L, *U.S. Life Insurance Company Income Tax Return*, and (3) Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*. However, for these filers, the $10 million asset threshold is the higher of the beginning or end-of-the-year total assets amounts reported on Schedule L of their respective Forms.

Pass-Through Entities (i.e., S-Corporations, Partnerships, and LLCs filing as partnerships) will not be required to file Schedule UTP with their 2010 income tax returns. Tax-exempt organizations also are not required to include Schedule UTP with their 2010 income tax returns. In the very near future the IRS will determine the timing or effective date of the requirement to file Schedule UTP for these entities.

Part I (Page 1 of 3) is to be completed for "*Uncertain Tax Positions for the **Current Tax Year.***" This requires the identification of (1) primary Internal Revenue Code Sections associated with the position, (2) timing codes indicating whether the issue involves a timing difference that is temporary, permanent, or both temporary and permanent, (3) the employer identification number of any associated Pass-Through Entity, (4) whether or not the position relates to an "Administrative Practice," and (5) the Maximum Tax Adjustment (i.e., the size of the issue).

Part II (Page 2 of 3) is to be completed for "*Uncertain Tax Positions for **Prior Years.***" This page requires the same relevant disclosures as Part I. These disclosures are required for prior years ... i.e., that's plural, not just for the previous year.

Part III (Page 3 of 3) is to be completed disclosing "***Concise Descriptions of UTPs.***" This is where a narrative description is coordinated with the uncertain positions disclosed in Parts I and II. Keep in mind Commissioner Shulman's statement in his remarks in January that... "By 'concise,' we mean a few sentences that inform us of the nature of the issue, and not pages of actual description or legal analysis."

The Draft Instructions for Part III state ... "The description must include a statement that (1) the position involves an item of income, gain, loss, deduction, or credit against tax, (2) a statement whether the position involves a determination of the value of any property or right or a computation of basis and (3) the rationale for the position and the reasons for determining the position is uncertain. In most cases, the description should not exceed a few sentences."

The Draft Instructions provide three "examples of concise descriptions."

Coordination with other reporting requirements. The Draft Instructions also provide that ... "A complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as if the corporation filed a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, regarding the tax position. A separate

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SCHEDULE UTP (Form 1120)

Department of the Treasury
Internal Revenue Service

Uncertain Tax Position Statement

► File with Form 1120, 1120-F, 1120-L, or 1120-PC.
► See Instructions.

OMB No. 1545-0000

2010

Name of entity as shown on page 1 of tax return	EIN of entity

This Part I, Schedule UTP (Form 1120) is page ______ of ______ Part I pages.

Part I **Uncertain Tax Positions For the Current Tax Year.** See instructions for how to complete columns A through F. Enter, in Part III, a description for each Uncertain Tax Position (UTP).

Check this box if the corporation was unable to obtain information from related parties sufficient to determine whether a tax position is a UTP (see instructions) ► ☐

A. UTP No.	B. Primary IRC sections (e.g., "61", "108", etc.)			C. Timing Codes (check if Permanent, Temporary, or both)		D. Pass-Through Entity EIN	E. Check if Administrative Practice	F. Maximum Tax Adjustment (size of issue)
				☐	☐	-	☐	
				☐	☐	-	☐	
				☐	☐	-	☐	
				☐	☐	-	☐	

Name of entity as shown on page 1 of tax return	EIN of entity

This Part II, Schedule UTP (Form 1120) is page ______ of ______ Part II pages.

Part II **Uncertain Tax Positions For Prior Tax Years.** See instructions for how to complete columns A through G. Enter, in Part III, a description for each Uncertain Tax Position (UTP).

Check this box if the corporation was unable to obtain information from related parties sufficient to determine whether a tax position is a UTP (see instructions) ► ☐

A. UTP No.	B. Primary IRC sections (e.g., "61", "108", etc.)			C. Timing Codes (check if Permanent, Temporary, or both)		D. Pass-Through Entity EIN	E. Check if Administrative Practice	F. Maximum Tax Adjustment (size of issue)	G. Year of Tax Position
				☐	☐	-	☐		
				☐	☐	-	☐		
				☐	☐	-	☐		
				☐	☐	-	☐		
				☐	☐	-	☐		

Name of entity as shown on page 1 of tax return	EIN of entity

This Part III, Schedule UTP (Form 1120) is page ______ of ______ Part III pages.

Part III **Concise Descriptions of UTPs.** Indicate the UTP number from Part I or Part II in the first column. Use as many Part III pages as necessary.

UTP No.	Concise Description of Uncertain Tax Position

(Continued from page 10)

Form 8275 or Form 8275-R need not be filed to avoid penalties with respect to that tax position."

MAXIMUM TAX ADJUSTMENT (MTA)

The MTA for a tax position taken in a tax return is an estimate of the maximum amount of potential U.S. Federal income tax liability associated with the tax year for which the tax position was taken. The MTA is determined on an annual basis. For tax positions that relate to items of income, gain, loss and deduction, the total amount should be estimated in dollars and multiplied by 0.35 (35%).

For items of credit, the total amount of credit should be estimated in dollars. The dollar estimates related to all applicable items of income, gain, loss, deduction and credit should be combined in order to determine the MTA of that tax position. For example, the MTA for a tax position taken in a tax return claiming a $100 deduction is $100 x 0.35 or $35. The MTA for a tax position taken in a tax return claiming a $50 credit is $50.

The MTA does not include interest or penalties. The effects of a tax position on state, local, or foreign taxes are disregarded when computing the MTA.

Each item of income, gain, loss, deduction or credit relating to a tax position taken in a tax return is determined separately and may only be offset by other such items relating to that tax position. For example, if a $100 deduction is associated with a tax position taken in a tax return, $35 would be entered on Schedule UTP, even if that deduction is used to offset $100 of income generated by general operations of the business. Likewise, if $200 of income is associated with a tax position taken in a tax return, $70 [($200 x 0.35)] would be entered on Schedule UTP, even if the $200 of income was offset by $200 of net operating losses.

Items of income, gain, loss, deduction or credit associated with a tax position may offset each other in determining the MTA for that tax position. For example, if income of $100 is associated with a tax position taken in a tax return and a deduction of $300 is associated with that same tax position, then the MTA is $70 [($300 - $100) x 0.35].

REPORTING UNCERTAIN TAX POSITIONS

The Draft Instructions (9 pages) are detailed in many respects and include many definitions of terms and comprehensive examples. Special disclosure requirements are provided (or waived) for situations where the same uncertain position has a bearing on more than one year.

Tax positions to be reported. Schedule UTP requires the reporting of a corporation's Federal income tax position for which the corporation or a related party has recorded a reserve in an audited financial statement.

Schedule UTP also requires the reporting of tax positions taken by the corporation in a tax return for which a reserve has not been recorded by the corporation or a related party based on an expectation to litigate or an IRS administrative practice.

A tax position is required to be reported on a Schedule UTP if (1) at least 60 days before filing the tax return, a reserve has been recorded with respect to that tax position or at least 60 days before filing the tax return a decision was made not to record a reserve based on an expectation to litigate or an IRS administrative practice and (2) the tax position has been taken by the corporation in a tax return for the current tax year or a prior tax year.

Reporting current year and prior year tax positions. Taxpayers are to report on ***Part I*** tax positions taken by the corporation in the ***current*** year's tax return for which the decision whether to record the reserve was made at least 60 days before filing the tax return.

Taxpayers are to report on ***Part II*** tax positions taken by the corporation in a ***prior*** year's tax return for which the decision whether to record the reserve was made at least 60 days before filing the tax return.

A corporation is not required to report a tax position that it has taken in a prior tax year if the corporation reported that tax position on a Schedule UTP filed with a prior year tax return.

The Draft Instructions state that ... "If a transaction results in tax positions taken in more than one tax return (and a decision whether to reserve has been made), [then] the tax positions arising from the transaction must be reported on Part I of the Schedule UTP attached to each tax return in which a tax position resulting from the transaction is taken regardless of whether the transaction or a tax position resulting from the transaction was disclosed in a Schedule UTP filed with a prior year's tax return." This requirement is illustrated in the Instructions by the example below.

"*Example 6 (permanent differences).* A corporation incurs an expenditure in its 2010 tax year and takes the position that the expenditure may be amortized over 5 years beginning in its 2010 tax return. The corporation determines it is uncertain whether any current deduction or amortization of this expenditure is allowable. The corporation has taken a tax position in each of the 5 tax years because in each year's tax return there would be an adjustment to a

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line item on that return if the position taken in that year is not sustained."

PRACTITIONER CONCERNS & UNANSWERED QUESTIONS

The IRS is aware that several major questions related to its new Schedule UTP are presently unanswered. In Announcements 2010-9 and 2010-17, the Service invited comments from the public on the questions listed below.

CONCLUSION

To date, many practitioners and their professional associations have raised serious questions about the IRS' new self-disclosure initiative which culminates in Schedule UTP.

Almost unanimously, the concerns raised by practitioners in speeches and articles have been (1) critical of what is perceived as the IRS' overreach, (2) defensive and (3) protective of taxpayer's perceived freedom against self-disclosure of vulnerable tax positions. Some practitioners seem to be concerned over how much they might be forced to do and/or how far they might be forced to go in doing the IRS' auditing work.

Based on these new developments and many unanswered questions, this article concludes with just one question ... How are you planning to deal with this new reporting requirement for 2010?

Schedule UTP Uncertain Tax Positions

QUESTIONS THAT NEED ANSWERS ... IRS REQUEST FOR COMMENTS

In two Announcements (2010-9 and 2010-17), the IRS identified eleven issues and/or questions which it intends to address in the final version of Schedule UTP. The IRS has invited comments from the public on these.

1. How the Maximum Tax Adjustment (MTA) should be reflected on the schedule so that it provides the Service with an objective and quantifiable measure of each reported tax position (e.g., specific dollar amount or by appropriate dollar ranges).
2. What alternative methods of disclosure of the amount at issue would allow the Service to identify the relative importance of the uncertain tax positions.
3. Whether the calculation of the Maximum Tax Adjustment should relate solely to the tax period for which the return is filed ... or to all tax periods to which the position relates ..., and whether net operating losses or excess credits should be taken into account in determining the MTA.
4. How the ***related entity rules*** should be applied.
5. Whether the scope of the Announcement should be modified (i.e., either narrowed or enlarged) regarding the uncertain tax positions for which information is required to be reported (e.g., positions for which no tax reserve has been established because the taxpayer determined the IRS has a general administrative practice not to examine the position).
6. Whether transition rules should be used or criteria modified to either include or exclude certain business taxpayers (e.g., the proposed threshold of $10 million total assets).
7. How the new schedule should address taxpayers that initially did not record a reserve for an issue, but in later years do record a reserve.
8. Whether the list of information proposed to be included should be modified ... including whether certain information should be requested in some circumstances during the examination process, rather than requiring that information to be filed with the income tax return.
9. Do the disclosures required by the new schedule duplicate those required by other forms, thus making forms, such as the Form 8275 and 8275-R, unnecessary or redundant in some circumstances?
10. What type of uncertain tax positions should be reported by ***pass-through entities and tax-exempt entities***?
11. How uncertain tax positions should be reported in various ***related entity contexts*** ... such as how uncertain tax positions should be reported by (1) members of a consolidated group for financial statement purposes or (2) members of a consolidated group for income tax return purposes or (3) entities that are disregarded for Federal tax purposes.

Questions #1-8 are from Announcement 2010-9 and Questions #9-11 are from Announcement 2010-17.

DEALERSHIP SUCCESSFULLY SUES CPA FIRM FOR IMPROPER TAX ADVICE OVER BUILT-IN-GAINS TAX

In a recent case, a dealership in Massachusetts ... Haddad Motor Group (HMG) ... successfully sued its former CPA firm ... Karp, Ackerman, Skabowski & Hogan, P.C., (KASH) ... and one of its partners for improper tax advice. The case name is *Haddad Motor Group, Inc. & George Haddad v. Karp, Ackerman, Skabowski & Hogan, P.C. & Peter J. Hogan.* It was originally tried in the U.S. District Court and then appealed to the U.S. Court of Appeals for the First Circuit. The Appeals Court decision (Docket Nos. 06-2206 & 09-1479) is dated April 20, 2010.

In the District Court, the dealership recovered damages and attorneys' fees. The Appeals Court reported the facts in this case according to the opinion of the District Court and a report by the Magistrate Judge. The original District Court Opinion and Report are unreported because the District Judge who presided over the pretrial and trial proceedings became terminally ill, and a successor District Judge took over after the merits had been resolved, but before a final decision had been made on the dealership's claim for reimbursement of attorneys' fees and costs.

FACTS

The owner of the dealership, Mr. George Haddad, had retained the KASH CPA firm in December of 1997 to assist in advising him on the tax consequences of his plan to acquire another dealership. Six months before retaining the CPA firm, the dealership had executed a so-called "margin-against-the-box" transaction to finance the purchase of a second automobile dealership.

At that time, the dealership owned shares of stock that were worth almost $360,000 in BankBoston. Mr. Haddad hoped to make use of the stock without immediately incurring a capital gain tax by selling it. In order to do this the dealership borrowed an equivalent amount of stock in BankBoston from its brokerage house on margin (i.e., paying interest for this privilege and pledging to replace the borrowed shares with its own shares at a later date).

The dealership then sold the stock that it had borrowed (in the margin-against-the-box transaction) in order to finance the acquisition of a second dealership. This effectively deferred the tax on the capital gain on its own original shares in BankBoston until the transaction was closed out by a later transfer of the dealership's shares of BankBoston stock to the broker in order to replace the borrowed shares that had been sold to finance the acquisition.

The long and the short of it was that eventually the dealership had to relinquish its shares and realize the long-term capital gain that was built up in its original shares. The cost of delaying the realization of the gain was the "rent," or margin interest, that it had to pay to the brokerage firm until the shares that the dealership had borrowed were replaced by the shares originally held by the dealership.

Tax planning discussions. In late 1997 and throughout 1998, the dealer and the partner in the KASH CPA firm had several discussions involving (1) the tax position of the dealer, Mr. Haddad, and his dealerships, (2) the possible closing of the "margin-against-the-box" transaction, (3) the conversion of the dealership from Subchapter C to Subchapter S status and (4) the use of the losses of the dealership to be acquired (i.e., the "new" dealership) to offset the gains in the acquiring dealership.

In December of 1998, the dealer and the dealership's controller met with the CPA to discuss whether the dealership should close out the margin-against-the-box transaction and whether the dealership should convert to S Corporation status.

In the original trial in the District Court, the parties could not agree on what advice was actually given at the meeting. But, obviously, the dealer blamed the CPA firm for misadvising him on the sequence and the timing of the steps that should be taken to obtain more favorable tax results. What was said or not said at this meeting, as it turns out, is not important or critical to the appeal, because in the District Court, the CPA firm and the partner were found liable by the jury because of the timing of tax payments, and not because of the transactions themselves.

In February of 1999, the dealership closed out the "margin-against-the-box" transaction, and it realized a capital gain of approximately $311,000 on the sale of the BankBoston stock. On March 15, 1999, the dealership made the S-election for 1999. This S-election was timely made to be effective for calendar year 1999.

As the Court of Appeals explained, "although normally a Subchapter S corporation, is not a tax-paying entity, HMG (the dealership) became liable for a so-called 'built-in gains' tax of approximately $135,000 on the gains because HMG had converted from Subchapter C to Subchapter S status and the stock dated from when HMG was a Subchapter C corporation. The built-in gains tax could have been

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avoided if (the dealership) had converted to Subchapter S status and kept the transaction open for 10 years."

A built-in gains tax applies to certain asset sales made by a company that converts from a Subchapter C to a Subchapter S corporation and this tax is designed to limit the use of conversions to S status to avoid paying tax on the gains. The built-in gains tax applies to sales of appreciated assets "dating from the S corporation's days as a C-Corporation" and applies so long as the asset is sold within 10 years of the first day of the S-Corporation election.

Technically, the built-in gains tax could have been avoided by closing the "margin-against-the-box" transaction before converting to a Subchapter S corporation, but then the dealership would have been a Subchapter C corporation when the capital gains were realized, and it would have had to pay tax at the corporate level on that capital gain.

ESTIMATED TAX PAYMENT ISSUES

The dealership closed the "margin-against-the-box" transaction during the first quarter of calendar year 1999 ... the first year in which the dealership was an S-Corporation. As a result, the dealership should have estimated its income tax liability for the built-in gains tax at that time (i.e., during the first quarter). As a result, the dealership would have begun making or increasing its quarterly estimated income tax installment payments to the IRS based on that estimate of tax on the built-in gain.

Even though an S-Corporation is a flow-through entity and it does not directly pay tax on its operating income, the liability for a built-in gains tax (much like its liability for a LIFO reserve recapture related to the last day of its last C-Corporation year) is reportable on Form 1120-S. As such, it is payable by the S-Corporation ... and not directly by its shareholders as a Schedule K-1 pass-through item.

The CPA firm did not inform the dealer that the dealership was liable for the built-in gains tax until December 1999. As a result, the dealership incurred additional liability for an underpayment of estimated tax because it did not adjust its first quarter estimated tax payment (as an S-Corporation). Also, because of an ongoing IRS audit of the dealership's 1997 income tax return, the CPA firm recommended that the dealership delay filing the tax return for 1999 from March 2000 until September 2000 ... thus lengthening the time by six months over which the penalty amount would be accruing.

On the Form 7004 *(Request for an Extension of Time to File Tax Return)* that was filed for the dealership's 1999 S-Corporation return (Form 1120-S), there was no reference to the large, built-in gains tax that was due. As a result, when the Form 1120-S was filed later in the year, the dealership was liable for a penalty of $5,200 for failing to make estimated quarterly tax payments on the built-in gains tax and interest of $5,084 for delaying the payment of tax in 2000 from March 15 until the return was filed later in the year.

Interestingly, the IRS abated a portion of the dealership's liability when the new accounting firm, which had taken over after the old one had been fired, blamed the delay in filing on KASH, the dealership's former CPA firm. (It's the old story here ... stranger comes to town (new CPA firm) and blames the old CPA firm for causing the penalty ... and the IRS abates some or all of the penalty). But, the dealership still had to pay some of the penalties.

Unfortunately, in a situation like this, there are also state income tax ramifications which cannot be overlooked. The State of Massachusetts also levied similar penalties, but in lesser amounts, against the dealership.

THE LAWSUIT

Three years later, in December 2002, the dealership sued its then former KASH CPA firm and a partner alleging that (1) the CPA firm gave faulty advice in recommending that the dealership close-out the margin-against-the-box transaction and convert to S-Corporation status, and (2) that in an attempt to delay facing up to the adverse tax consequences of those transactions, the KASH CPA firm had caused the dealership to incur unnecessary penalties and interest.

Essentially, the dealership claimed that the CPA firm (1) was negligent and (2) was liable under State (i.e., Massachusetts) law that provided a right-of-recovery for any business entity injured by "an unfair method of competition or an unfair or deceptive act or practice" by another business entity. Apparently, the dealership construed the actions of the CPA firm to be an unfair or deceptive act or practice.

Double or treble damages. The Massachusetts (State) law under which the dealership sued the CPA firm also (1) permitted the award of double or treble actual damages at the judge's discretion for "willful or knowing violation[s]" and (2) required the award of "reasonable attorneys' fees and costs" to a successful plaintiff, "irrespective of the amount in controversy."

see **DEALERSHIP SUCCESSFULLY SUES CPA FIRM..., page 16**

IN THE DISTRICT COURT

The dealership originally sued the KASH CPA firm in the Massachusetts State Court. In defending itself, the CPA firm raised numerous defenses, and its first strategy was to successfully remove the suit from the State Court to the Federal District Court.

The jury in the District Court found that the CPA firm had been negligent as to the failures to make timely payments, but the damages that were awarded to the dealership were solely for Federal and state interest and penalties incurred from March 15, 2000 (the date on which the dealership tentative taxes were due) until October 15, 2000 (the date on which the tax was paid).

