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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. 2010 ... THE YEAR IN REVIEW. It's been an interesting year from the standpoint of IRS tax developments, with the most significant development coming just a few weeks ago when the IRS issued long-awaited guidance on its interpretation of the Section 263A inventory cost capitalization rules for automobile dealerships.

The 2010 Timeline updates the 6-month version that appeared in the Mid-Year Edition of the *DTW*. This puts this IRS Section 263A guidance in Revenue Procedure 2010-44 into sequence with other 2010 activities. The Timeline begins on page 7.

On a personal note, the summer and fall seasons passed quickly and pleasantly. In October, my wife and I took a long-deferred vacation, driving out to Los Angeles to spend some time with our son who lives there and is currently working on the TV program *Castle*. Part of that vacation involved a visit on the set to meet the actors and a brief detour - via a flight from Burbank to Phoenix - to attend and participate in the AICPA Auto Dealership Conference.

Upon returning to Mt. Prospect in early November, I was out of town for a 3-day business trip after which I returned to the office on November 10. I was all set to write this Edition of the *DTW*.

In trying to plan ahead, I had "laid out" the content for the Year-End Edition of the *Dealer Tax Watch* based on what I knew before departing on vacation in early October. Upon returning from the AICPA Conference, I revised the layout again, and the content and my schedule looked pretty routine. There was just one catch ... I had assumed that (based on prior experience) it would be another year or two before the IRS actually published any guidance on cost cap. All of this just goes to show you what happens when you base your plans on faulty assumptions.

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Because, alas (on November 9), while I was out of town, the IRS published Rev. Proc. 2010-44. As a result, one of the major articles that I was planning to write for this Edition of the *DTW* was set aside for further development and will have to wait until next year. For more about this, see Watch Out #4.

#2. SECTION 263A GUIDANCE ... HOW THE IRS REALLY FEELS ABOUT DEALERSHIP COMPLIANCE. Well, now we know. And, for some dealers, there's some good news; unfortunately, for some others, the news is not so good.

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The analysis of Revenue Procedure 2010-44, which the IRS issued on November 9, begins on page 22. This analysis includes an overview of the Revenue Procedure which shows how the IRS has decided to resolve the treatment of certain dealership cost capitalization issues that were raised in TAM 200736026 and what it has left unsaid and unclarified.

The bottom line is - or seems to be - that many dealers should anticipate filing Forms 3115 for 2010 to make the appropriate elections to be covered under both safe harbor methods that the IRS offers in the Rev. Proc.

In general, the Forms 3115 required to change to the two cost capitalization safe harbor methods available under the Rev. Proc. can be filed under the automatic consent procedures. There are other aspects of the Form 3115 filing which will have to be addressed on a dealership-by-dealership basis.

On its website, NADA has a 5-minute "NADA-TV Report" which summarizes the Rev. Proc., calling it a "dealer win" and referring to the what is described as a "simple navigation route" for dealers to take into the Section 236A safe harbors. You can find this at http://www.nadafrontpage.com/dealers_unicap_win.xml or by going to www.nada.org and following the links provided there.

In this 5-minute report, you'll note the reference to the "simple process" of filing Form 3115.

I've attempted to provide for your consideration a template for the narrative statement that would be attached to Form 3115 in response to requirements found in the Instructions. This will have to be modified (considerably) on a dealership-by-dealership basis.

In the article, I've also reminded you once again that (at least in the more complicated dealerships Section 263A situations) you probably should consider obtaining a written engagement letter. This engagement letter should be signed, and it should describe (1) the responsibility for the accumulation of information (especially where other CPA firms have been involved with the dealership in the past), (2) the responsibility for the computation of the transitional adjustments at the beginning of the year of change and the computation of the costs to be capitalized at the end of the year, if any, and (3) whether or not the fee for services rendered includes the cost of future representation services in the event that the IRS requires further information or challenges the computations in connection with the Form 3115 filed.

As I said in my opening paragraph, and as discussed more fully in the article beginning on page 22, my overall impression of the Revenue Procedure is that it has some good news for some dealerships, and (unfortunately,) it has some bad news for some other dealerships. Also, for those unfortunate enough to have to actually prepare the Forms 3115, I've analyzed some of the pitfalls and requirements (if you're going to make complete disclosures to the IRS in the application) that you'll have to deal with. It's always easier to talk about doing it than it is to do it if you're going to follow the Instructions closely.