The jury awarded nothing for the other penalties the IRS imposed on the dealership for failing to make quarterly installment payments in 1999.

The jury also awarded nothing to the dealership on its claim that the CPA firm negligently advised it on the Subchapter S conversion and closing the "margin-against-the-box" transaction. In the Appeals Court, the dealership did not challenge the jury's verdicts on these issues.

Here's where it gets hairy. On the "deceptive acts" issue under State law, the jury in the District Court gave an advisory verdict rejecting any award; apparently it had concluded that the CPA firm's activity did not reach the "threshold of wrongdoing." However, the District Court Trial Judge (as the trier of fact as to this claim) found for the dealership: the Judge concluded that the CPA firm had violated the State law by deceiving the dealership as to the required payments and had knowingly misstated the dealership's tentative tax on the extension form (Form 7004) which was filed in March 2000.

The District Court Trial Judge expanded the damage award. The jury awarded the dealership only the amount of interest and penalties that had been imposed on the dealership after March 15, 2000. The Judge added $5,200, however, to the amount of the jury's award for interest and penalties. This additional amount was based on the IRS penalty imposed on the dealership for not making quarterly estimated tax payments.

Although it is somewhat difficult to keep track of the calculus, after the Judge added that $5,200, the total award stood at $12,345. Then, the Trial Judge ***trebled*** that amount to a total of $37,035. Finally, additional assessments for interest, and then a recalculation of interest, lead to a final damage award of $42,227 against the CPA firm and in favor of the dealership.

The real shocker: Attorneys' fees & costs. That $42,000 seems a mere pittance compared to what happened next. After further proceedings, the District Court awarded the dealership an additional $206,000 in attorneys' fees and $54,000 in costs. Under Massachusetts law, the award of attorneys' fee for the prevailing plaintiff is ***mandatory***. So, if you're doing the math in following this, there's now about $300,000 at stake.

IN THE APPEALS COURT

Perhaps this $300,000 amount makes the decision of the CPA firm to take the case further on up to Appeals more understandable. The CPA firm appealed both the judgment imposing damage liability and the later award of attorneys' fees and costs. These were consolidated by the Appeal's Court.

In the Appeals Court, the CPA firm adopted a "kitchen sink" approach (the Appeals Court's term). The CPA firm challenged numerous rulings of the District Court on multiple grounds. However, its main attacks were directed against the District Court's holdings under State law which lead to the treble damages and attorneys' fees awards. The CPA firm also challenged the calculation of the attorneys' fees.

The Appeals Court discusses at length, with considerable footnote support, the defenses raised by the CPA firm. At this point, those defenses will only be summarized here, in part because State law involves complex considerations. However, the details make fascinating reading.

But, let's stick to the main theme... After discussing various allegations of error made by the CPA firm with respect to the District Court opinion, the Court noted that, to an extent, there was some merit to the CPA firm's claim that the dealership understood its liability for the extra tax and deliberately underpaid its tax in order to conserve cash.

However, the Appeals Court found the CPA firm's attack defective. It said "it is of no use for the CPA firm to cite to or even describe evidence in its favor without also discussing the evidence the other way and showing by analysis why no reasonable judge or jury could decide the issue against it. ... Importantly, (CPA firm) does not explain its own patent understatement of the taxes due when it filed an extension form. The jury and the trial judge agreed that (the CPA firm) was at fault for that non-payment (although not to the same degree)."

The CPA firm raised three arguments. ***First,*** its conduct did not rise to the level of "rascality." ***Second,*** the District Court Judge erred by meeting with the jury after the jury rendered its own verdict. ***Third,*** →

the District Court erred by denying the KASH CPA firm's later requests for admissions as to what the Judge told the parties about his communications with the jury. All of the CPA firm's arguments were rejected by the Appeals Court.

Time value of money. The Appeals Court Judge did indicate that the CPA firm raised a more credible defense in its attack on the calculation on the amount of damages. The CPA firm argued the fact that the delay in paying its taxes gave the dealership the use of the money in the meantime.

Basically, the argument was that the rate of return on the use of the money by the dealership offset any interest in penalties imposed by the IRS and State Tax authorities. This point was a disputed issue that was resolved by both the jury and the District Court Judge against the CPA firm, and it was not seriously developed in the trial at Appeals.

Another critical point in the CPA firm's defense *might have been* a basis for reducing damages if a remand for that purpose was what the CPA firm was seeking in the Court of Appeals. Apparently, however, the CPA firm did not ask for a recalculation that would reduce the award for damages ... instead, it had asked "for a determination that there were ***no*** net damages, and even a 7% return on withheld payments would not show that. Whether the tax authorities imposition is regarded as interest, a penalty or some combination of the two, the total tax paid by HMG (the dealership) appears to exceed what it could have earned in interest."

The Appeals Court stated that the CPA firm's "all-or-nothing gambit is understandable." However, the CPA firm did not seek a remand to recalculate damages, so those issues did not warrant further attention by the Appeals Court.

After considerable discussion regarding the CPA firm's objection to treble damages, the Court found that the CPA firm had forfeited certain objections to the trebling of the damages by failing to make certain arguments in the proper procedural manner.

As the "reasonableness of attorneys' fees and costs," the CPA firm argued that no fees were reasonable because it had made a settlement offer to the dealership (which obviously had been declined). As to this issue, State law was "unclear." After lengthy discussion, the Appeals Court referred to the fact that the lower Court found the claims in the case to be sufficiently "interconnected" and ... "the case law contains examples of ... cases where the fees awarded far exceeded the damages awarded."

The Appeals Court said ... "Here, the final recovery is not trivial - about $40,000 - with the potential recovery being perhaps greater. The Magistrate Judge considered other factors (for example, the complexity of the case) and reduced the requested fees and costs by about 18%. The CPA fails to show that this result was impermissible. Other judges might have reduced the fee because of the time spent on a quite weak claim, but this is a judgment call which we (the Appellate Court) decline to second-guess."

Although the CPA firm offered still other arguments, the Appellate Court said that it had considered all of them and thought none of them in need of further discussion. Accordingly, it affirmed the holding of the District Court and the Magistrate's Report which reduced the requested reimbursement for attorneys' fees and costs by about 18%.

So, apparently, the award to the dealership for damages due to the faulty tax work topped out at about $42,000, plus another $213,000 ($260,000 x 82%).

LESSONS ... OBSERVATIONS ... CONCLUSIONS

The ultimate award to the dealership appears to have been about $255,000. This is quite a chunk of change ... not to mention the costs to the KASH CPA firm in terms of distraction from its practice, lost partner time in mounting a defense and payment of fees and costs to its own attorneys.

There seem to be several important lessons as one reflects on this case.

First, every CPA who's ever heard any type of presentation on the need to be careful in rendering tax advice in order to minimize professional liability, knows that two of the most common sources of litigation against CPA firms are for allegedly improper or negligent tax advice or mistakes in tax return preparation. This case demonstrates this in spades.

Second, it appears in this case that the more issues the CPA firm raised in trying to defend itself, the more likely the jury (in District Court) and the judges at both levels seemed to look to the so-called "bottom line" in awarding damages to the plaintiff dealership.

What the Appellate Court seemed to really fasten on, in affirming the District Court, was that the CPA firm "failed to tell HMG (i.e., the dealership) to make quarterly installment tax payments and then filed a misleading extension form (i.e., Form 7004)." The dealer "specifically testified that he had been assured that taxes on the closing would be small" and "the supposed earlier misadvice was HMG's explanation

see **DEALERSHIP SUCCESSFULLY SUES CPA FIRM...**, page 18

as to why KASH would want to conceal the resulting adverse tax consequences."

Third... ***"rascality"***... that's what seems to have done them in! One of the arguments the CPA firm raised was "that its conduct did not rise to the level of "rascality" needed to establish a ... violation (under State/Massachusetts law).

The Appellate Court said that "the trial judge found that KASH (i.e., the CPA firm being sued) failed to give proper advice so as to conceal the adverse tax consequences of its earlier advice and, further, found that KASH knowingly provided false information to the IRS about the tax due when filing the extension form. This is enough, whatever the standard of Appellate review governing the rascality label."

Once the case rises from the District Court level to the Appellate Court level, the proper standard of review "ought to depend on the precise challenge or challenges: construing the statute is a matter of law; findings as to conduct and motive are reviewed for clear error; and on 'law application' issues deference is often afforded although there are exceptions."

Fourth, the income tax law regarding built-in gains taxes and S-Corporation elections is very complex. A CPA reading this case has to wonder whether the partner in the CPA firm that was sued sought advice from others in his firm or outside consulting assistance in dealing with the unusual facts in the case.

For some CPAs, this may be the first time they have encountered the sophisticated technique of using a "margin-against-the-box" transaction in connection with financing the acquisition of a dealership.

Perhaps, the lesson here is to err on the side of saturating oneself with research and "expert" technical guidance in dealing with tax matters of seeming complexity. In fairness to the CPA involved in this case, we do not have the benefit of being able to find out to what extent he may or may not have sought assistance beyond his own experience in dealing with this matter.

Fifth, when rendering tax advice, it is prudent to document the advice given to a client (in a meeting or by phone) by formalizing that advice in a written memorandum or letter, rather than leaving it to recollections that may become vague and/or emotionally distorted over time.

Note that the Appeals Court referred to the fact that there was a meeting in December 1998 involving the CPA, the dealer and the dealership's controller. However, "both sides agree that at this meeting, they discussed ... [certain tax issues]. ***Just what advice was given was disputed at trial*** - Haddad blamed KASH for misadvising him on these steps... ."

Although it turned out that faulty recollections of this meeting were not critical to the Appeal, the lack of written evidence of what actually was said or what advice was given suggests a shortcoming that could have been avoided. Who knows? It might even have prevented a lawsuit.

Sixth, if a CPA firm is going to attempt to defend itself in a tax practice negligence case of this sort, it should not underestimate the complexities of the State law under which it will attempt to defend itself. In this case, the statute involved determining whether the claims arose from a "single chain of events" and whether or not the claims were "sufficiently interconnected."

Also, apparently the CPA firm did not follow all of the required procedures in making a settlement offer to the dealership. You'll have to read the case for yourself to glean the intricacies. Nevertheless, the failure to follow proper protocol in this regard obviously proved costly to the CPA firm in the end.

Finally, most cases of this sort are settled long before ever getting to court. Due to unusual circumstances, the decision in the District Court and the Magistrate's Report are not available for review. If they were, that perhaps would satiate the voyeuristic consumption instinct of CPAs looking for lessons in the publicized miseries of our contemporaries. However, the decision in the Appeals Court reveals much useful information and has to be regarded as an object lesson ... one might say, "Juicy reading" ... or one of the best "case studies" of what not to do that has come around in a long time.

The *Haddad Motor Group* case can be summarized in one long sentence. ... What really cooked the goose for the CPA firm was that it did not face up to the necessity of advising the dealer/dealership that, in fact, it became liable for a fairly large built-in gains tax, ***and then it did not reflect that tax liability on the Form 7004 that it prepared for the dealership to sign and file with the IRS.***

SECTION 263A COST CAP ISSUES WORKSHOP AT THE NADA CONVENTION

At the NADA Convention in Orlando in February, the IRS tax matters workshop was devoted almost exclusively to a discussion of the inventory cost capitalization provisions of Section 263A. This workshop was entitled, "Breaking Down UNICAP - What's the View from Your Perspective?" It was moderated by Paul Metrey (the NADA Director of Regulatory Affairs).

The two-member panel consisted of Terri Harris (the IRS Motor Vehicle Technical Advisor) and Robert Zwiers, who has considerable experience in dealing with Section 263A issues. Before retiring from the IRS, Mr. Zwiers was the IRS Motor Vehicle Technical Advisor. After retiring from the IRS, Mr. Zwiers has been significantly involved with these issues on behalf of NADA and the dealership clients of the accounting firm with which he is currently associated.

Basically, this 75-minute presentation consisted of seven sections, each of which is indicated by the captions which sub-divide the following summary.

#1. MR. METREY ... INTRODUCTORY REMARKS

Mr. Metrey set the stage by saying that there were essentially "two buckets of issues" involved in the ongoing discussions with the IRS over the proper application of the Section 263A Cost Capitalization rules to dealership inventories.

The first "bucket of issues" involves what can be generalized as "production" or "producer" issues. These relate to various installation and improvement activities that are performed in the dealership's service department on vehicles which are owned by customers and/or owned by the dealership. The overarching question here is ... "Does the dealer perform installation or improvement activities on vehicles that could be deemed to rise to the level of 'production' activities under Section 263A?"

The second "bucket of issues" involves what can be generalized as "reseller" issues. These issues relate to the retail activities that a dealership is engaged in. They involve the determination of (1) whether certain activities meet the definition of "on-site sales," in which case the related or associated costs are immediately deductible or (2) whether these activities are "off-site sales" (i.e., they are not considered to be "on-site/retail sales" activities), in which case the related or associated costs are required to be capitalized as part of the cost of the inventory.

In a nutshell, the issues under Section 263A for dealerships fall into either one of these two "buckets."

#2. MS. HARRIS ... TECHNICAL EXPLANATION OF TAM 200736026

Section 263A became part of the Internal Revenue Code in 1986, so it has been around for almost a quarter of a century. During this period, the IRS activities in connection with auditing auto dealerships' compliance with the rules of Section 263A can be described as inconsistent.

Shortly before the issuance of Technical Advice Memorandum 200736026 in September of 2007, the IRS had reached several conclusions. First, dealers' historic methods for capitalizing costs under Section 263A were (in general) improper, and there were considerably more costs that dealerships should capitalize to inventory, rather than currently deduct.

Second, the Sec. 263A Regulations contain numerous *de minimis* rules, each of which - in its own right - is a method of accounting. Consequently, if a dealership did not properly and timely elect to use (all or any one of) them, the dealership would now be required to file a Form 3115 in order to apply them in its current Section 263A computations.

Over a period of time leading up to the issuance of TAM 200736026 (the TAM), the IRS began to appreciate the inconsistency of its own auditing activities and the degree to which the dealerships, in general, were noncompliant. In one IRS audit of a dealership, the examining agent sought technical assistance from others within the IRS, and the end result was the issuance of the TAM.

Ms. Harris indicated that at the present time, there is no overall national coordination of Section 263A examinations by the IRS. Examining agents currently are not required to report to Ms. Harris on these matters or to update her on what they decide to do (or not to do). However, some agents do and some don't seek her input.

Ms. Harris summarized the technical details in the TAM. The essence of the TAM was to conclude that several of the dealership activities might be construed as production activities (that's bad for the dealership!) and that the dealer's main location was a dual function storage facility (that's also bad for the dealership). Under both of these holdings, the dealership would not be allowed to deduct many costs currently but, instead, it would be required to capitalize these costs as part of its overall inventory costs.

see **SECTION 263A...**, page 20

(Continued from page 19)

Ms. Harris explained that the IRS now considers the 2007 TAM to be "working law" and because the operations of most dealerships are similarly structured, it was expected that the conclusions reached on the issues in TAM 200736026 would likely be the same conclusions that the IRS would reach when/if it were presented with a Form 3115 filing by another dealership. Notwithstanding that generalization, the facts and circumstances of a particular dealership situation could be different, and therefore, might result in (more favorable) different results.

[Comment: Since the TAM was extensively analyzed in the September 2007 issue of the **Dealer Tax Watch,** ***Ms. Harris' remarks summarizing the technical details are not repeated here.]***

#3. MR. ZWIERS ... INDUSTRY CONCERNS OVER THE HOLDINGS IN THE TAM

Mr. Zwiers said that in the early 2000's, on behalf of many dealership clients, his firm had approached the IRS in various ruling requests and/or change in accounting method Form 3115 filings. After full disclosure to the IRS of all relevant facts, his firm was successful in many situations in convincing the IRS that there would be no Section 263A costs capitalized to the dealerships' inventories. A good part of this success in convincing the IRS that there were no Section 263A costs for the dealerships was attributable to the proper election and application of the *de minimis* rules (previously mentioned).

Over time, this favorable end result came to be known as the so called "zero-UNICAP method." Also, over time, the IRS looked at so many Forms 3115 filed by dealerships to change their Section 263A methods of accounting to the "zero-UNICAP method" that it concluded, as a matter of administrative convenience, that dealerships did not need to request permission from the IRS in advance to change. In other words, dealers were permitted to make the change to the "zero-UNICAP method" as an ***automatic*** change in method (i.e., the Form 3115 could be filed after the end of the year and without the payment of a user fee).

Understandably, many CPAs jumped to the mistaken belief that they, too, could piggy-back onto this favorable result and obtain it for their dealership clients without doing any real work ... or, for that matter, without making proper elections to use *de minimis* rules or filing Forms 3115.

Slowly but surely, in more recent years when some IRS agents began to look more closely at the complexity of the operations and activities of a typical dealership, the IRS realized that it had painted itself into a corner with its prior approval in many instances of the "zero-UNICAP method."

Mr. Zwiers indicated that in some cases, he had seen cost capitalization rates as high as 20% proposed by the IRS!

Hence, the issuance of TAM 200736026 represents an about-face which now perplexes many dealers and their CPAs, not only because of the IRS' complete reversal of its acceptance of the "zero-UNICAP method," but also for a variety of other reasons.

Mr. Zwiers asked a simple question... "What do you see when you look at a dealership? Do you see a retailer, or do you see a producer?" Mr. Zwiers sees a retailer (and not a producer).

Mr. Zwiers went on to explain some of the industry concerns by raising the following questions.

How can the same activity in a dealership service department (for example, installing an alternator) be a "production" activity in one instance and a "handling" activity in another instance?

How can production costs be treated as "purchasing" or "handling" costs in the Simplified Resale Method formula?

Why is the dealership treated as if it were a wholesaler in connection with its sales of unwanted trade-ins? In many instances, the dealership will take in almost any kind of vehicle as a trade-in from a customer in order to make the sale of another vehicle out of its own inventory to that customer. Often, these vehicles taken as trade-ins essentially are not held for resale to a retail customer because of their poor condition or for some other reason; they are instead sold at auctions or to other dealers as "dealer trades."

Similarly, why are dealer trades treated as off-site sales ... shouldn't these be treated like "returned goods" rather than as if they were wholesale transactions?

If a dealership has a storage lot that customers can visit and select cars from, but that lot is not immediately adjacent to the main showroom or to the dealership's main lot, why can't that non-adjacent lot be treated as if it were part of the main retail sales facility?

[Comment: From the foregoing, one can see that Mr. Zwiers has framed each of the holdings in the TAM as an industry concern over the application of Section 263A to a dealership. In essence, every holding of TAM is an "industry concern."]

Among the other industry concerns, Mr. Zwiers indicated that there was need for more explanation and guidance of how the *de minimis* production rules would apply to the "first bucket" of Section 263A issues.

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In many instances, labor is already being capitalized on repair orders and charged out when the repair orders are closed out. As a result, applying additional Section 263A costs creates a duplication (to some extent) of costs capitalized to inventory, as well as to customer vehicles that have been serviced. This is an inconsistency which the IRS is aware of, but simply dismisses because the Sec. 263A Regulations have not been modified to take this type of situation in a dealership into account.

What should be alarming to any dealership from this portion of Mr. Zwiers' presentation was the statement that the IRS seems to be looking for a ***combined absorption ratio*** "in the neighborhood of 6%." In other words, if a dealership had $5 million worth of inventory, that would translate into $300,000 worth of Section 263A costs that would not be currently deductible because they were more properly costs that should be capitalized in the ending inventory. ***[Comment: Insert your own inventory number here and multiply by 6% ... odds are that your dealership has capitalized far less that that amount under Section 263A. Right?]***

Worse yet, Mr. Zwiers cited statistics that the overall average dealership's gross margin was 4½%. Accordingly, applying the Section 263A combined absorption ratio of 6% that is favored by the IRS, the result would be that the dealership had a gross margin of ***negative*** 1½%. Does this make sense?

#4. MS. HARRIS ... THE IRS FIELD DIRECTIVE & MORATORIUM ON RAISING SEC. 263A ISSUES

The next subject was the IRS Field Directive which announced a moratorium on raising Section 263A issues in the audit of dealerships for the period from Sept. 15, 2009 through Dec. 31, 2010. ***[Comment: Since this Directive was extensively analyzed in the Year-End 2009 Edition of the*** **Dealer Tax Watch*****, Ms. Harris' remarks summarizing the technical details are not repeated here.]***

Ms. Harris indicated that the method used for capitalizing costs in the TAM was the Simplified Resale Method. She also indicated that, to date, no dealership has brought a serious "Facts & Circumstances" cost capitalization method to the IRS for consideration. She said that the IRS has not ruled out the possibility that a "Facts & Circumstances" approach might work for a dealership ... Neither has the IRS ruled it (i.e., the "Facts & Circumstances" approach) in.

Ms. Harris indicated that, internally, the IRS needs to revise the tool kit, particularly to give it some narrative. She said that currently, agents were using it and seeing how it might be improved. She added that she hopes or expects to "have a revised 'tool kit' out by the end of the year." She also indicated that, internally, the IRS needs to train agents to enable them to use the tool kit effectively and efficiently.

Finally, Ms. Harris added that the IRS Tier III Team working on Section 263A issues does not have the authority to issue a Revenue Procedure that would provide dealerships with some type of safe-harbor approach for capitalizing Section 263A costs.

#5. MR. ZWIERS ... INDUSTRY CONCERNS RELATED TO THE IRS FIELD DIRECTIVE

In addressing the industry concerns relating to the IRS' moratorium and the tool kit materials that agents might use in auditing dealerships after the moratorium is lifted, Mr. Zwiers picked up on Ms. Harris' comment that, so far, the IRS had not been approached by a dealership with a "Facts & Circumstances" Method. Mr. Zwiers commented that the reason the IRS had not been presented with this method was because if the dealership used the LIFO Method for valuing inventory, the IRS would require that the Section 263A costs would have to be computed first, and then they would have to be applied to every item in inventory.

[Comment: This assertion leaves me puzzled, and I have a distinctly different point of view. I do not think it would take "an army of accountants" to deal with this matter. Specifically, the Sec. 263A Regulations provide a different treatment for inventories which are valued using LIFO and the application of those rules to a dealership has not been "reckoned with" by either the TAM or the IRS in any other situation since the TAM. The IRS has not been seriously challenged on this, and it continues to hide behind the TAM and an obscure provision of the Regulations. I could go on, but that's enough on this for now.]

If a dealership thought it could protect itself by filing Form 3115 to request a change to the "TAM Method" ... would the IRS allow that change in method to be made as an automatic change by the dealership after the end of the year (under Rev. Proc. 2008-52) or would the IRS require the dealership to request advance permission to make that change by filing Form 3115 before the end of the year (under Rev. Proc. 97-27)? That seems to be the $64 question and Mr. Zwiers believes the answer is that the change request should be filed before the end of the year as in "advance permission" request.

If it a dealership assumes that such a change could be made as an automatic change, and if the IRS were to hold otherwise, then the change request (and the use of the TAM method) would be invalid because

see **SECTION 263A...**, page 22

 (Continued from page 21)

the change request was not timely filed for the year intended to be the year of change. Accordingly, proceeding on the assumption that the change could be made after the end of the year as an automatic change would be "risky" to say the least. And, of course, the IRS Directive in September failed to give any answer - or even guidance - on this question.

All of this begs the question of whether it really would make sense or be advisable to file a Form 3115 to change to the so-called "TAM Method."

[Comment: For some random thoughts on the case against dealerships "jumping the gun" to change cost capitalization methods based on the IRS' Directive and moratorium and the TAM, see* Dealer Tax Watch, *Year-End 2009 Edition, pages 22-23.]

Another industry concern Mr. Zwiers expressed was over whether the IRS will allow a dealership to use a *de minimis* production test and, if so, how that test would actually be applied. Certainty over the application of the production rules and the production *de minimis* test would be critical issues in filing Form 3115 under the "TAM Method."

There are many concerns that relate to the need for clarification of key definitions that are part of the "tool kit" which the IRS group/team is presumably refining for eventual use after the moratorium is lifted. One part of the tool kit is an all-inclusive spreadsheet. Without actual numbers and some correlation to a dealership's operating statement, the spreadsheet is confusing and more of a threat than a tool, especially when combined with the lack of firm definitions or lists of what dealership activities or transactions correspond to line items on the spreadsheet.

And, there are more questions related to the spreadsheet in the tool kit. What activities constitute purchasing and handling activities, especially in the dealership's service department?

Exactly what costs are "storage" costs? Many costs are listed in the spreadsheet; some are more normally associated with storage costs (such as rent, insurance, etc.) but other cost categories that are on the list are extremely remote or very, very indirect.

How are internet sales to be treated? ... What are they and can the IRS provide a definition of what constitutes an internet sale? Similarly, definitions or clarifications are needed for "phone sales" and for "fleet sales." These activities tend to push a dealership away from being considered more as a reseller with on-site sales (good) and toward being considered more as a reseller with off-site sales or as a wholesaler (bad).

Other normal activities in a dealership that the IRS considers as constituting off-site sales (or wholesale sales) because they are not considered to be made directly to the ultimate customer include (1) sales of parts by the parts department to the service department and (2) parts sales in connection with warranty and/or service contract work.

What constitutes "purchasing" costs? Do "purchasing" costs include ... the physical taking of inven- →

Filing Form 3115 by Dec. 31, 2010? ... Still More Compliance Considerations Clouding the Issue

Mr. Zwiers detailed several other compliance considerations that cloud the issue of whether a dealership should file Form 3115 based only on the limited guidance that the IRS has provided to date.

(1) There is no audit protection for factual determinations. What kind of "audit protection," if any, will these Forms 3115 have?"

(2) Will the stand-down or moratorium period be extended?

(3) Will the Regulations be changed?

(4) Might Congress pass some new legislation (specifically affecting automobile dealerships and Sec. 263A) in the meantime?

(5) Might there be a favorable outcome in one dealership Sec. 263A case currently being litigated? ... How might the Court rule?

(6) Might there be new IRS or Treasury personnel changes that would involve individuals with positions and/or interpretations of the Regulations that are (significantly) different from those currently in vogue?

(7) Might the IRS reconsider accepting dealership Sec. 263A questions in its IIRP (Industry Issue Resolution Program)? ... Note: The IRS has rejected two previous NADA requests for IIR treatment for dealership Sec. 263A issues.

(8) If the IRS were to accept Sec. 263A as an IIR Program project, might the result be some kind of safe harbor, agreed upon overall Cost Capitalization Percentage (such as 2% or 3%) to be applied to the ending inventory?

tory, the valuation of trade-ins, insurance, accounts payable/personnel costs ... or even an allocable portion of goodwill being amortized in connection with the purchase of the dealership?

What costs should be allocated as mixed service costs to purchasing, handling and storage activities (particularly storage activities)?

Other general concerns over the Directive and the industry's view of it center around the IRS' sporadic issuance of "piece-meal guidance" and the Sec. 263A compliance burdens that are being placed on dealerships as a result of the IRS holdings in the TAM.

It would be helpful if the IRS would provide a more thorough sample Section 263A calculation with supporting data and a completed Form 3115 that could be used as a template. These tools would be even more helpful if the IRS, with the input of NADA, would bend a little and come up with a safe harbor or *de minimis* cost capitalization percentage that dealerships could use if they preferred to do that (as an alternative to making more detailed calculations).

#6. MR. ZWIERS ... COMPLIANCE CONSIDERATIONS PRIOR TO JAN. 1, 2011

In discussing compliance considerations ... basically whether or not it would be advisable for a dealership to file Form 3115 to adopt the TAM Method ... Mr. Zwiers repeated his earlier comments to the effect that it would be risky for a dealership to file a Form 3115 after year-end assuming the change could be made as an automatic change in method.

In other words, to eliminate this risk, the dealership would have to file Form 3115 with the IRS before Dec. 31, 2010 in order to make a change effective for calendar year 2010. This would involve the dealership having to pay a $4,200 user fee to the IRS with the filing of Form 3115.

It appears that such a Form 3115 would have to be filed before there is any substantial further guidance from the IRS. If the IRS were to issue a Revenue Ruling addressing the "first bucket of issues" which involve production activities, the holdings in that Ruling would have to be incorporated into the Form 3115.

Dealers filing Form 3115 would like some certainty that the method they are changing to by filing Form 3115 will be "audit proof."

Finally, Mr. Zwiers detailed eight compliance considerations that are clouding the question of whether a dealership should file Form 3115 based only on the guidance from the IRS so far. All are speculative, of course. But nevertheless, they are all possibilities in their own right.

#7. CLOSING QUESTION (TO BOTH PANELISTS)

Mr. Metrey, the panel moderator, added that NADA would exert as much effort as it could to persuade the IRS to issue precedential, comprehensive guidance, particularly in the form of some document arising out of the IIR Program. He suggested that attendees obtain a copy of NADA's request to the IRS for Section 263A relief that was made by letter dated December 1, 2009 for more information on NADA's positions. This letter is available on NADA's web site (www.nada.org), and it was reproduced in the Year-End 2009 Edition of the *Dealer Tax Watch* on pages 30-33.

In closing, Mr. Metrey asked both panelists this question ... ***"As we approach Dec. 31, 2010, what should dealers be focused on?"***

Ms. Harris responded by saying that dealers should look at the Regulations and the TAM and to try to understand them. She said that dealers should "keep tuned in" to see if or how the tool kit is revised. Ms. Harris also said she didn't anticipate that the IRS would issue any formal (i.e., precedential) guidance ... but that there may be something coming out of the Tier III Task Force Group in the form of "lesser guidance."

Mr. Zwiers responded by saying that if dealers were going to change their cost capitalization methods to the TAM method, they would have to file Form 3115 requests for advance consent by Dec. 31, 2010. That is the crucial due date for filing Form 3115. He added that he was hoping that the IRS might bend a bit and come up with some kind of a "rough justice" approach before Dec. 31. Finally, he expressed hope that before the calendar year is over, the IRS would issue something on this.

[Post Script: This NADA workshop was presented in February, 2010 at which time the end of the moratorium was 11 months away. As of mid-year 2010 - with only six months or less remaining - there has been no further guidance or response from the IRS on any of the concerns expressed above.]

FORM 3115 FILINGS: NEW REVISIONS & NEW CONCERNS

IN GENERAL

One of the most important forms a practitioner has to deal with when a client is going to change an accounting method is Form 3115. This Form is required to be filed for many, but not necessarily for all, changes in accounting methods (CAMs).

As a general rule, if a taxpayer wants to change an accounting method, it must secure permission from the Internal Revenue Service before making the change. However, there are some exceptions.

Over the years, the *Dealer Tax Watch* has contained many articles describing tax cases which involved changes in methods of accounting. These articles include discussions of (1) the advantages of cost segregation studies to accelerate depreciation deductions for dealership facilities, (2) various cases involving *Cordes Finance Corporation* (which was litigated all the way up to the Supreme Court), (3) *Rameau Johnson, et al.* regarding accounting methods for vehicle service contracts, (4) *Hinshaw's, Inc.* also regarding extended vehicle service contracts and (5) the proper treatment for handling floorplan assistance payments and the advantages of eliminating these trade discounts and certain advertising fees and expenses from inventory cost. Citations to all of these articles have been omitted, but are easily located in the *Dealer Tax Watch* Index of Articles available at www.defilipps.com.

Changes in methods of valuing inventories are common in many dealerships. Some involve LIFO matters ... others do not. Recently, one frequent change in valuing inventories resulted from an IRS initiative which focused on dealerships' lack of compliance with proper methods for applying the lower-of-cost-or-market method for valuing their used vehicle inventories. In this regard, see the IRS *Automotive Alert... "Tax Court Rules on Inventory Writedowns: West Covina Motors, Inc."* (January 2009). Also, there are several other automatic changes in accounting method which encourage dealers to make proper valuations of their used vehicle inventories.

The Exhibit on the facing page lists some of the more-frequently encountered automatic changes in accounting methods made by dealerships.

THE IRS & DEALERSHIPS AT WAR OVER SECTION 263A

More recently, there has been a very significant, stepped-up initiative by the IRS to enforce (what it believes to be the) proper application of the Section 263A inventory cost capitalization rules to automobile dealers. As a general class or group of taxpayers, the IRS considers dealerships to be significantly derelict or out-of-compliance with applying the general rules for capitalizing certain costs to their inventories of new and used vehicles and parts and accessories.

see **FORM 3115**, page 26

Form 3115 Changing Methods

Procedures for Requesting Permission to Change Accounting Methods (CAMs)
Analysis of Form 3115 & Instructions (Dec. 2009 Revision)

"Automatic" CAMs

FREQUENTLY ENCOUNTERED AUTOMATIC CAMs IN DEALERSHIPS PER FORM 3115 INSTRUCTIONS (REV. DEC. 2009)*

IRC Code Section	Designated Automatic CAM #	Change in Method Relates to ...	Inventory & LIFO Changes	Other Method Changes†
471	53	Qualifying volume-related trade discounts (i.e., elimination of floorplan assistance payments from inventory cost under Reg. Sec. 1.471-3(b))	✓	
	54	Impermissible methods of inventory valuation	✓	
472	56	Change from LIFO inventory method (i.e., termination of LIFO elections)	✓	
	57	Determining current-year cost	✓	
	58	Alternative LIFO Inventory Method (for *New* Vehicles)	✓	
	59	*Used* Vehicle Alternative LIFO Method	✓	
	60	Determining the cost of used vehicles purchased or taken as trade-ins	✓	
	61	Change to IPIC inventory method	✓	
	62	Changes within IPIC inventory method	✓	
471 & 472	63	Replacement cost method for auto dealers' parts inventory	✓	
	96	Replacement cost method for heavy equipment dealers' parts inventory	✓	
472	112	Changes to the Vehicle-Pool Method	✓	
471	139	For new vehicle retail dealerships, elimination of certain invoice advertising association costs from inventory	✓	
472	140	Changes within the Used Vehicle Alternative LIFO Method	✓	
Various	7	Depreciation or amortization (impermissible depreciation/amortization methods)		✓
56 & 167	8	Depreciation (permissible)		✓
Various	10	Sale or lease transactions		✓
263	21	Costs incurred in retirement and removal of depreciable assets		✓
263A	22	Certain uniform capitalization methods used by small resellers, formerly small resellers, and reseller-producers		✓
	23	Certain uniform capitalization methods used by producers and reseller-producers		✓
267	26	Related party transactions		✓
446	31	Multi-year insurance policies for multi-year service warranty contracts (SWIM - Service Warranty Income Method)		✓
461	43	Timing of incurring real property, personal property and state income tax liabilities		✓
	45	Timing of incurring payroll tax liabilities		✓
471	48	Cash discounts		✓
263(a)	78	Costs of intangibles and certain transactions		✓
1400N	104	GO Zone additional first year depreciation deduction		✓
168 & 1400L	105	Additional first year depreciation deduction		✓
Various	107	Depreciation or amortization for dispositions of depreciable or amortizable property		✓
461	113	Payroll tax liabilities		✓
168	115	Kansas additional first year depreciation		✓
	116	Depreciation of MACRS property acquired in a like-kind exchange or as a result of an involuntary conversion		✓
167 & 168	119	Change from depreciating land and/or land improvements		✓
446	125	Multi-year service warranty contracts		✓
118	129	Nonshareholder contributions to capital under Section 118		✓
461	133	Timing of incurring liabilities for bonuses		✓
	134	Timing of incurring liabilities for vacation pay		✓
	135	Rebates and allowances		✓
467	136	Section 467 rental agreements re: uneven vs. fixed rents/deferrals		✓
471	137	Permissible methods of inventory identification and valuation		✓
	138	Change in the official used vehicle guide utilized in valuing used vehicles		✓
168	146	Dispositions of structural components of a building		✓
	147	Dispositions of tangible depreciable assets (other than a building or its structural components)		✓
461	149	Ratable accrual of real property taxes		✓

* *The IRS will continue to designate additional changes in accounting method as eligible to be made by the "automatic" change procedures in subsequent Revenue Procedures, other guidance and announcements.*

† *The identification of the CAMs in the "Other Method Changes" column is for general purposes only. It is not intended to be all inclusive. Some of the other IRS' Designated Automatic Changes may be relevant or pertinent to very small or very large dealerships, or in cases where the dealership conducts special activities (such as buy-here, pay-here operations) and/or extensive leasing operations.*

(Continued from page 24)

The concern of the IRS over the improper capitalization of Section 263A costs by dealerships is so great that in September 2009, in a Memorandum to the LMSB (Large and Medium Sized Business) Industry Directors and other IRS personnel, the Industry Director (Heavy Manufacturing and Transportation) issued a Directive suspending the examination of auto dealership Section 263A issues effective September 15, 2009 and continuing through December 31, 2010.

This Directive said that the moratorium was placed in effect in order to encourage dealerships to comply with Section 263A and to allow them the opportunity "to voluntarily change their methods of accounting to comply with the legal reasoning allowed in TAM 200736026."

What is most significant at this time is that if a dealership is going to "voluntarily" change its cost capitalization methods and submethods (and many practitioners question the wisdom of doing so at this time) that dealership will have to cope with the revised Form 3115 and all its implications, including the lack of guidance at this time from the IRS on many significant issues and questions.

For more on this, see (1) the summary of the Section 263A Issues Workshop at the NADA Convention earlier this year (pages 19-23 in this Edition) and (2) *"The Case Against Dealerships 'Jumping the Gun' to Change Cost Cap Methods for 2009 Based on the IRS' IDD"* on pages 22-23 of the Year-End 2009 Edition of the *Dealer Tax Watch*. The latter refers to 2009, but it is equally applicable to 2010.

DEC. 2009 REVISION OF FORM 3115

The IRS does not revise Form 3115 annually. Rather, every so often a revision is introduced, and until recently, the last revision of Form 3115 was in December of 2003. The last revision of the Instructions for Form 3115 was in May of 2006.

The recent issuance of several Revenue Procedures ... especially Rev. Proc. 2008-52 ... and the lengthening of the list of accounting method changes that can be made without advance approval from the IRS account for some of the difficulties that CPAs have experienced in completing Forms 3115.

In May, the IRS released revisions of both Form 3115, *Application for Change in Accounting Method*, and the Instructions for Form 3115. The revisions of Form 3115 and the Instructions are both dated December 2009. Accordingly, for some, these revisions are a welcome development.

The December 2009 revision of Form 3115 must be used for all filings with the IRS after June 1, 2010. In certain circumstances, taxpayers were allowed to use the previous version of Form 3115 for method changes that were filed with the IRS before June 1.

In general, the December 2009 revisions of Form 3115 and the Instructions are relatively straightforward. Form 3115 remains an eight (8) page document. The revised Instructions include an up-to-date list of 149 changes in accounting method which can be made without advance approval from the IRS. The Instructions, including the list of automatic changes, comprise 17 pages of fine print.

The list of changes that can be made without securing advance consent or permission from the IRS (i.e., "automatic changes") has increased significantly over time. These changes can be made by filing Form 3115 after the end of the year, as part of the income tax return for the year of change.

Although at first glance, there doesn't appear to be much difference between the schedules in the "old" Form and Instructions and the "new" revisions, there are several new requirements and/or conditions that have been slipped into Form 3115 in various places.

My discussion of the revisions to Form 3115 in this article reflect the assumption that you are basically familiar with many aspects of the Form and the underlying changes in methods being discussed. Accordingly, my discussions and comments are somewhat selective.

IS THE CAM AN "AUTOMATIC" CHANGE?