There's a lot of technicality underlying the "simple process" and what's left for dealerships whose main facilities are not covered under the retail sales facility safe harbor method. Before assuming that the IRS might just treat everyone kindly and overlook many of the technicalities (see the article for more), remember if you can - or will - *Mountain State Ford Truck Sales* and what happened to this dealership which tried to do things on the up-and-up and ended up with the Tax Court slamming the Code down on its attempts and for which there was no relief until there was full - rather than partial - capitulation by the IRS in a Revenue Procedure a few years later.

As we go to press, NADA has scheduled a webinar on November 30 to further discuss Rev. Proc. 2010-44 and its ramifications. You should be able to purchase access to this webinar (i.e., listen to a recording) through NADA, even though you may hear about it after the event has transpired.

#3. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE UPDATE. The AICPA Annual National Auto Dealership Conference was held October 20-22, 2010 at the Arizona Grand Hotel in Phoenix, AZ. The broad range of subjects and speakers attracted some 400 participants from dealerships and CPAs with auto dealership practices.

Regrettably (and unfortunately for you if you did not attend), the AICPA did not tape any of the Conference presentations. In the past, we've had the benefit of being able to go back and listen to the presentations to reinforce our initial hearing of the material. Not anymore.

IRS update. Beginning on page 10, I've summarized the excellent *"Update from the IRS"* presentation by Terri Harris, the IRS Motor Vehicle Technical Advisor. Of course, Revenue Procedure 2010-44 had not been officially released by the IRS in October, so Ms. Harris was somewhat limited in her remarks concerning the status of Section 263A (UNICAP) issues. As discussed more fully in the summary, she bundled a number of other dealership tax issues and developments under the broader category of "Dealership Transition Issues."

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Ms. Harris also introduced a new topic for discussion - at least it was the first time I had heard it included in her presentation ... The issues arising in connection with capitalization versus expensing of repairs and improvements.

The shorthand for all of this is "C2R" or "Capitalization to Repair." This relates to Code Section 263(a) not to be confused with the infamous Section 263A and not to be referred to as an imaginary Code Section 263C2R or as "Son-of-Section 263A."

Dealer - Manufacturer update. Also, beginning on page 15, I've included a summary of the excellent dealer legal/franchise issues update that was presented by Richard N. Sox, Esq.

In prior Editions of the *Dealer Tax Watch*, we've summarized many other presentations by Mr. Sox. His material is always up-to-date and reflects the extensive litigation and representation services that his firm (Bass Sox Mercer, previously Myers & Fuller) provides for dealers and dealer associations.

In his *"Automobile Franchise Legal Update"* presentation, Mr. Sox commented on the lessons to be learned from his firm's representation of Chrysler and General Motors dealers in arbitration proceedings. These lessons should not be overlooked now that, to some extent, the "smoke has cleared."

Other remarkable achievements during the past year are the significantly improved dealer protections that Mr. Sox and his firm have assisted dealer associations in obtaining in revisions of the dealer franchise laws of many states.

Uncertainty update. Finally, related to the AICPA Conference, beginning on page 46, is the outline that I used in my presentation entitled *"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."*

As I told those who attended my presentation, this outline represents a full-day, or a half-day, presentation on this topic. It has been my preferred approach to stay away from "PowerPoint" slides so that I can convey more information in a more useful form. I believe you can adapt this material quite readily for your own in-house discussion and training or CPE needs.

#4. TAXABILITY OF MANUFACTURER PAYMENTS & REIMBURSEMENTS TO DEALERSHIPS FOR FACILITIES & IMAGE UPGRADES AND GENERAL MOTORS EBE (ESSENTIAL BRAND ELEMENTS) PROGRAM.

In Watch Out #1, I referred to the article that I was planning to write for this Edition of the *Dealer Tax Watch*. This article was preempted by the need to analyze Rev. Proc. 2010-44 in this Edition and will appear next year.

I did not want to do a "partial job" on this topic, and in reading the Elements of the General Motors EBE Program, it occurred to me that, perhaps, what should be said about that GM Program was somewhat different from what might be said about other manufacturers' programs that are more specifically targeted or limited to upgrading dealership facilities and other image considerations.

The main reason for considering these programs as the subjects of separate analysis is because in the GM EBE Program, the facilities upgrade component is just one of four components, and all four components are inextricably combined with each other and with the opportunity for the dealership to receive cumulative payments over a fairly rigid time frame.

Under the EBE Program, GM's desired changes include (1) exclusive showrooms by October 31, 2010 if the facility is a non-GM dual facility, (2) exclusive entire facilities by September 30, 2011 if the facility is a non-GM dual facility and (3) other facility renovations and/or upgrades, regardless of whether or not a dual facility is involved.

The other three components of the GM EBE Program involve (1) participation in a coordinated and integrated customer sales and service retention program, (2) adoption of a common digital strategy and (3) establishment and maintenance of a highly-trained and professional sales and service organization.