Before concluding that a change in accounting method can be made automatically or that the change requires advance consent, one must consider three sources. Stated differently: the following sources are to be consulted before reaching the conclusion that a change in accounting method can be made as an automatic change:

1. The controlling document that governs the type of change ... either Rev. Proc. 2008-52 which is the controlling guidance for automatic changes in method ... or Rev. Proc. 97-27, the controlling guidance for changes that require advance consent from the IRS.

2. The Appendix to Rev. Proc. 2008-52 to determine if, for the change being considered, there is a more specific section that waives the general prohibition found in the controlling document. This is particularly important in order to determine whether the scope limitations in Section 4 of Rev. Proc. 2008-52 are waived by the specific language found in the section of the Appendix where the automatic change is more fully discussed.

see **FORM 3115,** page 28

At A Glance	***APPLICATION FOR CHANGE IN ACCOUNTING METHOD*** ***FORM 3115 & INSTRUCTIONS ... CHANGES & REVISIONS - REV. DEC. 2009***
Overview	• In almost all situations, Form 3115 must be filed to request a change in an accounting method, a submethod or the accounting treatment or definition of any "item." All are considered to be CAMs. ◆ For situations where Form 3115 is not required to be filed, see *Practice Guide.* • There are two procedures a taxpayer may use to request a change in accounting method. ◆ ***Automatic change*** requests ... wherein advance permission or consent from the IRS to make the change in method is not required. (Rev. Proc. 2008-52) ◆ ***Advance consent*** requests ... this involves all changes in method other than those specifically treated as automatic change requests. (Rev. Proc. 97-27) • Current revision of Form 3115 is dated Dec. 2009 ... Previous revision was Dec. 2003 • Current revision of Instructions is dated Dec. 2009 ... Previous revision was May 2006
Form 3115 ... 8 Pages	
Page 1	• Taxpayer Identification, CAM Identification & Signature Blocks • Part I ... Information for Automatic Change Request (Ques. 1-2) • Part II ... Information for All Requests (Ques. 3, 4a & b)
Page 2	• Part II ... Information for All Requests ... Cont. (Ques. 4c-11)
Page 3	• Part II ... Information for All Requests ... Cont. (Ques. 12-17) • Part III ... Information for Advance Consent Request (Ques. 18-23) • Part IV ... Section 481(a) Adjustment (Ques. 24-25)
Page 4	• Part IV ... Section 481(a) Adjustment ... Cont. (Ques. 26-27) • ***Schedule A ... Change in Overall Method of Accounting*** ◆ ***Part I ... Change in Overall Method*** (Ques. 1-3) ◆ ***Part II ... Change to the Cash Method for Advance Consent Request*** (Ques. 1-2) • ***Schedule B ... Change to the Deferral Method for Advance Payments*** (Ques. 1-2d)
Page 5	• ***Schedule C ... Changes within the LIFO Inventory Method*** ◆ Part I ... General LIFO Information (Ques. 1-6) ◆ Part II ... Change in Pooling Inventories (Ques. 1-4)
Page 6	• ***Schedule D ... Change in the Treatment of Long-Term Contracts under Section 460, Inventories or Other Section 263A Assets*** ◆ Part I ... Change in Reporting Income from Long-Term Contracts (Ques. 1-5) ◆ Part II ... Change in Valuing Inventories including Cost Allocation Changes (Ques. 1-5c)
Page 7	• ***Schedule D*** ... Cont. ◆ Part III ... Method of Cost Allocation ▪ Section A ... Allocation & Capitalization Methods (Ques. 1-3) ▪ Section B ... Direct and Indirect Costs Required to Be Allocated (Lines 1-28)
Page 8	• ***Schedule D*** ... Cont. ◆ Part III ... Method of Cost Allocation ...Cont. ▪ Section C ... Other Costs Not Required to be Allocated (Lines 1-11) • ***Schedule E ... Change in Depreciation or Amortization*** (Ques. 1-7g)
Instructions for Completing Form 3115 ... 17 Pages	
Instructions ... Page Layout	• General & specific instructions (Pages 1-4) • Part I ... Information for automatic change request (Page 4) • Part II ... Information for all requests (Pages 4-6) • Part III ... Information for advance consent requests; discussion of scope limitations (Page 6) • Part IV ... Section 481(a) adjustment (Page 7) • ***Schedule A*** ... Change in overall method (Pages 7-8) • ***Schedule B*** ... Change to the deferral method for advance payments (Page 8) • ***Schedule C*** ... Changes within the LIFO inventory method (Page 8) • ***Schedule D*** ... Change in the treatment of long-term contracts, inventories or other Sec. 263A assets (Page 8-9) • ***Schedule E*** ... Change in depreciation or amortization (Page 9) • List of 149 ***Automatic*** Accounting Method Changes (Pages 9-17). This includes 6 previously automatic CAMs which are now obsolete.

(Continued from page 26)

3. All Revenue Procedures and/or any other guidance issued by the IRS that amplifies or modifies these controlling documents.

SCOPE LIMITATIONS ... Page 1, Item 2

If the change in accounting method can be made under the automatic filing procedures, then Part I on Page 1, must be completed. There should be no entry in the section on Page 1, immediately above Part 1, caption "Check the appropriate box to indicate the type of accounting method change being requested."

All that needs to be entered on Part 1, Item 1 is the number that the IRS has designated as the automatic change number for the change that is being requested or made. This number can be found in the list of automatic changes included in the Instructions.

Item 2, in Part I asks for confirmation as to whether any of the scope limitations in Revenue Procedure 2008-52 apply to prevent the change in method from being made under the automatic provisions. These scope limitations are discussed more fully in the Instructions to Form 3115. If any limitation applies, the check-mark or "X" in the "Yes" box acts as a red flag; but that is not necessarily a problem because there may be a provision in the terms and conditions in the Appendix to Revenue Procedure 2008-52 describing the change that specifically provides for the waiver of the scope limitation.

Accordingly, if despite the more general expression of the scope limitations, the change is permitted to be made as an automatic change, an explanation describing and/or citing the appropriate source of the waiver must be attached to Form 3115.

AUDIT PROTECTION (OR LACK THEREOF) FOR CAMs ... Page 2, Item 8

In general, one of the advantages of initiating a change in accounting method by filing Form 3115 is that the taxpayer, by volunteering to make the change (i.e., not being forced to make the change under the duress of an actual IRS audit examination) receives "audit protection." Basically this means that the IRS will not try to go back and adjust in prior years for the use of a different, or improper, method. Audit protection is a good thing.

However, the IRS does not automatically grant audit protection in all cases, even if the change in method is one that is permitted to be made under the automatic filing procedures.

Item 8 on Page 2 highlights this and requires that an explanation be attached if the question is answered in the affirmative. A check-mark or "X" in the "No" box indicates that audit protection applies.

Once again, in order to correctly respond to Item 8, it is necessary not only to review the appropriate controlling Revenue Procedures, but also to review the applicable sections of the Appendices and any guidance that the IRS might have issued after those Revenue Procedures were issued.

5-YEAR "LOOK-BACK" PERIOD ... Page 2, Item 9

The purpose of Question 9 is to extract from the taxpayer any and all information related to any activities within the past five years that involved actual, potential or defective changes in accounting methods.

The five-year look-back period relates to the year of change plus the four years preceding the year of change. If a change in method effective for 2010 is requested, the look-back analysis involves the years 2006, -07, -08, -09 and 2010. Note that this reach for information includes: (1) not only the taxpayer, but any predecessor entity and any related party and (2) all changes that may have been made regardless of whether or not they were automatic or required advance approval from the IRS.

Also, this reach for information should not be confused with the five-year look-back period which is the focus for one of the scope limitations discussed above.

If there has been a CAM during the look-back period. Part (b) of Question 9 requires only a description of the change in method that was made. There is no specific requirement to attach a copy of the Form 3115 (or the subsequent consent documentation) that was filed with the IRS in connection with the prior change.

Part (c) of Question 9 probes even deeper. There are three other situation in which the IRS wants information regarding "defective" applications. In other words, information must be submitted related to potential changes in accounting methods that arose in any of the following situations: (1) the taxpayer filed the Form 3115 and subsequently withdrew it before the change was perfected, (2) a change was previously requested, but the request was denied by the IRS, or (3) a change was previously requested, permitted by the IRS, but the taxpayer did not follow through and make the change.

IRS FOLLOW-UPS ON WITHDRAWN CAM REQUESTS

The IRS will internally follow up on withdrawn requests and/or requests where IRS declines to issue a favorable ruling. Interestingly, the IRS National Office (routinely) advises the local IRS offices in situations where the taxpayers have requested ad- →

vance permission to change an accounting method and then either withdrawn the request or failed to follow through on it.

IMPORTANCE OF THE TERM "SEPARATE TRADES OR BUSINESSES" ... Page 3, Item 13 and Page 1, Item 3

In some instances, all of the activities of a taxpayer comprise a single trade or business activity. In other instances, the activities of a taxpayer may consist of more than one separate trade or business.

The Regulations under Section 446 state the following in describing what will be considered as a separate trade or business.

"(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. ... The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

"(2) No trade or business will be considered separate and distinct ... unless a complete and separable set of books and records is kept for such trade or business.

"(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases or expenses) so that income of the taxpayer is not clearly reflected, the trades or business of the taxpayer will not be considered to be separate and distinct."

The new revisions (to Form 3115 and the Instructions) continue to use this term with no further clarifications.

One area where the "separate trade or business" distinction is important results from the proliferation of the use by many dealerships of limited liability companies and other disregarded entities or S-Corporation tiered structures. There are many planning opportunities in connection with disregarded entities ... especially single-member LLCs ... in deciding whether or not to elect LIFO for the inventory of a member of a (dealership) group that was a multi-member LLC when that dealership becomes a single-member LLC.

In one IRS Technical Advice Memorandum (TAM 199911044) that dealt with LIFO pooling questions in connection with an auto dealer's new vehicle inventory, the IRS held that a dealership with multiple franchises and several locations all in the same city could use one pool for all new cars (and a separate pool for all new light-duty trucks) because all of the dealership's activities through its multiple franchises and locations constituted a single trade or business. The TAM discussed three factors ... (1) separate geographical locations, (2) one complete set of books and records and (3) separate sales force for new vehicle sales and for service mechanics.

The concept of what constitutes "separate trades or businesses" is also important in analyzing the potential opportunity to avoid the acceleration of the Section 481(a) adjustment for the recapture of the LIFO reserve when a LIFO election is terminated. This is discussed in more detail in the situations described in ILM 200935024 (dated August 17, 2009). A complete analysis of this ILM appears on pages 33-35 of the Year-End 2009 Edition of the *LIFO Lookout*. This potential opportunity is also discussed in the article in same Edition of the *LIFO Lookout* entitled *"Dealers Low on New Vehicle Inventory at Year-End May Face Stiff LIFO Reserve Recapture ... Planning May Lessen the Blow."*

Resolving the controversy over Sec. 263A with the IRS. Another aspect of the "separate trades or businesses" concept has become increasingly more important as the IRS has stepped up its interest in how automobile dealerships are capitalizing inventory costs under Section 263A.

Can the argument be made, and sustained, that the separate departments in an automobile dealership ... (1) new vehicle sales, (2) used vehicle sales, (3) service department and (4) parts department ... should be considered separate trades or businesses?

Or, are all of these separate, departmental activities considered to be one overall integrated, single activity for purposes of Section 263A?

This could be of importance in trying to resolve Section 263A issues with the IRS, particularly in terms of the IRS' emphasis on trying to identify certain activities of the dealership as production or installation activities which are to be distinguished from other, more distinct, activities which it conducts as a reseller.

There again, can the dealership's activities as a reseller be further sub-divided into trade or business activities as (1) a retailer selling to the ultimate customer and (2) a wholesaler who is not selling to the ultimate customer? This latter distinction is significant in several of the TAM 200736026 issues, resulting in the allocation of costs between on-site and off-site storage facilities.

see **FORM 3115,** page 30

 (Continued from page 29)

Separate trade or business distinctions could become even more important where dealers are using LIFO. Some dealerships value their new vehicle inventories using LIFO (which would appear to have separate rules for the allocation of costs to ending inventory under Section 263A) while their used vehicle inventories may be valued at lower-of-cost-or-market and their parts and accessories inventories may be valued using replacement cost. In TAM 200736026, the IRS lumps all of the inventories together and would appear to apply a single ratio to the overall total dollar amount of inventory, irrespective of the valuation method used by the dealership.

As a result of so many different possible scenarios, practitioners should pay considerable attention to which or what activities of a dealership may or may not be fragmented into constituting separate trades or businesses. Here again, these determinations (or computation alternatives) will vary because different dealerships will have different fact patterns. Some dealerships do very little wholesaling (at auction) of used vehicles taken as customer trade-ins and/or dealer trades. In other dealerships, these activities may constitute a significantly larger percent of their overall activity. Some dealerships engage in extensive Internet (and other social media) selling activities, even to the point of having separate technical managers and personnel devoted solely to these activities. These differences in operations will produce significantly different results under Section 263A.

GROSS RECEIPTS INFO IS NOW REQUIRED FOR ALL INVENTORY CAMs ... Page 3, Item 17

The current revision of Form 3115 now requires that the amount of gross receipts for the last three years be reported in connection with any change in accounting method relating to inventories.

ADVANCE CONSENT REQUESTS ... Page 3, Part III

If a change in accounting method cannot be made under the automatic change procedures, then it must be made as an advance consent request. In this case, the applicant should complete the top, right-hand section of Page 1 of Form 3115 entitled "Check the appropriate box to indicate type of change being requested." The ***"Other"*** box should be checked and the change described as, ***"Change in method of capitalizing inventory costs under Section 263A."*** Or, alternatively, ... ***"Change from the [ABC] method to the [XYZ] method of capitalizing inventory costs under Section 263A."*** Do not complete Part I, Lines 1a or 1b for advance consent requests.

Part III on Page 3 contains a list of six matters or issues that must be addressed, including on Line 23 the requirement that a user fee must be paid in connection with advance consent requests.

The time for filing a Form 3115 requesting advance permission to make a change is before the end of the year for which the change in accounting method is intended to become effective.

It seems to be the consensus of practitioners with whom I've discussed the matter that a Form 3115 filed to request permission to change their current Section 263A cost capitalization methods to the so-called TAM 200736026 method would have to be filed under the ***advance consent*** procedures. The LMSB Directive gives no guidance on whether or not this Form 3115 filing request can be made as an automatic request.

→

Part III	**Information For Advance Consent Request**	**Yes**	**No**
18	Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request?		
	If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent request procedures.		
19	Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. Also, include either a discussion of the contrary authorities or a statement that no contrary authority exists.		
20	Attach a copy of all documents related to the proposed change (see instructions).		
21	Attach a statement of the applicant's reasons for the proposed change.		
22	If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed?		
	If "No," attach an explanation.		
23a	Enter the amount of **user fee** attached to this application (see instructions). ► $ ____________		
b	If the applicant qualifies for a reduced user fee, attach the required information or certification (see instructions).		

Also, a change to the so-called TAM 200736026 method does not seem to qualify as one of the various automatic changes in accounting method under Section 263A listed in the Instructions for Form 3115. In particular, Automatic Changes #22 and #23 do not even come close to fitting this situation.

CITATIONS OF AUTHORITY ... Page 3, Item 19

For changes requiring advance consent from the IRS, Item 19 requires a thorough dissertation of all matters related to the proposed change in method.

After describing all of the information that an applicant is required to provide, the Form states ... "Also, include either a discussion of the contrary authorities ***or a statement that no contrary authority exists***."

The requirement for a statement, if applicable, "that no contrary authority exists" has been added in the 2009 revision.

Query: How much research must one do before such a statement can be made with any degree of confidence or assurance? ... How extensive does your research have to be? ... Does this mean "substantial authority" based only on the sources listed in Reg. Sec. 1.6662-4(d)(3)(iii) where that term is defined?

Do you have to cite guidance issued by the IRS that has no precedential value, such as Private Letter Rulings and Technical Advice Memoranda (which are considered substantial authority in the list cited above)? ... There seems to be some conflict here.

How seriously does one have to take this requirement in order to sign the jurat that the Form 3115 preparer is required to sign?

This simple or mere "add-on" to Form 3115 deserves further clarification.

SECTION 481(a) ADJUSTMENT DETAIL ... Page 3, Item 25

Part IV relates to the adjustment required under Section 481(a). There is no material change in Questions 24-27.

When a dealership files Form 3115 to change its Section 263A inventory cost capitalization method(s), there will be a Section 481(a) adjustment.

At the present time, the uncertainty over the proper computation of the Section 481(a) adjustment attributable to any potential change in accounting method under Section 263A creates quite a dilemma - a major obstacle - for automobile dealerships considering changing their cost capitalization method to the so-called "TAM 200736026" method.

In this regard, another point for emphasis is the requirement in Question 25 that if the Section 481(a) adjustment is based on more than one component, the computation for each component should be shown. This is likely to happen in situations where a dealership is making any change in method for valuing non-LIFO inventories (for example, if it is making a change in methods for valuing its used vehicle inventory) or if it is terminating its LIFO election for new vehicles.

For example, whenever Form 3115 is being filed in connection with the termination of a LIFO election, both components of the Section 481(a) adjustment should be shown ... (1) the amount of LIFO reserve being recaptured and (2) the amount of Section 263A adjustment attributable to the termination of the LIFO election.

See page 33 for more information on the Section 481(a) adjustment and a presentation format for a Section 481(a) adjustment with 2 components.

CHANGES IN INVENTORY VALUATION METHODS

Section D, Part II on Page 6 of Form 3115 must be completed when a dealership is changing a method for valuing inventories.

In filing Form 3115 in connection with these changes, Question 3b in Part II directly confronts the dealership making the change with the onerous implications of Section 263A. This question asks: "Is the applicant's present inventory valuation method in compliance with Section 263A? If 'No,' attach a detailed explanation."

The recent activities of the IRS in connection with its concerted effort to enforce a change in procedures followed by virtually all automobile dealerships in capitalizing costs under Section 263A has been referred to earlier in this article and discussed extensively in previously Editions of the *Dealer Tax Watch*. In this article, we have already referred to the crucial interplay with Section 263A regarding (1) the concept of separate trades or businesses and (2) the two components of the Section 481(a) adjustment.

What is critical here is that the position of the IRS, as set forth in the Instructions and in the Regulations is that ***"if an applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115, the applicant must first comply with Section 263A before changing an inventory valuation method."***

Just what does this mean?

see **FORM 3115,** page 32

 (Continued from page 31)

TERMINATION OF LIFO ELECTIONS ... Page 6, Sch. D, Part II

Because of the continuing significant interest in terminating LIFO elections and the more recent emphasis by the IRS on Section 263A matters, the Mid-Year 2010 Edition of the *LIFO Lookout* includes an updated sample proforma Form 3115 filing package for terminating a LIFO election for use in connection with the December 2009 revision of Form 3115.

The "mechanics" of the process for filing Form 3115 to terminate a LIFO election are discussed fully in the *LIFO Lookout* and will not be repeated here. However, on pages 36-37, there is a brief discussion of the problematic interrelationship between (1) filing a Form 3115 to terminate a LIFO election and (2) the greater IRS emphasis on Section 263A.

COST ALLOCATION METHODS & SEC. 263A CHANGES ... Pages 7 & 8, Sch. D, Part III

These are the critical schedules that must be dealt with when filing Forms 3115 to change inventory valuation methods and/or methods of accounting under Section 263A for inventories.

This portion of Form 3115 appears on pages 34-35 with accompanying comments and observations.

CONCLUSION

In September 2009, auto dealerships were encouraged by the Director of the LMSB (in its issuance of a moratorium on pursuing Section 263A matters until January 1, 2011) to consider filing Forms 3115 to change to the Section 263A methodology espoused in TAM 200736026.

Dealerships and their CPAs are facing December 31, 2010 as a critical filing deadline if they are planning to request advance consent from the IRS to change their cost capitalization methods.

As a result, most ... if not all ... dealerships are (or should be) in a quandary over whether they should file Forms 3115 in connection with their Section 263A methods of accounting. And, if they're going to file, they should have a strategy for how they are going to complete the Form 3115.

Throughout this article, comments and observations have been included relative to some of the issues to be considered if a dealership is planning to file a Form 3115 in regard to TAM 200736026.

Practice suggestions. Consider obtaining an engagement letter from the dealer in connection with Form 3115 filings (see below) and review other suggestions on pages 38-40.

Practice Suggestion

OBTAIN A SIGNED ENGAGEMENT LETTER WHEN YOU ARE INVOLVED WITH FORM 3115 FILINGS

The Best Suggestion I Can Make. In my opinion, you should consider obtaining a signed engagement letter from the client before embarking on most, if not all, change in accounting method request filings.

Once initiated, the Form 3115 filing process may involve considerably more time and expense than originally anticipated. This likelihood increases if the IRS should require additional information to be submitted or computations to be provided, or if it raises unexpected or novel reasons for considering an adverse ruling in response to your request.

This engagement letter might (or should) include an estimate of how much time and fees might be involved in ...

(1) Accumulating information for the ruling request ... Remember complete information must be submitted and if the change involves Section 263A cost capitalization methods, computations and schedules also must be submitted,
(2) Completing the Form and drafting the narrative statements,
(3) Reviewing Form 3115 with the client after it is prepared, but before it is sent to the IRS,
(4) Discussing Form 3115 with the IRS, either by phone or in a conference in the National Office if that should become necessary, and
(5) Implementing the change in method if the IRS grants permission to make the change ... or if permission is deemed to be granted, in the case of automatic changes.

Another practical problem created by the length of time some accounting request changes take is that the taxpayer may change CPA accounting firms before the National Office completes its review and acts on the Form 3115.

If the dealership has (recently) changed CPA firms, there may be significant problems between the predecessor CPA firm and the successor CPA firm ... especially if additional information needs to be gathered before the Form 3115 can be filed or if additional information is requested by the IRS after the original Form 3115 has been submitted. (Problems of this nature are clearly illustrated in recently issued Letter Ruling 201005026.)

All of this suggests the importance having a signed, written engagement letter describing the responsibility for the accumulation of information, the computation of the transitional adjustments, if any, and the representation services to be rendered before the IRS in connection with the Form 3115 accounting method change request.

See also, *Practice Guide ... Ten Suggestions for Form 3115 Filings* on pages 38-39 & *Appendix A* on page 40

Spread Periods	***Section 481(a) Adjustments***
Sec. 481(a) Adjustment Period ... General Rules	• For a net positive Sec. 481(a) adjustment, the spread period is 4 years. • For a net negative Sec. 481(a) adjustment, the spread period is 1 year. • ***De minimis rule.*** If the net positive Sec. 481(a) adjustment for the change in method is less than $25,000, a taxpayer may elect to use a one-year Sec. 481(a) adjustment period, in lieu of the 4-year spread period. ◆ The taxpayer must complete the appropriate line on Form 3115 to elect this treatment. • ***Short period as a separate taxable year.*** If the year of change or any other taxable year during the Sec. 481(a) adjustment period is a short taxable year, the Sec. 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year.

Certain Events *"Will"* Shorten the Spread Period
 	
Section 5 of Rev. Proc. 2008-52
	• The spread period will be shortened if the taxpayer ceases to engage in the trade or business or if it terminates its existence.
	  ◆ If a taxpayer ceases to engage in a trade or business or terminates its existence, it must take the remaining balance of any Sec. 481(a) adjustment relating to the trade or business into account in computing taxable income in the taxable year of the cessation or termination.
	• In general, a taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer.
	  ◆ The "substantially all" requirement is met if ... "there is a transfer of assets representing at least 90% of the fair market value of the net assets ***and*** at least 70% of the fair market value of the gross assets held by the corporation immediately prior to the transfer.
	  ◆ This is the definition of "substantially all" that is provided in Section 3.01 of Rev. Proc. 77-37.
	• Examples of the cessation of a trade or business include...
	  ◆ The incorporation of the trade or business,
	  ◆ The purchase of the trade or business by another taxpayer in a transaction to which Sec. 1060 applies,
	  ◆ The transfer or termination of the trade or business pursuant to a taxable liquidation, or
	  ◆ The contribution of the assets of the trade or business to a partnership.

Presentation Format for Section 481(a) Adjustment with 2 Components

Beginning Inventory of Used Vehicles for the Year of Change	
Valued Under the ***Proposed*** Method *	$ 1,500,000
Valued Under the ***Present*** Method **	(1,300,000)
Difference (Positive Section 481(a) Adjustment - Increase in Computing Taxable Income) Due to Change to Lower-of-Cost-or-Market Method as of the Beginning of the Year of Change	200,000
Section 263A Costs Capitalized in Beginning Inventory for Year of Change Under ***Proposed*** Method	24,000
Section 263A Costs Capitalized in Beginning Inventory for Year of Change Under ***Present*** Method	(20,000)
Difference (Positive Section 481(a) Adjustment - Increase in Computing Taxable Income) Due to the Additional Amount of Section 263A Costs Capitalized under the Simplified Resale Method with Respect to the Inventory as of the Beginning of the Year of Change	4,000
Total - Net Positive Section 481(a) Adjustment ($200,000 + 4,000)	$ 204,000

* ***Proposed*** method for valuing used vehicles ... Cost or Lower-of-Cost-or-Market under Reg. Sec. 1.471-3(b). (Or, see also, Automatic Changes #137 & #138 in Sections 20.11 and 20.12 (respectively) of the Appendix to Rev. Proc. 2008-52.)

** ***Present*** method for valuing used vehicles ... "Dealer's Best Guess" Method.

CHANGES IN INVENTORY (SECTION 263A) METHODS
INFORMATION RE: PART III ... METHOD OF COST ALLOCATION (Pgs. 7-8)

- The caption at the top of Schedule D, Part II *(Change in Valuing Inventories Including Cost Allocation Changes)* on Page 6 of Form 3115 states ... "Also complete Part III on Pages 7 and 8."
  - This means that ***Part II of Schedule D must also be completed*** any time there is a change in the method of valuing inventories (such as a change in valuing used vehicle inventories to a permitted lower-of-cost-or-market method, the termination of the LIFO inventory valuation method, etc.).
  - This requirement to complete Part III could, or may, pose problems for automobile dealerships (as well as other taxpayers) who want to terminate their LIFO elections but who do not necessarily want to make any changes in their methods for capitalizing inventory costs under Sec. 263A at the same time.
- The Instructions for Form 3115 (on page 8-9) state that a change to or from any of the several methods available for allocating and capitalizing costs under Section 263A is a change in accounting method that requires IRS consent. Before completing Schedule D, Part III, the applicant should verify which methods are presently being used - and which methods the taxpayer proposes to use - for ...
  (1) Allocating direct and indirect costs,
  (2) Allocating mixed service costs, and
  (3) Capitalizing additional Section 263A costs.
- The Instructions list the applicable alternatives and Regulation citations for all of the choices. However, the Instructions do not provide any further explanation for any of the choices.
  - The alternative choices under (1), (2) and (3) above are also listed in Part III, Section A. (See below)
  - Under each of the three groups above, the last method listed is "any other reasonable allocation method," with citation to Reg. Sec. 1.263A-1(f)(4).
- ***Sample computations must be included*** along with the descriptions of the present and proposed methods.
- How a dealership completes Form 3115, Pages 7-8, Schedule D, Part III (Sections A, B & C) will depend on how it is handling matters related to the application of the Sec. 263A inventory cost capitalization rules to the dealership's inventories and whether the dealership is willing to agree or acquiesce to the IRS positions stated in TAM 200736026 regarding various "producer issues" and/or "on-site vs. off-site" reseller issues.
  - Production and handling activities ... 6 major issues (with sub-issues) and IRS holdings
  - Retail sales facility (i.e., reseller) issues ... 3 major issues (with sub-issues) and IRS holdings
  - Identification and allocation of costs ... 3 major issues (with sub-issues) and IRS holdings
- At this time, given the uncertainties and the lack of specific, precedential guidance from the IRS on many of these matters, it is not possible to suggest specific responses to Part III of Schedule D.
- In this regard, note particularly ...
  - "Handling, processing, assembly and repackaging costs" ... Section B *(Costs Required to Be Allocated)* ... Line 9.
  - "Off-site storage and warehousing costs" Section B *(Costs Required to Be Allocated)* ... Line 10.
  - "On-Site storage" Section C *(Costs Not Required to Be Allocated)* ... Line 9.

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Part III **Method of Cost Allocation** (Complete this part if the requested change involves either property subject to section 263A or long-term contracts as described in section 460 (see instructions)).

Section A—Allocation and Capitalization Methods

Attach a description (including sample computations) of the present and proposed method(s) the applicant uses to capitalize direct and indirect costs properly allocable to real or tangible personal property produced and property acquired for resale, or to allocate and, where appropriate, capitalize direct and indirect costs properly allocable to long-term contracts. Include a description of the method(s) used for allocating indirect costs to intermediate cost objectives such as departments or activities prior to the allocation of such costs to long-term contracts, real or tangible personal property produced, and property acquired for resale. The description must include the following:

1 The method of allocating direct and indirect costs (i.e., specific identification, burden rate, standard cost, or other reasonable allocation method).

2 The method of allocating mixed service costs (i.e., direct reallocation, step-allocation, simplified service cost using the labor-based allocation ratio, simplified service cost using the production cost allocation ratio, or other reasonable allocation method).

3 The method of capitalizing additional section 263A costs (i.e., simplified production with or without the historic absorption ratio election, simplified resale with or without the historic absorption ratio election including permissible variations, the U.S. ratio, or other reasonable allocation method).

Section B—Direct and Indirect Costs Required To Be Allocated

Check the appropriate boxes showing the costs that are or will be fully included, to the extent required, in the cost of real or tangible personal property produced or property acquired for resale under section 263A or allocated to long-term contracts under section 460. Mark "N/A" in a box if those costs are not incurred by the applicant. If a box is not checked, it is assumed that those costs are not fully included to the extent required. Attach an explanation for boxes that are not checked.

		Present method	Proposed method
1	Direct material		
2	Direct labor		
3	Indirect labor		
4	Officers' compensation (not including selling activities)		
5	Pension and other related costs		
6	Employee benefits		
7	Indirect materials and supplies		
8	Purchasing costs		
9	Handling, processing, assembly, and repackaging costs		
10	Offsite storage and warehousing costs		
11	Depreciation, amortization, and cost recovery allowance for equipment and facilities placed in service and not temporarily idle		
12	Depletion		
13	Rent		
14	Taxes other than state, local, and foreign income taxes		
15	Insurance		
16	Utilities		
17	Maintenance and repairs that relate to a production, resale, or long-term contract activity		
18	Engineering and design costs (not including section 174 research and experimental expenses)		
19	Rework labor, scrap, and spoilage		
20	Tools and equipment		
21	Quality control and inspection		
22	Bidding expenses incurred in the solicitation of contracts awarded to the applicant		
23	Licensing and franchise costs		
24	Capitalizable service costs (including mixed service costs)		
25	Administrative costs (not including any costs of selling or any return on capital)		
26	Research and experimental expenses attributable to long-term contracts		
27	Interest		
28	Other costs (Attach a list of these costs.)		

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Part III **Method of Cost Allocation** (see instructions) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses		
2	Research and experimental expenses not included in Section B, line 26		
3	Bidding expenses not included in Section B, line 22		
4	General and administrative costs not included in Section B		
5	Income taxes		
6	Cost of strikes		
7	Warranty and product liability costs		
8	Section 179 costs		
9	On-site storage		
10	Depreciation, amortization, and cost recovery allowance not included in Section B, line 11		
11	Other costs (Attach a list of these costs.)		

Sch. D ... Part II Form 3115	*TERMINATING LIFO ELECTIONS ... SECTION 263A CAM RAMIFICATIONS INFORMATION RE: PART II ... CHANGE IN VALUING INVENTORIES (Pg. 6)*

- Lines 1 & 2 ... A Narrative Statement should be attached with complete descriptions. (A proforma Narrative Statement for the termination of an automobile dealership's LIFO election for new vehicles is included in the Mid-Year 2010 Edition of the *LIFO Lookout.*)
- Lines 3a & 3b ... Question 3a in Part II on Page 6 of Form 3115 usually will be answered ... "Yes."
  - The answer to Question 3b may be problematic (especially in view of the current IRS "moratorium").
  - ***The potential implications of this statement/requirement for automobile dealerships terminating their LIFO elections are unclear.***
- The Instructions for Line 3 state: "If the applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115 the applicant must first comply with Section 263A ***before*** changing an inventory valuation method."
  - This statement should not be interpreted as having little significance. It does not contradict the statement in Rev. Proc. 2008-52 with respect to "permitted methods" (that can be used after LIFO is terminated) that "whether an inventory method is a permitted method is determined without regard to the types and amounts of costs capitalized under the taxpayer's method of computing inventory cost" under Section 263A which governs the types and amounts of costs required to be included in inventory cost. [Section 22.01(1)(b)(iii)]
- Line 4a ... *Inventory Identification Methods & Valuation Methods* ... See below.
- Line 4b ... The amounts entered in the columns as the values at the end of the year preceding the year of change under the present method and the proposed method should agree or reconcile with the amount of the net Section 481(a) adjustment related to the recapture of the LIFO reserve.
- Line 5c: *Statement Required by Section 22.01(5)* of the Appendix of Rev. Proc. 2008-52 ...
  - *"After the termination of Taxpayer's LIFO election for new vehicles, the new method of* ***identifying*** *new vehicle inventory goods is the specific identification method. After the termination of Taxpayer's LIFO election for new vehicles, the new method for* ***valuing*** *new vehicle inventory goods is cost or market, whichever is lower."*
  - This is evident the proper completion of Line 4a below.

Part II **Change in Valuing Inventories Including Cost Allocation Changes** (Also complete Part III on pages 7 and 8.)

1 Attach a description of the inventory goods being changed.

2 Attach a description of the inventory goods (if any) NOT being changed.

3a Is the applicant subject to section 263A? If "No," go to line 4a . . . . ☐ Yes ☐ No

b Is the applicant's present inventory valuation method in compliance with section 263A (see instructions)? If "No," attach a detailed explanation . . . . ☐ Yes ☐ No

4a Check the appropriate boxes below.	Inventory Being Changed NEW VEHICLES		Inventory Not Being Changed
	Present method	Proposed method	Present method
Identification methods:			
Specific identification		✓	✓ USED + PARTS
FIFO			
LIFO	✓		
Other (attach explanation)			
Valuation methods:			
Cost	✓		
Cost or market, whichever is lower		✓	✓ USED
Retail cost			
Retail, lower of cost or market . . . . R.P. 2002-17			
Other (attach explanation) PARTS / REPLACEMENT COST			✓ PARTS
b Enter the value at the end of the tax year preceding the year of change			

5 If the applicant is changing from the LIFO inventory method to a non-LIFO method, attach the following information (see instructions).

a Copies of Form(s) 970 filed to adopt or expand the use of the method.

b **Only for applicants requesting advance consent.** A statement describing whether the applicant is changing to the method required by Regulations section 1.472-6(a) or (b), or whether the applicant is proposing a different method.

c **Only for applicants requesting an automatic change.** The statement required by section 22.01(5) of the Appendix of Rev. Proc. 2008-52 (or its successor).

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Change in Valuing Inventories ... Termination of LIFO Elections ... Page 6, Schedule D, Part II

If a dealership is terminating its LIFO election, it is required to complete Page 6, Schedule D, Part II (and not Page 5, Schedule C, Part I). The dealership is also required to attach copies of Forms 970 that were filed to adopt or expand the use of the LIFO method. Literally interpreted, this requirement does not obligate the dealership to attach copies of Forms 3115 that may have previously been filed in order to make changes within the LIFO method.

Dealerships terminating a LIFO election are also required to complete Schedule D, Part III. This may require considerably more time, thought and effort than everything else in connection with the termination of the LIFO election, per se.

The aspect for immediate and significant concern lies in Question 3(b) of Part II which brings Section 263A into the picture. This question asks: ***"Is the applicant's present inventory valuation method in compliance with Section 263A? If 'No,' attach a detailed explanation."***

There will be a crucial interplay with Section 263A regarding the two components of the Section 481(a) adjustment. And, there may also be a crucial interplay with Section 263A depending on whether the dealership is attempting to apply the concept of separate trades or businesses in (partial) defense of its Section 263A methodology.

What is critical here is that the position of the IRS, as set forth in the Instructions and in the Regulations, is that ***"if an applicant is subject to, but not in compliance with, Section 263A, generally on the same Form 3115, the applicant must first comply with Section 263A before changing an inventory valuation method."***

Just what does this mean? ... "On the same Form 3115" ... "Generally?" In this regard, is there an exception for dealership LIFO terminations?

Could the IRS deny a dealership's request to terminate its LIFO election (even if it is made under the automatic filing procedure) if the dealership is not in compliance with Section 263A (as the IRS interprets proper compliance through its issuance of TAM 200736026)? In other words, could the IRS make a dealership remain on LIFO because it has not changed its method of accounting under Section 263A to comply with TAM 200736026? Or, possibly worse yet ... might the IRS take the position that there is some implied agreement or consent by a dealership that wants to terminate (or has already terminated) its LIFO election that it also agrees (or has agreed) to change to the "TAM 200736026" Method?

Section 481(a) Adjustment Detail ... Page 3, Part IV, Item 25

Part IV, spread over Pages 3-4 of Form 3115 relates to the adjustment required under Section 481(a).

The point for emphasis here is the requirement in Question 25 that ***if the Section 481(a) adjustment is based on more than one component, then the computation for each component should be shown.***

Note: See page 33 for an example of disclosure where the Sec. 481(a) adjustment consists of two components.

This requirement takes on significantly greater emphasis as a result of the heightened interest by the IRS in auto dealership cost capitalization procedures. Accordingly, whenever Form 3115 is being filed in connection with the termination of a dealership's LIFO election, both components of the Section 481(a) adjustment should be shown (in an attachment to Form 3115) ...

(1) The amount of LIFO reserve being recaptured ***and***
(2) The additional amounts of Section 263A costs attributable to the termination of the LIFO election as a result of changing the valuation of the beginning inventory for the year of change when it is not valued at LIFO ... i.e., when it is valued at Specific Identification Cost or FIFO.

At the present time, the uncertainty over the proper computation of the component of the Section 481(a) adjustment attributable to any potential change in accounting method under Section 263A creates quite a dilemma for dealerships that are terminating their LIFO elections.

In terminating their LIFO elections, some dealerships report as the amount of the Section 481(a) adjustment only the amount of the LIFO reserve being recaptured. Other dealerships will recompute their previously capitalized Section 263A costs and include this amount as a component of the Section 481(a) adjustment. Still others make no reference at all to the impact of Section 263A on the computation of the Section 481(a) adjustment. If this (i.e., the Section 263A-related) component of the Sec. 481(a) adjustment is a zero amount, then perhaps that (position) should be stated, rather than not mentioned or identified at all ... because, it is, after all, a zero amount.