As indicated above, these three components are integrated with the fourth component which may be summarized as the alignment of the GM dealership facility with GM's image standards.

As a matter of first impression (but certainly subject to revision based on further research), it would appear that since payments to GM dealerships under the EBE Program are based upon the cumulative satisfaction of all four components, these payments should be treated as ordinary income (rather than as basis reductions charged against either fixed asset and/or goodwill accounts). But, that is simply a tentative observation at this time.

A few other "tentative observations" at this time... ***First,*** over the past 4 or 5 years, just about every CPA that I have discussed the treatment of manufacturer payments related to facility improvements/upgrades with seems to be of the "opinion" that the receipt of these payments from the manufacturer can be treated as currently non-taxable; that they can be offset against basis and/or treated as excludable under Section 118.

see **DEALER TAX WATCH OUT**, page 4

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Although this may be the more popular opinion, it may also be - in many cases - the incorrect treatment.

Second, Section 118 relates to corporations and many dealerships conduct operations in non-corporate form. Accordingly, attention must be given to the IRS LMSB Memorandum for Industry Directors, et al. dated October 5, 2007. This Directive alerts IRS Field Directors to the improper application of the provisions of Section 118 in connection with non-shareholder contributions of capital, noting that partnerships and other non-corporate entities may attempt to exclude contributions to capital from gross income. In fact, this was issued as an "LMSB Directive on Abuse of Capital Contribution Provisions."

Third, there are other related considerations involving the application of Section 118 arising as a result of the *Elder-Beerman Stores Corp.* case, the related IRS Retail Industry Paper dated October 7, 1996 and the subsequent ISP Settlement Guidelines Paper dated September 23, 1998.

Fourth, there is the very old case involving a Ford dealer (*John B. White, Inc.*) who received payments from Ford to induce the corporation to move to another location in order to increase the sales of Ford products and enhance the Ford image. The IRS and the Tax Court held that the payments received by the dealership were taxable as ordinary income upon receipt. And, the decision was upheld on appeal.

Fifth, dealerships and/or CPAs preparing dealership tax returns in which such payments are offset against basis should consider whether they should file Form 8275 or make some other disclosure(s) in light of the recently-tightened taxpayer penalties, tax return preparer penalties and Schedule UTP disclosure considerations.

Sixth, the IRS has recently released an *Audit Technique Guide* for Agents to consult in cases where "C2R" or "Capitalization to Repair" issues may be involved.

Some of the expenditures that may be involved under various manufacturers' programs are referred to in a few of the PowerPoint slides in the "Upgrading My Image" section of Ms. Harris' presentation at the October AICPA Dealership Conference.

I would welcome any reader comments and opinions, as well as any information concerning specific manufacturers' programs. These would be helpful for further consideration in connection with my upcoming article on this subject.

#5. MANUFACTURER BANKRUPTCIES & DEALERSHIP CLOSINGS ... WHAT REALLY HAPPENED. On July 19, 2010, the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) issued its report entitled *"Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks."*

The SIGTARP Report contains the findings of the Independent Office created in connection with the TARP (Troubled Asset Relief Program). The findings in the Report were - to some extent - surprising, disappointing and not without criticism from many of the folks affected by the decisions of GM and Chrysler.

The Report finds that the manufacturers were inconsistent in two respects. They did not treat all affected dealerships consistently, nor did they consistently follow their own stated criteria. The Report further finds that "dealership termination decisions were not based on GM's and Chrysler's cost savings estimates."

The information on the dealership performance measurement criteria used (inconsistently) by General Motors and Chrysler is shown on the facing page. This is taken from the SIGTARP Report ... page 17 for General Motors and page 22 for Chrysler.

As an example of the "inequitable application" of these criteria by the manufacturers, Richard Sox stated in his presentation at the October AICPA Dealership Conference that about 40% of the General Motors dealers who were candidates for termination because they failed to meet GM's "performance criteria" (i.e., they were legitimate candidates for termination) were ***not*** terminated by GM.

The boldest statement of the SIGTARP Report appears on page 31 ... "At a time when the country was experiencing the worst economic downturn in generations and the Government was asking its taxpayers to support a $787 billion stimulus package designed primarily to preserve jobs, Treasury made a series of decisions that may have substantially contributed to the accelerated shuttering of thousands of small businesses and thereby potentially adding tens of thousands of workers to the already lengthy unemployment rolls - *all based on a theory and without sufficient consideration of the decisions' broader economic impact."*

The SIGTARP Report adds, "That the automakers have offered reinstatement to hundreds of terminated dealerships in response to Congressional action without any apparent sacrifice to their on-going viability further *demonstrates the possibility that such dramatic and accelerated dealership closings may not have been necessary ...".*

see **DEALER TAX WATCH OUT**, page 6

SIGTARP Report

DEALERSHIPS PERFORMANCE CRITERIA ALLEGEDLY CONSIDERED BY GENERAL MOTORS & CHRYSLER CORP. IN EVALUATING DEALERSHIP CANDIDATES FOR CLOSING

General Motors ... GM Dealer Performance Summary (DPS) Score Categories

Category	Weighting	Description
Retail Sales Index (RSI)	50 Percent	Ratio of actual sales to expected sales. GM calculates expected sales[a] based on a segment-adjusted state average.
Customer Satisfaction Index (CSI)	30 Percent	Ratio of actual score to expected score. GM calculates expected score based on a regional average.
Capitalization	10 Percent	Ratio of actual working capital to standard working capital. GM calculates standard by averaging a dealership's needs for working capital over a year.
Profitability	10 Percent	Ratio of actual dealer return on sales to expected return on sales. GM calculates expected return based on a regional average.

[a] GM calculates expected annual sales, CSI, capitalization, and profitability, based on vehicle registrations, industry averages, and other historical data.

Source: SIGTARP analysis of GM data (Table 3, Page 17 of SIGTARP Report)

Chrysler Corporation ... Example of Chrysler's Decision-Making in One Market

Dealership	Brands	In Target Location	2008 MSR[a]	2008 New Vehicles Sold	Terminated	Chrysler Rationale
Dealer A	Jeep	Yes	442%	486	Yes	Blocking the addition of Jeep franchises in three other sales areas.
Dealer B	Dodge, Chrysler	Yes	172%	477	No	In target area, above-average sales performance. Jeep brand to be added in August 2009.
Dealer C	Chrysler, Dodge, Jeep	Yes	103%	390	No	In target area, above-average sales performance. New 2007 dealer and in line with project Genesis.
Dealer D	Dodge	Yes	445%	378	No	In target area, above-average sales performance. Jeep brand to be added in August 2009.
Dealer E	Chrysler, Dodge	Yes	162%	190	No	In target area, above-average sales performance.
Dealer F	Chrysler, Jeep	Yes	82%	145	Yes	Below-average sales performance, not profitable, under-capitalized.
Dealer G	Chrysler, Jeep	Yes	29%	45	Yes	Below-average sales performance, under-capitalized on finance hold, nearby dealership has above-average sales.
Dealer H	Dodge	No	87%	41	Yes	Not in target area, below-average sales performance, not profitable.

[a] Minimum Sales Responsibility (MAR) is a ratio of the actual sales to the average number of vehicle registrations in a state. One hundred is considered average. The state average is broken down by market share and market segment (small, mid-size, etc.)

Source: SIGTARP analysis of Chrysler data (Table 4, Page 22 of SIGTARP Report)

Source: The complete SIGTARP Report ... *"Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks"* ... Dated July 19, 2010 ... Issued by the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) can be found at http://www.sigtarp.gov/audits.shtml under *"Released Audit Reports."*

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#6. DISCUSSION AGENDA FOR YEAR-END REVIEW MEETING. I've included on pages 20-21 a proforma for an agenda of items to be discussed in a year-end review meeting with your dealership clients.

Over the years, I have found a variation of this discussion agenda useful in my own practice.

#7. REPORTING UNCERTAIN TAX POSITIONS TO THE IRS. The Mid-Year Edition of the *Dealer Tax Watch* alerted you to the IRS' new reporting initiative that will be starting this year requiring self-disclosure of *Uncertain Tax Positions* (UTPs).

This involves completing a new schedule (Schedule UTP) to identify, briefly summarize and rank uncertain tax positions which are involved in the determination of the tax liability shown on the income tax return being filed.

In September, the IRS released the final version of Schedule UTP along with revised Instructions. A large number corporation tax return filers breathed a collective sigh of relief because the final version of Schedule UTP only has to be filed for 2010 if the corporation has assets that equal or exceed $100 million.

For all other corporations, there is a 5-year phase-in of the reporting requirement based on the corporation's asset size.

Other liberalizations ... at least for the time being ... include the removal of the original requirement for reporting the Minimum Tax Adjustment (MTA). In lieu of MTA computations, taxpayers are instead required to show the "Ranking of Tax Position" based on the U.S. Federal income tax reserve (including interest and penalties) recorded for the position taken in the return.

For a summary of the revised - and liberalized - requirements and a look at the final version of Schedule UTP, see pages 17-19.