Practice Guide	*TEN SUGGESTIONS FOR FORM 3115 FILINGS* Page 1 of 2
#1. *Don't Assume ...*	• Don't assume that all changes require the filing of Form 3115. • Don't assume that you can change a method under the automatic change provisions. Be sure the scope limitations do not apply or are waived by provisions in the Appendix to Rev. Proc. 2008-52. • Certain changes do not require the filing of Form 3115. ◆ Corrections of mathematical or posting errors are not changes in accounting methods. ◆ A change in treatment resulting from a change in underlying *facts* (Reg. Sec. 1.446-1(e)(2)(ii)(b)). ◆ Changes in method of accounting following certain corporate reorganizations and liquidations which are required to be made by the Regulations under Section 382. ◆ The initial election to use LIFO requires filing Form 970 with the first income tax return on which LIFO is being used, along with other filing requirements ... but it does not involve or require filing Form 3115. ◆ The extension of the LIFO inventory method to additional classes of inventory goods. This is referred to as a "subsequent" election and it involves filing a new Form 970 ... and not Form 3115. • ***Borderline situation ... Changes in sampling approaches.*** In Letter Ruling 8403009, the IRS held that a change in sampling procedure was an unauthorized change in accounting method. The taxpayer in that case had repriced only certain types of raw materials instead of repricing its entire inventory. Subsequently, as a result of what the taxpayer considered to be a change in *facts*, it computed its indexes by repricing the entire inventory. The IRS held that this change, even though intended by the taxpayer to produce a more accurate overall result, was to be treated as a change in sampling procedure made without IRS advance approval. To be on the safe side, it may be advisable to file Form 3115 in these situations. • Don't assume ***for changes that require advance approval of the IRS (i.e., filed under R.P. 97-27)...*** ◆ That if you request permission to change LIFO methods, the IRS will automatically audit prior or current income tax returns ... regardless of the nature of the reasons for your request. ◆ That just because a similar change request might have been approved without "too much trouble" a few years ago, that the current request will go through as quickly or readily as in the past. ▪ Policies and IRS personnel attitudes towards specific technical issues differ, individuals gain more experience over time dealing with technical matters, issues are litigated and decided and what seem to be relatively simple change requests may now require more background information or evaluation. ▪ Case in point ... the current situation with respect to the application of Section 263A to auto dealerships, TAM 200736026, etc. ... as discussed in other articles in the *Dealer Tax Watch.* ▪ There also may be a large backlog of Forms 3115 pending in the National Tax Office ahead of yours.
#2. *Engagement Letter*	• ***Consider obtaining a signed engagement letter before embarking on the change request process.*** • See accompanying article for further discussion of the reasons for this suggestion.
#3. *Conference Request*	• It is usually advisable to request that a conference be held in the National Office if the IRS believes that it will be unable to approve the change request.
#4. *Watch Your Language*	• Be careful to avoid disparaging or incriminating language in describing the reason(s) for requesting the change. Downplay - or at least don't elaborate on - the possible unfavorable impact of assumptions, judgments, shortcuts or other inaccuracies that may be inherent in the prior computational methods. For example, if a change from the unit or double extension methods to the link-chain, index method is being requested, justification for the request can be worded to emphasize the taxpayer's desire to have a new computational methodology that is believed to be more likely to clearly reflect income than the previous method (without going into details over the shortcomings of that previous method). • On the other hand, if there is some clear cut authority or decision in support of your change request ... such as Revenue Procedure 2008-23 for a combination of new vehicle LIFO pools ... simply cite that authority and say no more.
#5. *Citing Authority*	• If you cannot find authoritative, written support for your change request, say so ... and mention (1) the absence of any discussion on the issue (if the Code and Regulations are silent) and (2) the lack of any specific prohibition against the change you are requesting. In some instances, the National Office requests taxpayers to cite "authority" in the Code or Regulations for a requested change when, in fact, there is no formal guidance on the matter anywhere. • The Dec. 2009 revision of Form 3115 (Part III, Item 19) requires an affirmative statement if no contrary authority "exists" ... How can you be sure it doesn't exist and you just haven't found it because your research was limited (by time, resources or fee, etc., limitations)? • There is some question over exactly what constitutes "authority."

Ten Suggestions for Form 3115 Filings

#6. ***Don't Underestimate Your Professional Judgment***	• If you have a strong feeling or belief that the change you are requesting should more clearly reflect sound accounting practices, then ***say so*** ...even though you may not be able to document it with any authoritative literature on what constitutes present LIFO practices. (In some cases, there simply isn't any!) Even if your own practical experience is all you have to rely on, don't underestimate your own professional judgment as to what constitutes a reasonable effort at compliance with the "clear reflection of income" standard. • If you do not have complete prior year information relative to the index computations or methodology, provide as much background information as possible relative to the LIFO computations and the inventory size and mix so that the IRS has some overall frame of reference for considering the change request.
#7. ***Not All Computations Have to Be Submitted with Form 3115***	• ***For Section 263A CAMs filed ...*** How you complete Form 3115, Pages 7-8, Schedule D, Part III (Sections A, B & C) will depend on whether you are willing to agree or acquiesce to the IRS rationales expressed in TAM 200736026 regarding various producer and/or reseller issues and determinations. ◆ Section A requires that ***sample computations be included*** along with the descriptions of the present and proposed methods. Care should be exercised in determining how much underlying support for the computations should be included. In many instances, electing to use various *de minimis* rules may require the submission of extensive underlying information. • ***For changes within the LIFO method ...*** Very often there will be no Section 481(a) adjustment. Instead, the use of the cut-off method will be permitted or required. This will result in LIFO indexes having to be rebased to 1.000 or in the splitting or combinations of LIFO pools as of the beginning of the year of change. ◆ It is not necessary to submit proforma computations to the National Office as part of your Form 3115 filing. It is advisable to make proforma computations (in advance - even though you don't submit them) to see whether any unanticipated problems or wrinkles may come up in effecting the change.
#8. ***User Fees Could Be Significant***	• For changes requiring advance permission from the IRS, taxpayers are required to pay a user fee. In many instances, the user fees are significant ... currently, $4,200, unless the applicant qualifies for a reduced user fee. ◆ A schedule of user fees is found in Revenue Procedure 2010-1, Appendix A. • These fees should be discussed with the taxpayer in advance, so the taxpayer is not surprised when it is presented with the Form 3115 for filing ***and*** a reminder to pay the user fee. • If the taxpayer missed the deadline for filing and is requesting an extension of time to file Form 3115, there are special procedures and the payment of a separate user fee (for considering the extension request) is required ... currently, $5,000, in addition to the $4,200. • ***For Section 263A CAMs filed under advance consent procedures ...*** Consider requesting a refund of the user fee if the IRS determines that the change request qualifies under the automatic change procedures.
#9. ***If Time Runs Out & You Have to File a Tax Return***	• One of the practical problems with Form 3115 filings that require advance approval from the IRS is that the request process may take so long in the IRS National Office that the taxpayer requesting the change will have to file a tax return for the year of change before it knows whether or not permission to change methods will be granted. • ***For Sec. 263A CAMs filed under (R.P. 97-27) advance consent procedures ...*** This could be a problem. • See ***Appendix A*** for this *Practice Guide ... What if Tax Returns for the Year of Change Are Due Before the IRS Grants Advance Approval to Make the Change?*
#10. ***If You Have Second Thoughts About Making the Change***	• ***Withdrawing a request.*** After filing Form 3115, a taxpayer may decide that it doesn't want to make the change in method after all. In the case of Forms 3115 that are filed under Rev. Proc. 97-27 advance consent procedures, a taxpayer may withdraw its request. ◆ In many instances, the National Office will notify the local office of the IRS that a change in method of accounting has been withdrawn. ◆ It is unlikely that the IRS will refund the user fee. ◆ In the case of changes made under the designated automatic change filing procedures, it appears that the only recourse is the filing of an amended return. This could be very messy. • ***Declining to make the change after permission is granted.*** Even if a taxpayer receives a letter from the IRS National Office granting permission to change, it still does not have to make those changes. ◆ The IRS allows the taxpayer 45 days in which to make a ***final*** decision as to whether that change will be made or not for the year in question. This is usually stated in the closing paragraphs in the change approval letter the IRS sends back. Therefore, if the IRS approves the change requested, don't necessarily assume that you are required to make that change.

This is an updated revision of a **Practice Guide** *that first appeared in the* **LIFO Lookout** *15 years ago.*

Appendix A (Practice Guide)	***FORM 3115 FILING SUGGESTIONS*** ***WHAT IF THE TAX RETURN FOR THE YEAR OF CHANGE IS DUE BEFORE THE IRS GRANTS APPROVAL TO MAKE THE CHANGE?***
Overview	• For changes which require advance permission from the IRS before they may be made (i.e., for advance consent requests), one of the practical problems with Form 3115 filings is that the request process may take so long in the IRS National Office that the taxpayer requesting the change will have to file its tax return for the year of change before it knows whether or not permission to change methods will be granted. • ***For Section 263A CAMs filed under advance consent procedures (i.e., filed under Rev. Proc. 97-27)...*** This could be a significant problem because of the lack of guidance and/or clarification from the IRS on many Section 263A dealership issues. ◆ If a dealership wants to change to the so-called "TAM 200736026" method effective for calendar year 2010, Form 3115 must be filed before December 31, 2010 if it is being filed under the advance consent procedures.
The Technical Requirement	• Technically, until the taxpayer receives official permission from the IRS to change methods, it cannot unilaterally change from its current method. • From this it follows that the taxpayer is required to file its tax return (for the year of change) using the old method(s) and then, when or if permission to change methods is eventually received, it should file an amended tax return using the new method. • This requirement is consistently expressed in the Regulations, Form 3115 Instructions, etc.
Ramifications, Practical Difficulties	• (Many) state income tax returns and/or personal property tax returns are dependent on amounts reported in Federal income tax returns. • Many taxpayers filing Forms 3115 are flowthrough entities (i.e., S-Corporations, partnerships, LLCs - disregarded entities, etc.) often with many shareholders, partners or members. ◆ All tax returns for individual shareholders, partners or members of the flowthrough entity (Federal, as well as state) would also need to be filed using the old method and then (years?) later amended to reflect the new method, if permission to change is granted. • Significant costs are attendant with any and all of these multiple filings. • These considerations, and others, create practical problems for taxpayers and their CPAs who often will have to decide whether to file the tax return (for the year of change) using the "old" or previous method or to file the tax return using the "new" computation method(s) being requested.
Alternatives	• In some cases, because the IRS review process is expected to be so lengthy (especially in cases where the taxpayer is required to submit additional information), the taxpayer may request to defer the year of change from the year originally specified on the Form 3115 to the following year. • Alternatively, taxpayers who have filed Forms 3115 under the advance consent procedures frequently decide to file their income tax returns for the year of change, (1) assuming that the requested change will be permitted by the IRS and (2) using the "new" computational method and/or employing the change(s) requested.
Suggested Disclosures if Tax Return Is Filed Reflecting the Change before IRS Grants Permission to Change	• Disclose in a statement attached to the tax return being filed that a Form 3115 change in method request is pending in the National Office from the "old method" to the "new method" and that the new method has been reflected in the tax return that is being filed for the year of change. • State in the attachment to the income tax return that if permission to make the change is ***not*** granted, the taxpayer will file an amended return for the year reflecting the former method. • Also state that if permission to change is received, a copy of the consent (i.e., permission) letter from the IRS National Tax Office will be associated with the current year return being filed for the year of change by filing a copy of it as part of an amended return: Form 1120-X. • Answer all inventory questions on Form 1120, Form 1120-S or From 1065 to indicate that a change in method of accounting has been made. The boxes in the Cost of Goods Sold/Inventories sections should also be checked indicating that a change has been made so that the IRS has obvious notice on the face of the tax return as to what is going on in computing the valuation of the ending inventory. • ***Caution:*** If the income tax return is filed reflecting the change before permission to change is granted, that may raise a question as to how Form 8275-R, the *Regulation Disclosure Statement*, is supposed to tie in with the disclosure of items or positions that are contrary to Treasury Regulations. Also, consider new ***Schedule UTP*** filing requirements and implications.

BUSINESS ACQUISITIONS & THE BROAD REACH OF SECTION 197

The recent Tax Court decision in *Recovery Group, Inc., et al.* (T.C. Memo 2010-76) sheds more light on writing-off costs to be capitalized in connection with business acquisitions.

In *Recovery Group, Inc.*, an S-Corporation redeemed all of the stock that was held by a minority shareholder. This shareholder was also a key employee. In addition to paying him for his 23% interest in the corporation's stock, the corporation paid him $400,000 for his covenant not to compete for one year. The corporation deducted the $400,000 pro rata over the 12 months the covenant was in effect.

The IRS took the position that this payment should have been amortized over 15 years as a Section 197 intangible. The Tax Court agreed with the IRS on the treatment of this covenant.

FACTS

The total amount that Recovery Group, Inc. (i.e., the Company) paid for the employee's 23% stock ownership was slightly in excess of $800,000. Out of this amount, $400,000 was described in the itemized buyout payment statement as having been paid for the key employee's "noncompetition payment."

Interestingly, the president of the Company and the Company's CPA did not discuss the tax implications of the treatment of the noncompetition payment. They both testified that deductibility was not a consideration in the structuring of the deal. The president said that he just assumed that the tax treatment of the payment would be whatever the accountants determined it should be.

The CPA firm servicing this Company assigned two high-level individuals to this account. One was the relationship partner and the other was a tax specialist in the CPA firm who had extensive experience. This specialist "consulted case law, together with the statutory language, regulations and legislative history of Section 197," and after his research, he concluded that the covenant not to compete was not a Section 197 intangible, and thus, the 15-year amortization period requirement was not applicable.

SECTION 197 & *FRONTIER CHEVROLET, INC.*

At first blush, one might ask ... By what reasoning could the payment for this covenant not be subject to Section 197? The answer to that question is what makes this case worth further study. It demonstrates the depth of research and reasoning employed by the Company's CPA firm.

In analyzing the application of Section 197 to this case, the Tax Court drew distinctions between the facts in this case and the facts in *Frontier Chevrolet Co. v. Comm.* The Tax Court decision in *Frontier* was analyzed in the June 2001 issue of the *Dealer Tax Watch* (pages 6-10), and the Court of Appeals decision (which upheld the Tax Court's decision) was analyzed in the June 2003 issue of the *Dealer Tax Watch* (pages 8-10).

The essential distinction was that in this case (i.e., *Recovery Group*), the stock interest in the Company being acquired was a minority (23%) interest. In contrast, in *Frontier Chevrolet*, the stock interest in the company being acquired was a majority (75%) interest.

The Tax Court's detailed analysis in *Recovery Group, Inc.* parsed the wording used in the term *"an interest in a trade of business"* and whether the word "*interest*" means an ownership interest of any percentage, large or small. Further, there was a disagreement between the IRS and the Company over the antecedent of the word *"thereof"* in the statutory language.

Section 197 states, "In general ..., the term 'Section 197 intangible' means ... any covenant not to compete ... entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof ... ."

The IRS took the position that it was immaterial whether the key employee's stock interest in the Company would be characterized as *"substantial."* The Tax Court agreed, and it also held, in the alternative, that a 23% stock interest ***is*** substantial. The Tax Court cited the Report of the House Conference Committee which states that, in effect, when Congress used the term *"an interest in a trade of business or substantial portion thereof,"* it was referring to a substantial portion of a trade or business - and not a substantial portion of ***an interest in*** a trade or business.

The phrase *"interest in"* was included with reference to covenants not to compete in order to make it clear that the acquisitions that trigger the application of Section 197 encompass "not only the assets of a trade or business, but also acquisitions of the stock in a corporation that is engaged in a trade or business." In other words, Section 197 is intended to apply to indirect (as well as to direct) acquisitions of an interest in a business. Accordingly, the Tax Court concluded

see **SECTION 197**, page 42

(Continued from page 41)

that this term included minority interests in a company, as well as controlling or majority interests.

The Tax Court's analysis of the Section 197 and its purpose is divided into three parts ... (1) the meaning of *"interest,"* (2) the antecedent of *"thereof"* and (3) what interest would be *"substantial"*? These detailed analyses should be read in order to appreciate the technical intricacies and interpretations of these *words*.

In analyzing the contrast of this case with *Frontier Chevrolet*, the Court observed that in both cases the departing shareholder, (whose interest in the business was being acquired) agreed to refrain from competing with the company and received consideration, not only for stock, but also for the covenant not to compete. Each key employee's covenant not to compete protected the company against competition from a former shareholder and both companies obtained the covenants via redemptions involving their acquisition of "an interest in a trade or business."

In *Frontier Chevrolet*, the dealership corporation redeemed a 75% shareholder, and the remaining shareholder (i.e., the shareholder who owned 25% before the redemption occurred) became the sole shareholder after the redemption was completed. Recovery Group, Inc. relied heavily upon the fact that none of its remaining shareholders obtained a controlling interest in the company as a result of the redemption of the key employee's stock by the Corporation.

The Tax Court said that it did not interpret Section 197 to require the acquisition of a controlling interest. Furthermore, it said that it did not find this conclusion to be inconsistent with either the Tax Court opinion or the Court of Appeals opinion in *Frontier Chevrolet*.

In *Frontier Chevrolet* (where the 75% interest was involved), the Court held that a redemption of stock qualifies as a direct or indirect acquisition of an interest in a trade or business for purposes of Section 197. Furthermore, the acquiring dealership corporation had entered into the covenant not to compete with the departing key employee in connection with its acquisition of an interest in a trade or business and therefore the amortization of the cost of the covenant over 15 years was required by Section 197.

The Court of Appeals for the Ninth Circuit confirmed that Section 197 "only requires taxpayers to acquire an interest in a trade or business," not "an interest in a ***new*** trade or business."

In its opinion in *Frontier Chevrolet*, the Court of Appeals said,

"Accordingly, the only issue we address is whether a redemption of 75% of a taxpayer's stock constitutes an indirect acquisition of an interest in a trade or business for purposes of Section 197. We need not and do not decide whether all stock redemptions made in connection with an execution of a covenant not to compete constitute an acquisition of an interest in a trade or business within the meaning of Section 197."

The Tax Court said that in this case (i.e., *Recovery Group*), it was answering "a question not asked in *Frontier Chevrolet* ... namely, whether a corporation that redeems not 75%, but only 23% of its stock thereby makes 'an acquisition (directly or indirectly) of an interest in a trade or business'."

TAX COURT HOLDINGS

The Tax Court sustained the IRS on all three of its positions. ***First,*** Recovery Group's redemption of 23% of its stock was an acquisition of an interest in a trade or business. ***Second,*** the key employee/shareholder's covenant not to compete was therefore a Section 197 intangible. ***Third,*** Recovery Group, Inc. was required to amortize the $400,000 it paid for that covenant not to compete over 15 years under Section 197.

ACCURACY-RELATED PENALTIES

In this case, the IRS assessed accuracy-related penalties under Section 6662 because the accelerated deductions over the 12-month period resulted in significant underpayments of tax in the two taxable years over which the 12 months of the noncompete period were spread.

The Tax Court held that the accuracy-related penalties should not be assessed because the corporation had relied on competent, fully-informed professionals to prepare its tax returns. This reliance satisfied the reasonable cause and good faith exception that avoids liability for the penalty.

The Tax Court's reasoning ... discussed on pages 43-45 ... provides an excellent refresher on how these penalties may be avoided.

CONCLUSION

The Tax Court's opinion in *Recovery Group, Inc.*, sheds more light on the broad reach of Section 197 in situations where interests in business are being acquired. It clarifies that Section 197 will apply regardless of whether the interest in the business being acquired is more than 50% or less than 50%.

It also demonstrates that covenants not to compete entered into with departing, key employees (who may or may not also be shareholders) are usually an integral part of direct and/or indirect business acquisitions.

Accuracy-Related Penalties Were Not Assessed in Recovery Group, Inc.

Overview

In *Recovery Group, Inc.*, the IRS assessed accuracy-related penalties under Section 6662 against the corporation (Recovery Group) because the deductions for the key employee's 12-month noncompete agreement were taken in the two tax returns for the years which the noncompete agreement straddled (i.e., 2002 - the year in which it started and 2003 - the year in which it ended).

These (accelerated) deductions in 2002 and 2003 resulted in ***substantial*** understatements of income tax in both tax returns filed by Recovery Group. The allocation of the $400,000 paid between those two years (rather than over the 15-year period 2002-2016 required by Sec. 197) resulted in a deduction of roughly $167,000 in 2002 and $233,000 in 2003.

In relation to amounts reported in Recovery Group's tax returns, these amounts constituted less than 2% of the deductions reported for those years. This relatively small perspective for these amounts did not deter the IRS from assessing accuracy-related penalties.

The Tax Court held that the accuracy-related penalties should not be assessed because Recovery Group had relied on "competent, fully-informed professionals" to prepare its tax returns. This reliance satisfied the reasonable cause and good faith exception that avoids liability for the penalty.

General Principles w/r/t Section 6662 ... Accuracy-Related Penalties

Section 6662 imposes an "accuracy-related penalty" of 20% of the portion of the underpayment of tax attributable to any substantial understatement of income tax.

By definition, an understatement of income tax for an S-Corporation is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return.

The IRS bears the burden of production and must produce sufficient evidence showing the imposition of the penalty is appropriate in a given case (Section 7491(c)). Once the IRS meets this burden, the taxpayer must come forward with persuasive evidence that the IRS' determination is incorrect.

A taxpayer who is otherwise liable for the accuracy-related penalty may avoid the liability if it successfully invokes one of three provisions ...

(1) Where the taxpayer had substantial authority for its treatment of any item giving rise to the understatement, [Section 6662(d)(2)(B)(i)], ***or***

(2) Where the relevant facts affecting the item's treatment are adequately disclosed ***and*** the taxpayer had a reasonable basis for its treatment of that item, [Section 6662(d)(2)(B)(ii)], ***or***

(3) If the taxpayer shows that there was reasonable cause for a portion of an underpayment and that it acted in good faith with respect to such portion [Section 6664(c)(1)].

Accordingly, if the taxpayer can meet any one of the three exceptions above, no accuracy-related penalty will be imposed with respect to the portion of the penalty that relates to the exception that can be shown to exist.

Whether the taxpayer acted with reasonable cause and in good faith depends on the pertinent facts and circumstances, including its efforts to assess its proper tax liability, its knowledge and experience, and the extent to which it relied on the advice of a tax professional [Reg. Sec. 1.6664-4(b)(1)].

The IRS Determined that There Were *"Substantial Understatements"*

Recovery Group reported negative taxable income for both 2002 and 2003. The IRS determined built-in gains tax for both years and deficiencies of $46,138 for 2002 and $70,011 for 2003, and the Tax Court upheld these determinations.

Recovery Group's understatement for each year thus exceeds both $5,000 and 10% of the tax required to be shown on its return. Both understatements are, therefore, substantial. The IRS has carried the burden of production imposed by Section 7491(c). Therefore, Recovery Group bears the burden of proving any defenses, such as (1) substantial authority, (2) disclosure and reasonable basis and (3) reasonable cause and good faith.

The accuracy-related penalty is mandatory. Sec. 6662(a) provides that it "shall be added."

Accuracy-Related Penalties *Were Not Assessed in* Recovery Group, Inc.

Defense #1 ... Substantial Authority for Positions Taken

The Law ...

- Only where the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary positions does substantial authority for a tax treatment exist.
- The substantial-authority standard is less stringent than the more-likely-than-not standard (met only when the likelihood of a position being upheld is greater than 50%).
- However, the substantial-authority standard is more stringent than the reasonable-basis standard [Reg. Sec. 1.6662-4(d)(2)].
- "Substantial authority" is found in... the Internal Revenue Code and other statutes, Regulations construing the statutes, case law and legislative intent reflected in committee reports [Reg. Sec. 1.6662-4(d)(3)(iii)].
- The weight of an authority depends on its source, persuasiveness and relevance [Reg. Sec. 1.6662-4(d)(3)(ii).

Application to the Case ... What the Tax Court Said

The CPA firm's tax specialist testified that the legislative history convinced him that some covenants not to compete could still be amortized over their useful lives under Section 167. He was correct in that conclusion ... ***Section 197 attaches only to certain covenants not to compete*** (i.e., those acquired in connection with the acquisition of an interest in a trade or business or substantial portion thereof).

However, the tax specialist's reliance on the Court of Appeals' ***footnote #2*** in *Frontier Chevrolet Co. v. Comm.* (329 F.3d at 1134), was misplaced. The Court of Appeals in *Frontier* stated that it need not and did not decide whether all stock redemptions constitute acquisitions of interests in a trade or business. The Court left that question for another day. The most that can be said in Recovery Group's favor is that *Frontier Chevrolet* did not foreclose the argument that a 23% redemption is not an acquisition of an interest in a trade or business; but that does not affirmatively support that argument.

While "a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision" [Reg. Sec. 1.6662-4(d)(3)(ii)] in these cases, Recovery Group used its ***unwarranted extrapolation from the footnote*** in *Frontier Chevrolet* to impute into the statute a requirement that the interest acquired be a majority interest or some substantial interest greater than 23%. T***his is not a well-reasoned statutory construction.***"

Therefore, Defense #1, the substantial authority exception, does not apply.

Defense #2 ... Disclosure & Reasonable Basis for Treatment

The Law ...

- Provided the taxpayer adequately disclosed the relevant facts affecting the tax treatment of an item and had a reasonable basis for its treatment, no accuracy-related penalty may be imposed for a substantial understatement of income tax with respect to that item. [Sec. 6662(d)(2)(B)(ii); Reg. Sec. 1.6662-4(e)].
- A taxpayer may adequately disclose by providing sufficient information on the return to enable the IRS to identify the potential controversy [*Schirmer v. Comm.*, 89 T.C. 277 (1987)]. Recovery Group fails to qualify for this defense because it did not adequately disclose the item at issue.

Application to the Case ... What the Tax Court Said

Recovery Group's returns for the years in issue list the deductions for the covenant not to compete as individual line items on two statements itemizing "other deductions" for each year. These entries recite "non compete expense" and the amount deducted. They provide no further details, such as Recovery Group's entering into this covenant not to compete in the redemption transaction with the key employee/shareholder whose stock interest was being redeemed.

The Court found that Recovery Group's tax returns ***did not include sufficient facts*** to provide the IRS with actual or constructive knowledge of the potential controversy involved with Recovery Group's deduction of the cost of the covenant not to compete. While Recovery Group did list the deduction on its return, ***merely claiming the expense was insufficient to alert the IRS*** to the circumstances of the acquisition of the covenant or the decision by Recovery Group's accountants not to treat the covenant as an amortizable Section 197 intangible.

Therefore, Defense #2, the adequate disclosure exception, does not apply.

ACCURACY-RELATED PENALTIES WERE NOT ASSESSED IN RECOVERY GROUP, INC.

Defense #3 ... Reasonable Cause ... Reliance on Professional Advice

The Law ...

A taxpayer may be able to demonstrate reasonable cause and good faith ... and thereby escape the accuracy-related penalty of Section 6662 ... by showing its reliance on professional advice [Reg. Sec. 1.6664-4(b)(1)].

However, reliance on professional advice is not an absolute defense to the Section 6662(a) penalty. (See *Freytag v. Comm.*, 89 T.C. 849, 888 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. 501 U.S. 868 (1991))

A taxpayer asserting reliance on professional advice must prove that...

(1) His adviser was a competent professional with sufficient expertise to justify reliance,
(2) The taxpayer provided the adviser necessary and accurate information, ***and***
(3) The taxpayer actually relied in good faith on the adviser's judgment.
(See *Neonatology Associates, P.A. v. Comm.*, 115 T.C. 43, 99 (2000), affd. 299 F.3d 221 (3d. Cir. 2002))

Application to the Case ... What the Tax Court Said

Mr. Orleans, a Certified Public Accountant, was involved with the buyout agreement from the beginning, and he had access to correct information and to all the information he needed to properly evaluate the tax treatment of the cost of the covenant. In turn, Mr. Orleans relied on Mr. Troy ... another qualified professional and tax specialist in his CPA firm ... to determine the tax treatment of the covenant not to compete.

The president of Recovery Group testified that he was a businessman - not a tax expert - and that he hired accountants to ensure that his company's books were properly kept and its tax returns were properly filed.

The Court was satisfied that (1) Recovery Group's accountants were competent professionals with sufficient expertise to justify Recovery Group's reliance, that (2) they had the necessary information, and that (3) Recovery Group actually relied on its accountants in good faith.

The Supreme Court has said: "When an accountant or attorney ***advises*** a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. ..." [*United States v. Boyle*, 469 U.S. 241, 251 (1985)]

In *Recovery Group, Inc.*, the Tax Court said, "Neither the special rules for the amortization of intangibles that Congress enacted in Section 197, nor the rule in Section 197(d)(1)(E) applying that regime to covenants not to compete, nor the exception for such covenants when they are not 'entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof' ... none of these provisions is likely to be known even to the sophisticated manager of a business like Recovery Group. Much less are these rules intuitive. With the Internal Revenue Code as complicated as it is, corporate taxpayers with even moderately complex transactions are effectively required to consult tax professionals to prepare their returns. When they do consult such professionals, when they disclose their facts, and when they then rely on the advice they are given, they should not be penalized ... and Section 6664(c) assures that they will not be."

Conclusion... The Tax Court held that Recovery Group had established that it had reasonable cause and acted in good faith with respect to the substantial understatements of income tax for the years in issue.

Therefore, Defense #3, the reasonable cause exception, has been satisfied, and the accuracy-related penalty will not be sustained.

Note... Under Section 6662(b)(1), the accuracy-related penalty is also imposed where an underpayment is attributable to the taxpayer's negligence or disregard of rules or Regulations. However, the IRS had demonstrated that Recovery Group substantially understated its income tax for the years in issue for purposes of Section 6662(b)(2).

Therefore, the Court said that it did not need to consider whether, under Section 6662(b)(1), Recovery Group was negligent or disregarded rules or Regulations.

ALLOCATION OF PROFESSIONAL FEES PAID IN THE ACQUISITION OF A DEALERSHIP ... *WEST COVINA MOTORS, INC.* REVISITED

In the Mid-Year 2009 Edition of the *Dealer Tax Watch*, we analyzed the decision of the Tax Court in *West Covina Motors, Inc.* (T.C. Memo 2008-237). This case involved several issues related to the deductibility of legal fees paid by the dealership and writedowns for year-end used vehicle inventories.

The Tax Court had held that all of the legal fees in question were not deductible by the dealership and that none of the writedowns of the inventory were deductible, either. In addition, the Tax Court held that the dealership was liable for accuracy-related penalties.

However, on December 16, 2009, the Tax Court issued a Supplemental Memorandum Opinion in which it reconsidered ***only*** the deductibility of the professional fees that the dealership had paid in connection with the acquisition of another dealership's assets.

This time, the Tax Court allowed the deduction for the professional fees ... after they were properly allocated to the asset classes acquired.

IN THE TAX COURT ... THE FIRST TIME

West Covina Motors had paid about a $140,000 in professional fees to lawyers, CPAs and others in connection with its acquisition of Clippinger Chevrolet. These fees were paid over the two-year period (1999-2000) when the negotiations were in process and finalized.

During the IRS audit of the dealership and throughout all of the discussions with the IRS at various levels and in preparing stipulations for the proceedings in the Tax Court in 2008, the dealership apparently did not take the time nor make the effort to properly substantiate and document these professional fees. Also, the dealership did not submit any itemized billings for services rendered that it had paid to the professionals.

The first time in the Tax Court, West Covina had taken the position that all of the professional fees were currently deductible (1) because those fees either related entirely to inventory financing or physical inventory and (2) because 80%-90% of the purchase price of the Clippinger assets was incurred for the purchase of inventory.

The Tax Court did not agree with West Covina. The Court held that these fees were nondeductible capital expenditures because (1) they were incurred in connection with the purchase of a capital asset and (2) West Covina did not provide necessary evidence concerning the total purchase price or the amounts paid for inventory.

Poor preparation & poor performance. In the Tax Court trial, the Court 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. Also, 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.

On top of that, the Tax Court found that the accountant's testimony on this issue was not credible, and the dealership's records contradicted several of the arguments it advanced.

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.

IN THE TAX COURT ... THE SECOND TIME ... TWO ISSUES

After the initial decision by the Tax Court, the dealership filed a motion for reconsideration. This motion was accepted by the Court for the limited purpose of accepting evidence regarding the allocation of the legal/professional fees paid in connection with the acquisition of Clippinger Chevrolet and the proper period of amortization or deduction for those fees.

Significantly, before the reconsideration by the Tax Court this time, the dealership and the IRS agreed and stipulated to all of the additional facts that would be necessary to address these two issues.

In its Supplemental Memorandum Opinion, the Tax Court considered only two issues.

First issue ... Was any portion of the professional fees related solely to inventory? ***And,*** if so, when should those fees be allowable as an increase in the dealership's deduction for Cost of Goods Sold? (This deduction is an offset against net sales in determining the gross profit for the dealership.)

Second issue ... Was any portion of the remaining fees allocable to the acquired assets? ***And,*** if so,

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over what period of time should those fees be deducted or amortized?

ACQUISITION TRANSACTION

Mr. Alhassen, the dealer, had entered into an agreement to purchase (purchase agreement) the assets of Clippinger Chevrolet (Clippinger), an established new car dealership in Covina, California. Mr. Alhassen assigned the purchase rights to his corporation, West Covina Motors, Inc., which consummated the purchase agreement with Clippinger in November 1999. West Covina Motors paid $6,050,601 for certain assets of Clippinger. It paid $3.5 million for goodwill, $2,300,600 for inventories of used vehicles and parts, $250,000 for fixed assets, and $1 for miscellaneous assets.

The dealership and the IRS further agreed that West Covina acquired Clippinger's new and demonstrator vehicle inventory for an additional $6,258,074. This inventory was subject to a $6,421,047 floorplan line of credit.

Accordingly, the total purchase price for all of the Clippinger assets was $12,308,675 ($6,050,601 for assets under the purchase agreement plus the $6,258,074 that was separately paid for new and demonstrator vehicle inventory).

PROFESSIONAL FEES PAID

In 1999, West Covina paid acquisition-related legal fees of $116,293 to Clippinger's counsel, Mr. Norman Hoffman. Most, if not all, of the fees paid to Mr. Hoffman were for drafting multiple loan documents and leases related to a seller-financing arrangement for the assets purchased under the purchase agreement.

Apparently, when West Covina Motors was unable to proceed with the acquisition transaction on a cash basis, Clippinger Chevrolet required West Covina to assume responsibility for the payment of the legal fees that Clippinger had incurred for structuring the seller-financing arrangement.

West Covina also paid $2,958 to Chrysler Financial in 1999 and $9,564 to Cooksey, Howard, Martin & Toolen in 2000. These fees were paid primarily for document review and other services related to inventory financing.

Finally, West Covina had paid $9,550 to Rogers, Clem & Company, CPA's in 2000 in connection with the Clippinger acquisition. These fees were related to the overall Clippinger acquisition as well as to the physical inventory of the vehicles. Approximately $6,675 of the $9,550 paid to Rogers Clem was paid for service related to the physical inventory (i.e., physical counts, reconciliation of physical count to various schedules, etc.)

The final tally was that West Covina Motors, Inc. had paid a total of $138,365 for professional fees (legal and other) related to the Clippinger Chevrolet acquisition.

FEES 100% ATTRIBUTABLE TO INVENTORY

As a result of the new stipulated facts and other information regarding the transaction, the Tax Court reviewed the treatment of the professional fees attributable entirely (i.e., solely or 100%) to inventory and the proper allocation of any remaining acquisition-related fees and their period of amortization.

To the extent that fees were properly attributable solely to inventory, they would be allowable as part of the cost of goods sold deduction. At the original trial in the Tax Court, West Covina had not properly substantiated the fees it claimed were associated entirely with inventory. Subsequently, however, the IRS and the dealership stipulated further evidence regarding these fees, including itemized billing statements from the respective attorneys.

The Tax Court held that the legal fees paid to Chrysler Financial ($2,958) and to Cooksey ($9,564) were attributable to inventory financing. The Court further found that $6,675 of the amount paid to Rogers Clem CPAs was for services related to physical inventory of the vehicle inventory. Accordingly, these fees totaling $19,197 were allowable as part of the costs of goods sold deduction.

In this regard, the IRS and West Covina had stipulated that 40% of any fees attributable to cost of goods sold would be deductible in 1999 (the year of acquisition) and the remaining 60% would be deductible in the following year - 2000.

ALLOCATION OF OTHER FEES (THAT WERE NOT 100% ATTRIBUTABLE TO INVENTORY)

The Tax Court next turned its attention to how to treat the remaining fees that were paid in the amount of $119,168 ($116,293 paid to Clippinger's attorney, Mr. Hoffman and $2,875 paid to Rogers Clem, CPAs).

In this regard, the Tax Court made a distinction between the legal fees paid to Mr. Hoffman and the "accounting" or other fees paid to Rogers Clem, CPAs.

Clearly, these amounts were not specifically or exclusively related to inventory, but instead were capital expenditures related to the Clippinger acquisition. As such, these expenditures must be amortized over the useful life of the assets to which they relate.

see *WEST COVINA MOTORS, INC.*, page 48

(Continued from page 47)

The Court held that the legal fees paid to Mr. Hoffman were incurred in furtherance of the seller-financing agreement and were related ***only to the assets purchased under the purchase agreement.*** However, the remaining professional fees of $2,875 paid to Rogers Clem were related to the ***overall*** Clippinger purchase and had to be allocated accordingly.

Although the IRS and West Covina had agreed and stipulated as to the amounts paid for each category of assets, they disagreed on how these fees should be allocated among the assets.

The IRS took the position that the fees must be allocated in accordance with the fair-market-value limitations of Section 1060, which applies to certain asset acquisitions. As a result, the IRS argued that the fees must be allocated under Section 1060 to *Class V Intangible Assets,* which class includes goodwill and going concern value. Accordingly, the IRS argued that under Section 197, the fees must be amortized ratably over 15 years, with amortization beginning in the month of purchase.

West Covina did not dispute that its purchase of Clippinger assets constitutes an "applicable asset acquisition" under Section 1060. Its argument, however, was that Section 1060 was not applicable in this case because there was no controversy over the allocation of the purchase price to these assets. In their second appearance before the Tax Court, there was no controversy between the IRS and West Covina Motors because they had agreed and stipulated that $8,808,675 was allocated to *Class III Assets*, and $3,500,000 was allocated to goodwill.

TREATMENT OF LEGAL FEES PAID TO HOFFMAN

The IRS could not cite any authority that would require legal fees to be allocated under the fair-market-value limitations of Section 1060 where the parties have stipulated the cost of each asset. And, the Tax Court could not find any authority to that effect, either.

Section 1060 is meant to prevent abuse where there is no agreement between the parties concerning how much of the purchase price is allocable to which category of assets. The residual allocation method prevents the parties from taking inconsistent positions for individual tax advantages.

The Tax Court disagreed with the IRS' position and agreed with West Covina because the parties had stipulated the cost of each asset. Therefore, Section 1060 did not apply. It is helpful for our purposes to discuss the Court's analysis in concluding that Section 1060 was not applicable. (See page 53: *"What the Tax Court Said About the Inapplicability of Section 1060 to* West Covina Motors, Inc.")

Having lost on the application of Section 1060 argument, the IRS had made no alternative argument as to how the acquisition-related legal fees should be allocated. Therefore, the Tax Court agreed with West Covina that the legal fees should be allocated proportionately to the assets with which they are associated.

The parties (i.e., the IRS and West Covina) had stipulated that Mr. Hoffman had been paid to draft documents related to the seller-financing arrangement. Therefore, the Court concluded that the legal fees paid to Mr. Hoffman should be allocated pro rata among the assets acquired under the purchase agreement. These assets included all assets except the new and demonstrator car inventory.

Accordingly, the legal fees paid to Mr. Hoffman were to be allocated to fixed assets (4.1%), goodwill (57.9%) and used vehicle and parts inventories (38%).

TREATMENT OF OTHER FEES PAID TO CPAs

The Court held that the balance of the professional fees paid to Rogers Clem (the CPAs), excluding the amount paid for physical inventory, should be allocated proportionally among ***all*** of the assets that were purchased by West Covina.