#8. ESTATE TAX REPEAL FOR 2010 AND UNCERTAINTY FOR SURVIVORS & PRACTITIONERS. The Mid-Year Edition of the *Dealer Tax Watch* (Watch Out #10) also briefly raised a warning about the difficulties that tax return preparers should expect to face in preparing tax returns for individuals who died after January 1, 2010.

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 ... unless, of course, Congress legislates something else.

As we go to press, Congress still has not addressed this void or vacuum in the tax law.

However, if you are going to have to prepare a Form 1040 for a dealer who died during 2010, you will probably have to cope with a new form, Form 8939, to show the details of the carryover basis adjustments for property in the decedent's estate.

Form 8939 has already been issued as a *Draft* Form, and subsequently withdrawn because the IRS realized that it had not fully considered all of the ramifications. So, again, *"as we go to press"* - sorry to have to use that phrase yet again - we have no idea of what the final Form 8939 will look like. However, we've included a copy (condensed to 1 page) of the initial *Draft* Form which was withdrawn.

In the previous Edition of the *DTW* (on page 5), I summarized some of the problems that could result from the "carryover basis" provisions if they should be applicable. The article, beginning on page 42, expands that discussion and signals that coping with these problems next year will not be an easy task.

2010 Timeline	*JANUARY 1, 2010 TO DATE*
Jan. 1	• 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 ... subject to certain, limited increases. • All Gift Tax provisions, however, still remain fully applicable during 2010.
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 connection 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 originally was announced to be effective from Sept. 15, 2009 through Dec. 31, 2010 (but see extension granted by Notice #2 Aug. 9, 2010 & Rev. Proc. 2010-44). ◆ 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."*
Dec. 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 item 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.
March 19	• In *Robinson Knife Manufacturing Company, Inc.*, the U.S. Court of Appeals, Second Circuit (600 F.3d 121, 105 AFTR2d 2010-1467) reversed the Tax Court Memo Decision (TCM 2009-9). The Tax Court Memo Decision had ruled in favor of the IRS. • The Court of Appeals held that the taxpayer's trademark royalty payments were based on sales and these payments were incurred only upon the sale of the tools manufactured by the taxpayer. Therefore, these royalty payments were immediately deductible and did not have to be capitalized into inventory under Section 263A. • This case involved three issues, one of which involves the application of Section 263A, and some of the discussion by the Appeals Court of that issue (relating to indirect costs that are properly allocable to property produced) may be (remotely) pertinent to the current controversy between the IRS and auto dealerships over the application of Section 263A.
March 30	• The ***Economic Substance Doctrine*** was enacted into Code Section 7701(o) by the *Health Care Act* (*Health Care & Education Reconciliation Act of 2010*, P.L. 111-152). ◆ This allows the IRS to disregard any transaction a taxpayer enters into for which the taxpayer cannot demonstrate a proper business purpose. • The *Act* also imposes a "strict liability penalty" under Section 6662(b)(6). ◆ This penalty is 40% of the underpayment of tax attributable to a transaction lacking economic substance or failing to satisfy a similar rule of law. ◆ There is no reasonable cause exception or other means to avoid the penalty. ◆ The penalty is reduced to 20% if the relevant facts affecting the tax treatment of the questionable transaction are adequately disclosed on the tax return or on a statement attached to the tax return.

2010 Timeline	JANUARY 1, 2010 TO DATE Page 2 of 3
April 15	• *Recovery Group, Inc.* (T.C. Memo 2010-76) relates to the franchise costs, dealership goodwill and other intangibles (including covenants not to compete) that are required by Section 197 to be amortized over a 15-year period. • The company unsuccessfully tried to distinguish its acquisition of a 23% interest (i.e., a minority interest) in the business via a stock redemption from the facts and holdings in *Frontier Chevrolet, Co.* which involved the acquisition of a 75% interest (i.e., a majority interest) in a dealership indirectly by a stock redemption. • In *Recovery Group*, the Tax Court also declined to impose accuracy-related penalties against the company because it had reasonably relied on the CPAs for the company who were found to be "competent, fully-informed professionals" who were able to prepare its tax returns.
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) • See Sept. 2010 ... IRS releases final version of Schedule UTP.
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 Form 3115 and Instructions 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 to assist dealerships in evaluating whether they should file Forms 3115 before December 31, 2010 to adopt the IRS positions in TAM 200736026.
July 19	• ***SIGTARP Report.*** The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) issued its report entitled *"Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks."* • Report findings state that the manufacturers did not treat all affected dealerships consistently and "dealership termination decisions were not based on GM's and Chrysler's cost savings estimates."
Summer	• Arbitration proceedings (mandated by Dec. 2009 legislation for terminated GM and Chrysler dealers) are commenced and finalized, with a few dealers having their franchises reinstated.
August 4	• As of Oct. 1, the Large and Mid-Size Business (LMSB) Division of the IRS becomes the Large Business and International Division (LB&I). • This change reflects the expansion, centralization and coordination of more IRS agents and activities involving compliance with international tax issues into this new unit. • The LB&I will continue to focus on corporations, S-corporations and partnerships with assets of more than $10 million and certain high-wealth individuals.
August 9	• ***Extension of IRS moratorium on raising Section 263A issues for automobile dealerships.*** • In *Tier III - Field Directive on the Planning and Examination of IRC Section 263A Issues in the Auto Dealership Industry #2*, dated August 9, 2010, the IRS extended the existing audit suspension period (i.e., the moratorium) until the date the IRS publishes guidance (on these Section 263A issues) in the *Internal Revenue Bulletin.* • The *Field Directive* explains the reason for the extension as follows... "The IRS Office of Chief Counsel is currently considering additional published guidance related to dealership IRC Section 263A issues. It is expected that the guidance will address many of the issues outlined in TAM 200736026 and will apply to various retail motor vehicle dealerships."