Because the parties had stipulated the allocation of the Clippinger purchase price, these fees should be allocated to fixed assets (2.03%), goodwill (28.44%), used vehicle and parts inventories (18.69%) and new and demonstrator vehicle inventories (50.84%).

RECOVERY PERIODS

The IRS and West Covina had also stipulated the period of amortization or deduction for fees allocated to each category of assets. The Tax Court, therefore, concluded that the legal/professional fees allocated to fixed assets are amortizable over 7 years under Section 168, and those attributable to goodwill are amortizable over 15 years under Section 197.

Based on the stipulations by the parties that 40% of the fees paid were allocable to 1999 and 60% were allocable in 2000, the Court further held that the fees allocated to inventory (both new and used, including parts) should be allowable as a part of the dealership's deduction for Cost of Goods Sold in arriving at its gross profit for those years.

SCHEDULES

The accompanying schedules show the Tax Court's analysis broken down into 4 steps. Step 1 (Schedule 1) summarizes the facts, based on the new information entered into the record as a result of the additional documentation and substantiation submit- →

ted by West Covina and the joint stipulations made by both parties.

Step 2 (Schedule 2) shows the allocations of the various professional fees paid to the dealership assets, including goodwill, that were acquired. This includes all legal fees, CPA fees and other fees related to the asset acquisition.

Step 3 (Schedule 3) summarizes these fees by the three asset classes to which they are allocated ... i.e., (1) new and used vehicles and parts inventories, (2) fixed assets and (3) goodwill.

Step 4 (Schedule 4) shows the approximate recovery of the capitalized costs beginning in 1999 (the year of acquisition and through subsequent years).

As a result of the additional substantiation and detailed allocations and stipulations by the parties, West Covina was able to recover slightly more than 50% (i.e., 51.8%) of the capitalized acquisition costs by the end of the second year. In retrospect, this result does not seem to be too unfavorable for West Covina ... unless you take into account the time, effort and cost it took to get the result finalized (by the second visit to the Tax Court ten years after the acquisition took place).

FORM 8594

Form 8594, *Asset Acquisition Statement under Section 1060*, is generally required to be filed by both the buyer and the seller in connection with this type of transaction. Apparently, the filing requirement for this Form, or its absence, was not a matter of record in the Tax Court opinion although (if not an oversight) its non-filing by West Covina Motors would be explained by its position that its acquisition of Clippinger's assets was not subject to Section 1060.

The latest revision of Form 8594 is February, 2006. The Instructions for this Form (3 pages, revised December 2008) include (1) detailed definitions of the term "trade or business," (2) a list of factors to be considered in determining whether goodwill or going concern value might be present and (3) the types of property which comprise each of the definitions which are the ***seven*** classifications for "deemed or actual" asset acquisitions. The number of *"Classes"* has changed over the years as a result of changes in the law and Regulations.

For more about Form 8594, see pages 54-55.

Practice suggestion. It's prudent practice to include language in the purchase agreements or contracts (1) specifying which party will be responsible for completing the Form 8594 (sometimes it's the buyer's or the seller's CPA) and (2) obligating both the buyer and the seller to file that Form 8594 as part of their respective income tax returns for the year of acquisition ... and in any subsequent year, should there be modifications (either increases or decreases) in the consideration paid.

OBSERVATIONS

West Covina could have saved itself a lot of time and trouble before the case was tried in the Tax Court if it had submitted all of the detailed information and itemized billing statements that were ultimately made available.

In some cases, dealerships may have simply deducted all of the legal, accounting and other fees paid in connection with an acquisition in the tax return filed for the year when the fees were paid. In other cases, dealerships may have capitalized all of the expenses under Section 197 and amortized them over a 15-year period. The *West Covina* case reflects neither of these two extremes.

This case now provides a very useful template or guide for tracking the proper deduction for these expenditures. To assist you in understanding the end results, the accompanying Schedules break down the Tax Court's analysis into four steps... the results of which can be compared to positions you may have previously taken in tax returns where similar fees were paid in connection with dealership acquisitions.

It may be advisable to (1) review the treatment of professional (legal, CPA, etc.) fees paid in connection with asset acquisitions, (2) determine whether comparable detail for professional services rendered in connection with the acquisition is available (or can be reconstructed), (3) prepare a proforma computation that shows the recovery of professional fees paid based on the allocations of fees paid to asset classes involved and (4) if appropriate, file amended returns if improper amounts were previously capitalized or deducted. These amended returns might either accelerate some deductions or more properly spread them out over a longer period of time.

Finally, what is most important to keep in mind in connection with *West Covina* is that Section 1060 did not apply because all of the facts regarding amounts paid and the nature of the services rendered were agreed upon (i.e., stipulated) by West Covina and the IRS before they went to Court.

Post Script: If a dealership has aggressively written-off costs in connection with its acquisitions of other dealerships, this might constitute an uncertain tax position and require the completion of the IRS' new Schedule UTP. In this regard, see page 8 ... *"Disclosure of Uncertain Tax Positions ... The IRS' New Reporting Initiative for 2010."*

Schedule 1
Facts

ALLOCATION OF PROFESSIONAL FEES PAID IN THE ACQUISITION OF A DEALERSHIP ... *WEST COVINA MOTORS, INC.* REVISITED

	Consideration Paid for Clippinger Assets Acquired	Class III Assets Under Section 1060
Assets Acquired under Purchase Agreement		
Fixed assets	250,000	250,000
Goodwill	3,500,000	
Inventory (consisting of parts, used vehicles & misc. inventories)	2,300,600	2,300,600
All other miscellaneous assets *	1	1
Total Assets under Purchase Agreement	6,050,601	
Assets Acquired under Other Agreements		
New vehicle inventory **	6,258,074	6,258,074
Total Consideration Paid	12,308,675	
Total Class III Assets under Section 1060 ***		8,808,675

Professional Fees Paid		Amount	For Services Rendered Re:
Legal fees - N. Hoffman		116,293	- Loan documentation & seller financing
To Chrysler Financial		2,958	- Document review & inventory financing
To Cooksey		9,564	- Document review & inventory financing
To Rogers Clem, CPAs	6,675	6,675	- Related to inventory (physicals, reconciliations, etc.)
To Rogers Clem, CPAs	2,875	2,875	- Other work related to overall acquisition
Total Paid to Rogers Clem	9,550		
Total Professional Fees Paid		138,365	

Notes:

* Purchase Agreement allocated $1 to all other Miscellaneous Assets. This $1 has been ignored in these schedules.

** Floorplan line of credit ... $6,421,047

*** Class III Assets under Section 1060 are shown here. The Tax Court held that Section 1060 did not apply.

Schedule 2
Allocations

ALLOCATION OF PROFESSIONAL FEES PAID IN THE ACQUISITION OF A DEALERSHIP ... *WEST COVINA MOTORS, INC.* REVISITED

		Fixed Assets	Goodwill	Used Vehicle & Parts Inventories	New Vehicle Inventory	Total
Professional fees specifically allocated as related to inventory costs						
To Chrysler Financial	2,958					
To Cooksey	9,564					
To Rogers Clem, CPAs	6,675					
Total Fees to Be Allocated	19,197	By stipulation of parties, allocated 40% to 1999 & 60% to 2000				
Professional (Legal) fees to be allocated based on assets acquired under the Purchase Agreement (excludes new vehicle inventory)						
Fixed assets	4,768	250,000				250,000
Goodwill	67,334		3,500,000			3,500,000
Inventory (consisting of parts, used				2,300,600		2,300,600
vehicles & misc. inventories)	44,191					-
						6,050,600
Ratio of Amount Allocated to Total Amount		4.1%	57.9%	38.0%		100.0%
Total Legal Fees, as Allocated	116,293					
Professional fees (not specifically allocated to inventory) related to overall acquisition to be allocated based on all assets acquired (including new vehicle inventory)						
Fixed assets	58	250,000				250,000
Goodwill	818		3,500,000			3,500,000
Inventory (consisting of parts, used				2,300,600		2,300,600
vehicles & misc. inventories)	537					-
New vehicle inventory	1,462				6,258,074	6,258,074
						12,308,674
Ratio of Amount Allocated to Total Amount		2.03%	28.44%	18.69%	50.84%	100.00%
Total Fees to Be Allocated	2,875					

Schedule 3
By Asset Class

ALLOCATION OF PROFESSIONAL FEES PAID TO ASSET CLASSES IN THE ACQUISITION OF A DEALERSHIP ... *WEST COVINA MOTORS, INC.* REVISITED

		Allocation of Fees to Asset Class		
	Total Paid	Inventories... New, Used & Parts	Fixed Assets	Goodwill
Professional Fees Paid				
Legal fees - N. Hoffman (as allocated)	116,293	44,191	4,768	67,334
To Chrysler Financial	2,958	2,958		
To Cooksey	9,564	9,564		
To Rogers Clem, CPAs	6,675	6,675		
To Rogers Clem, CPAs (as allocated)	2,875	1,999	58	818
Total Professional Fees Paid	138,365	65,387	4,826	68,152
% of Totals	100.0%	47.3%	3.5%	49.3%

Schedule 4
Recovery Periods

RECOVERY PERIODS FOR CAPITALIZED PROFESSIONAL FEES PAID IN THE ACQUISITION OF A DEALERSHIP ... *WEST COVINA MOTORS, INC.* REVISITED

		Approximate Recovery (Deduction) for Capitalized Costs - by Year								
		Year 1 1999**	Year 2 2000	Year 3 2001	Year 4 2002	Year 5 2003	Year 6 2004	Year 7 2005	Year 8 2006	Year 9 & Subsequent Years
		Approximate Recovery (Deduction) for Capitalized Costs - by Year								
Recovery Periods for Allocated Costs		Year 1 1999**	Year 2 2000	Year 3 2001	Year 4 2002	Year 5 2003	Year 6 2004	Year 7 2005	Year 8 2006	Year 9 & Subsequent Years
Inventory *	65,387	26,155	39,232	-	-	-	-	-	-	-
Fixed assets **	4,826	345	689	689	689	689	689	689	347	-
Goodwill ***	68,152	757	4,543	4,543	4,543	4,543	4,543	4,543	4,543	35,593 †
Total Capitalized Fees	138,365	27,257	44,465	5,232	5,232	5,232	5,232	5,232	4,890	35,593
Percent (%) of Capitalized Costs Recovered										
By Year	100.0%	19.7%	32.1%	3.8%	3.8%	3.8%	3.8%	3.8%	3.5%	25.7%
Cumulative		19.7%	51.8%	55.6%	59.4%	63.2%	67.0%	70.7%	74.3%	100.0%

Recovery Period Notes:

* By stipulation of the parties, fees allocated to Inventory are deductible 40% in the year of acquisition (1999) and 60% to the following year (2000).
** By stipulation of the parties, recovery period for Fixed Assets is 7 years (under Section 168)
*** By stipulation of the parties, recovery period for Goodwill is 15 years (under Section 197), beginning with the month of the year when the acquisition occurred (November 1999)
† Remaining amortization of Goodwill under Sec. 197 ($68,152 ÷ 15 per year) over the remainder of the 15-year period beginning in Nov. 1999.

Conclusion

West Covina was able to recover more than 50% (i.e., 51.8%) of the capitalized acquisition costs by the end of the second year ... as a result of the stipulations by the parties and the detailed allocations required by the Tax Court.

Section 1060

WHAT THE TAX COURT SAID ABOUT THE INAPPLICABILITY OF SECTION 1060 TO WEST COVINA MOTORS, INC.

An applicable asset acquisition is any transfer (whether direct or indirect) of assets constituting a trade or business and in which the transferee's basis is determined wholly by reference to the consideration paid for such assets.

Generally, a written agreement is binding in such an acquisition as to the allocation of the consideration or as to the fair market value of any of the assets.

Where the parties do not allocate the consideration entirely, however, the residual method of purchase price allocation may apply to determine both the purchaser's basis in, and the seller's gain or loss from, each of the transferred assets. [*East Ford, Inc. v. Comm.*,* T.C. Memo. 1994-261]

A taxpayer generally allocates the consideration received to the acquired assets, to the extent of their fair market values, in descending order of priority by class under the residual allocation method.

Consideration is first reduced by the amount of Class I Assets, which include cash, bank accounts, and other similar items. Any remaining consideration is allocated to the remaining classes of assets in proportion to the assets' fair market value.

The remaining consideration is first allocated among Class II Assets, then among Class III Assets, then among Class IV Assets, and finally to Class V Assets.

Class II Assets include certificates of deposits, U.S. Government securities, readily marketable stock or securities, foreign currency and other similar items.

Class III Assets are, generally, tangible property (i.e., all assets other than Class I, II, IV, and V Assets).

Class IV Assets are all Section 197 intangibles except those in the nature of goodwill and going concern value. Accordingly, covenants not to compete are Class IV Assets.

Class V Assets are Section 197 intangibles in the nature of goodwill and going concern value.

Allocation of consideration is subject to fair-market-value limitations under the residual method. Therefore, the amount of consideration allocated to an asset (other than Class V Assets) must not exceed the fair market value of that asset on the purchase date. Thus, any residual consideration that is not allocated to other assets must be allocated to the Class V Assets.

- See *East Ford, Inc. v. Comm.* ... The residual class was Class IV Assets for the years at issue in *East Ford, Inc.* ... Class V Assets were subsequently added by the Regulations.

In West Covina Motors' acquisition of Clippinger Chevrolet, there were no Class I, Class II or Class IV Assets transferred. Therefore, the entire purchase price must be allocated between Class III (tangible property) and Class V (goodwill and going concern value) Assets.

However, the IRS and West Covina had stipulated that of the Clippinger purchase price, $8,808,675 was properly allocated to Class III Assets ... including new, used and demonstrator vehicle inventory, parts inventory and other fixed assets. ($6,258,074 for new vehicle inventory + $2,300,600 for used vehicle and parts inventories + $250,000 for fixed assets + $1 for miscellaneous assets.)

The parties had also stipulated that $3.5 million was properly allocated to goodwill.

Section 1060 is meant to prevent abuse where there is no agreement between the parties concerning how much of the purchase price is allocable to which category of assets. The residual allocation method prevents the parties from taking inconsistent positions for individual tax advantages.

Conclusion... Section 1060 is inapplicable in this case because any controversy concerning the allocation of the purchase price to these assets was eliminated by the joint stipulations of the parties.

Notes: Currently, there are 7 classes of assets for purposes of Section 1060 and related allocations. See the Regulations under Section 1060 and the Instructions for Form 8594 (Rev. Dec. 2008) for a current listing and description of the 7 classes.

* *For a discussion of* East Ford, Inc. v. Comm., *see "Allocating Sale Price to Assets in Buy-Sells ... Lessons from East Ford in the Tax Court," Dealer Tax Watch, June 1994,* page 2.

Form 8594 (1 of 2)	***ASSET ACQUISITION STATEMENT UNDER SECTION 1060*** ***SELECTED DEFINITIONS & TERMS*** Page 1 of 2
Who Must File Form 8594	• Generally, both the purchaser and seller must file Form 8594 and attach it to their income tax returns (Forms 1120, 1120S, 1065, etc.) when there is a transfer of a group of assets that make up a trade or business and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. ◆ This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser or both.
Form 8594 Is Not Required, However ...	• ***Form 8594 is not required when*** a group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which Section 1031 applies. ◆ ***However,*** if Section 1031 does not apply to all the assets transferred, Form 8594 is required for the part of the group of assets to which Section 1031 does not apply. • ***Form 8594 is not required when*** a partnership interest is transferred. ◆ ***However,*** the purchase of a partnership interest that is treated for Federal income tax purposes as a purchase of partnership assets, which constitute a trade or business, is subject to Section 1060 and Form 8594 must be filed.
When to File	• Generally, Form 8594 is attached to the tax return for the year in which the sale date occurred. • If the amount allocated to any asset is increased or decreased after the year in which the sale occurs, the seller and/or purchaser (whoever is affected) must complete Parts I and III of Form 8594 and attach the Form 8594 to the income tax return for the year in which the increase or decrease is taken into account.
Definition of "Trade or Business"	• A group of assets makes up a trade or business if goodwill or going concern value could under any circumstances attach to such assets. • A group of assets can also qualify as a trade or business if it qualifies as an active trade or business under Section 355 (relating to distributions of stock in controlled corporations).
Seven Classes of Assets ... Summary ***(See Instructions for More Specifics)***	1. ***Class I Assets*** ... Cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. 2. ***Class II Assets*** ... Actively traded personal property ... U.S. government securities and publicly traded stock ... Certificates of deposit and foreign currency even if they are not actively traded personal property. 3. ***Class III Assets*** ... Debt instruments, including accounts receivable ... Assets that the taxpayer marks-to-market at least annually for Federal income tax purposes. 4. ***Class IV Assets*** ... Inventory ... Property held primarily for sale to customers in the ordinary course of its trade or business. 5. ***Class V Assets*** ... Furniture and fixtures, buildings, land, vehicles, and equipment ... Also, all assets other than Class I, II, III, IV, VI and VII Assets. 6. ***Class VI Assets*** ... All Section 197 intangibles except goodwill and going concern value. Section 197 intangibles include ... Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business. ◆ See Page 2 of 2 for lists of what qualifies and does not qualify as a Section 197 intangible. 7. ***Class VII Assets*** ... Goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a Section 197 intangible).
Allocation of Consideration	• An allocation of the purchase price must be made to determine the purchaser's basis in each acquired asset and the seller's gain or loss on the transfer of each asset. • ***The residual method must be used for the allocation of the sales price among the amortizable Section 197 intangibles and other assets transferred.*** • The amount allocated to an asset, other than a Class VII Asset, cannot exceed its fair market value on the purchase date. Also, the amount allocated to an asset is subject to any applicable limits under the Internal Revenue Code or general principles of tax law.
Maximum Consideration	• In determining the maximum consideration to be paid, the assumption must be made that any contingencies specified in the agreement will be met and that the consideration paid for the assets acquired will be the highest amount possible. • If the maximum consideration cannot be determined, an explanation must be provided which indicates how the consideration will be computed and what the payment period will be.

(Continued on Page 56)

Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

► Attach to your income tax return. ► See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. 61

Name as shown on return | Identifying number as shown on return

Check the box that identifies you:

☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction | Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale | 3 Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

Part III Supplemental Statement—Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Form 8594 (2 of 2)	*ASSET ACQUISITION STATEMENT UNDER SECTION 1060* *SELECTED DEFINITIONS & TERMS* Page 2 of 2
Allocation of Subsequent Increases or Decreases in Consideration	• Any increases or decreases in the consideration paid for the assets after the transaction takes place ***must be taken into account to redetermine*** (1) the amount realized on the sale by the seller and/or (2) the amount of cost basis to be allocated to the assets acquired by the purchaser. • If an increase or decrease occurs after the purchase date, the seller and/or purchaser must allocate the increase or decrease among the assets. ◆ If the increase or decrease occurs in the same tax year as the purchase date, the increase or decrease is considered to have occurred on the purchase date. ◆ If the increase or decrease occurs after the tax year of the purchase date, the increase or decrease is considered to occur in the tax year in which it occurs.
Section 197 Intangibles... ***Include***	• Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business • Workforce in place • Business books and records, operating systems or any other information base, process, design, pattern, know-how, formula or similar item • Any customer-based intangible • Any supplier-based intangible • Any license, permit or other right granted by a government unit • Any franchise, trademark or trade name (with exceptions for certain professional sports franchises)
Section 197 Intangibles... ***Do NOT Include***	• An interest in a corporation, partnership, trust, or estate • Interests under certain financial contracts • Interests in land • Certain computer software • Certain separately acquired interests in films, sound recordings, video tapes, books or other similar property • Interests under leases of tangible property • Certain separately acquired rights to receive tangible property or services • Certain separately acquired interests in patents or copyrights • Interests under indebtedness • Professional sports franchises acquired before October 23, 2004 • Certain transactions costs

(Continued from Page 54)

De Filipps' DEALER TAX WATCH
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First-class