2010 Timeline	JANUARY 1, 2010 TO DATE Page 3 of 3
Sept. 2	• ***Form 8300 filings, penalties & recovery of costs.*** In *Bale Chevrolet Co.*, the Eighth Circuit Court of Appeals denied the dealership's request for reimbursement of litigation costs under Section 7430. ◆ The IRS had assessed a $100,000 *intentional disregard* penalty for failure to file Forms 8300 against the dealership. The dealership subsequently paid the penalties and then successfully challenged the assessment in District Court. In addition, the dealership sought to recover (from the IRS) its costs and attorneys' fees under Section 7430. ◆ Citing *Tysinger Motor Co.* (and other cases), the Eighth Circuit denied the recovery under Sec. 7430.
Sept. 15	• ***Registration of paid tax return preparers ... New PTIN registration requirements & restrictions*** • Initial on-line registration began on or about September 15, 2010. • Anyone who prepares all or substantially all of a return (or claim for refund) will be required to have a PTIN, regardless of whether they are required to sign the return. • Failure to provide a valid PTIN may result in penalties under Section 6695(c). • Eventually, all registrants for a PTIN will undergo an automatic suitability and compliance check.
September	• ***Schedule UTP, Uncertain Tax Positions.*** Final version of Schedule UTP with revised Instructions ... and liberalized provisions ... is released by IRS (IRS Announcement 2010-75). • A corporation must file Schedule UTP for 2010 if it has assets that equal or exceed $100 million. • For all others, there is a 5-year phase-in of the reporting requirement based on the corporation's asset size. • No reporting of the Minimum Tax Adjustment (MTA) is required. • In lieu of MTA computations, taxpayers are required to show the "Ranking of Tax Position." • A corporation is required to rank all of the reported tax positions based on the U.S. Federal income tax reserve (including interest and penalties) recorded for the position taken in the return.
Sept. 27	• *Small Business Jobs Act of 2010* (P.L. 111-240) includes several provisions that may benefit dealerships. Four key provisions are below. • For tax years beginning in 2010 and 2011 ... ◆ Section 179 expense limitation increases to $500,000, with a $2 million phase-out threshold. ◆ Qualified real property expensing limitation increases to $250,000. ◆ 50% bonus depreciation provisions are increased. • For 2011, the built-in gains holding period for an S-corporation is temporarily reduced from 7 years down to 5 years.
October	• Ford network changes ... Lincoln and Mercury... • ***Number of Lincoln dealerships downsized.*** Ford Motor Co. announces plans to eliminate at least 175 dealers from its Lincoln brand over the next two years. Reductions apparently will be focused in major metropolitan markets. ◆ Ford will meet with Lincoln dealers over the next 100 days to offer voluntary buy-outs. ◆ Many Lincoln dealerships that remain will be expected to upgrade their facilities. • ***All Mercury dealerships are to be completely eliminated by the end of 2010.***
Oct. 22	• De Filipps presentation at AICPA National Auto Dealership Conference in Phoenix, AZ. • *"The Practitioner's Nightmare - Uncertainty & Dealership Tax Issues: Opportunities & Pitfalls Lurking in Current Critical Tax Issues."*
Summer - Fall	• Form 8939, *Allocation of Increase in Basis for Property Received from a Decedent*, is required to be filed by executors to show allocation of carryover basis adjustments. • IRS issues *Draft* Form 8939 (3 pages), then realizes there are even more changes that might have to be reported on it, and subsequently withdraws the *Draft* Form 8939.
Nov. 9	• ***Section 263A issues.*** Long-awaited guidance from IRS is published in Rev. Proc. 2010-44. • Motor vehicle dealerships will be allowed to use either or both of the safe harbor methods of accounting in order to elect or change their Sec. 263A accounting methods to ... ◆ Treat certain sales facilities as retail sales facilities for purposes of Section 263A, and/or ◆ Be treated as resellers without production activities for purposes of Section 263A. • IRS will allow dealerships to use the automatic consent procedures under Rev. Proc. 2008-52 for filing Forms 3115 to implement the changes to elect to use the safe harbor methods.
November	• IRS publishes *Audit Technique Guide* dealing with the C2R ... Capitalization vs. Repairs ... issues. • In Jan. 2010, the IRS had released two IDD Directives regarding the importance of C2R issues.

UPDATE FROM THE IRS

TERRI HARRIS, IRS MOTOR VEHICLE TECHNICAL ADVISOR

At the AICPA National Auto Dealership Conference in Phoenix (Arizona Grand Resort), Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, presented an *Update from the IRS* on October 21, 2010.

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

- Section 263A ... Application of inventory cost capitalization (UNICAP) rules to auto dealerships ..... Page 1 of 5
- Dealership transition issues ..... Page 2 of 5
- Section 263a ... Capitalization to repair ..... Pages 3-5 of 5
- Employee tool & equipment plans - Finally, a compliant plan ... See Note below *

Under the broad topic of "dealership transition issues," Ms. Harris reviewed a number of familiar issues, none of which involve guidance issued in 2010 by the IRS.

* Ms. Harris' discussion/PowerPoint presentation of employee tool and equipment plans was essentially a walk-through of the provisions in the Section 62(c) plan which the IRS approved in Letter Ruling 200930029. The plan approved by the IRS is basically a dollar-for-dollar reimbursement arrangement. This Letter Ruling was thoroughly analyzed on pages 38-39 in the Year-End 2009 Edition of the *Dealer Tax Watch.*

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

MVTA Comments	• Ms. Harris' comments on UNICAP were (surprisingly) brief because she opted to omit the oft-repeated historical details and a discussion of the technical provisions underpinning the UNICAP dilemma. • Ms. Harris did review the key issues and IRS conclusions in TAM 200736026. ◆ Service department activity on dealership-owned vehicles may constitute *production* activities. ◆ Dealer's main location is a dual-function storage facility. ▪ Vehicles sold at wholesale, sold to another dealership at cost (i.e., dealer trades), leased vehicles and some parts sales are not on-site sales to retail customers. • Costs at the dealership location must be allocated between on-site sales and off-site sales. • Additional costs associated with the off-site sales portion must be capitalized, rather than deducted. • Everyone understands that (1) the TAM says what it says and (2) IRS Chief Counsel still has not changed its mind regarding the interpretations expressed in the TAM. • Accordingly, it comes down to this ... How are we going to deal with this? And, when will (real) guidance be issued by the IRS? • Ms. Harris noted that the Industry Director's Directives - September 15, 2009 and August 9, 2010 - first suspended through Dec. 31, 2010 IRS examinations of auto dealership compliance with Section 263A issues and then further amended the audit suspension date until the date guidance would be issued by the IRS and published in the *Internal Revenue Bulletin.* • Ms. Harris was optimistic in stating that she expected IRS guidance to be issued soon and that that guidance would address many issues. She added that until such guidance was published, no one could be sure what would be in it. However, she suggested CPAs and controllers should consider at least 4 questions... ◆ What specific Section 263A methods are your dealership using? ◆ Has the dealership filed Form 3115 to be treated as a dual-function facility? ◆ What Forms 3115 for changes in accounting method have been filed over the years by the dealership? ◆ How do you plan to react when the IRS finally gets around to issuing its guidance?
Note	• Just a few weeks after Ms. Harris' presentation, the IRS issued the guidance to which she was referring ... Revenue Procedure 2010-44. • For an analysis of this Revenue Procedure, see pages 22-41 of this Edition of the *Dealer Tax Watch.*

Dealership Transition Issues

MVTA Comments

- Manufacturers may compensate a dealership in order to induce it to close. In some instances, dealerships may receive payments from competing dealerships working with the manufacturer, as well as directly from the manufacturer.
  - Regarding situations where the manufacturer pays the dealer to close, Ms. Harris discussed Letter Ruling 200218034 and Revenue Ruling 2007-37 (potential for capital gain treatment in certain situations). *[For articles on these, see DTW Index of Articles at www.defilipps.com.]*
- Manufacturer bankruptcies resulted in some unique fact patterns.
  - Terminated dealers were required to sign wind-down agreements.
  - Congress mandated arbitration for terminated dealers.
  - Some manufacturers changed their minds regarding some of the dealers who were included on their original termination lists.
  - Continuing dealers were required to agree to new terms and conditions.
- ***Timing is everything...*** As a result of the above, the major question is: What is the proper time to recognize termination payments?
  - In a situation where a dealership received the first installment of a termination payment in 2009, and the final payment was scheduled to be received in 2010 ... should receipt of the first installment be recognized as taxable income in 2009, or can it be deferred to 2010?
  - What about the terminated dealer who received a termination payment and was subsequently reinstated? What are the tax consequences in this case? Did the dealer repay the termination payment?
- In 2009, Congress mandated that both General Motors and Chrysler Corp. engage in binding arbitration with terminated dealerships. In some cases, this arbitration in the summer of 2010 resulted in the reinstatement of the dealership or in the dealership receiving additional monetary settlements.
  - ***Query:*** Are payments made to settle and release any arbitration claims considered to be part of the same Agreement that terminated the dealership? ... Or, are these subsequent payments considered to arise under *separate* Agreements?
  - ***Query:*** Do the tax treatments differ as to long-term capital gain vs. ordinary income treatment?
  - Ms. Harris said that probably payments received by dealers or dealerships as ***termination*** payments would be eligible for capital gain treatment; however, payments that dealerships received that arose ***out of the arbitration proceedings*** would be treated as ordinary income.
- Both General Motors and Chrysler required continuing dealers to sign either new or amended Franchise Agreements. These Agreements were between the dealerships and the ***new*** legal manufacturer entities. In some cases, the new Agreements contain material differences from the old Agreements.
  - ***Query:*** May the dealership write-off the unamortized intangible costs related to the prior acquisition of the franchise (i.e., the intangible costs of a prior dealership acquisition)?
  - ***Example.*** A dealer allocated $500,000 to Buick franchise rights when it acquired another dealership. The $500,000 is being amortized (pursuant to Section 197) over 15 years and there are 10 years left on the amortization schedule. The dealer now has a new franchise Agreement with the new manufacturer entity (***New*** GM). The acquired franchise rights are with a different company (***Old*** GM).
  - ***Query:*** Can the dealership write-off the remaining amount of the unamortized Sec. 197 costs because the old Agreement that governed the purchased dealership no longer exists?
- What are the options for a dealership that elected LIFO and subsequently lost a manufacturer franchise(s)? If the dealership decides to stay in business, it may continue to operate its used vehicle sales and/or service operations, or it may continue to operate as a new vehicle dealer selling vehicles from its remaining franchises.
  - Some dealers elected to take a proactive approach to the dealership's use of LIFO for valuing its new vehicle inventories and terminate the LIFO election. Ms. Harris discussed the guidance in CCA 200935024. However, two of the three fact patterns involve dealerships that were not using the Alternative LIFO Method for New Vehicles.
  - Regarding CCA 200935024, see *"Year-End Planning for Dealers on LIFO ... IRS Guidance on Section 481(a) Adjustment Issues"* (*Dealer Tax Watch*, Year-End 2009, pg. 34).

Section 263(a) - Capitalization vs. Repair (Expense)

In her presentation, Ms. Harris introduced a new set of issues that she is starting to see creep into some dealership audit situations. These issues arise in connection with whether dealerships should be capitalizing or expensing repairs and improvements to their buildings and facilities. The shorthand for all of this is "C2R" or "Capitalization to Repair."

Many dealerships are replacing or significantly improving/upgrading their current facilities. Some of these changes are dealer-initiated and others result from strong encouragement or other forceful persuasion from the manufacturers. See Ms. Harris' PowerPoint slides #10-11-12 ("Upgrading my Image") and #16 ("Consider the Possibilities").

In November 2010, the IRS published an *Audit Technique Guide* specifically dealing with the C2R ... Capitalization vs. Repairs ... issues. This followed two previously-released Industry Director Directives regarding the importance of C2R issues.

All of this plays into whether the dealership has fine-tuned its depreciation lives and methods based on a cost segregation study and whether Section 118 might apply to exclude some payments from ordinary income.

For some dealerships, "capitalization vs. repair" issues will become an important audit issue in the future.

I Know What I Did....Now What Do I Do?
Capital Expense or Current Deduction?

- The distinction between capital expenditures and ordinary and necessary business expenses has never been an easy determination
  - Current regulation project started in 2004 in order to reduce controversy and provide clarity – continues today
- CPA Firms are approaching their clients citing underlying law but with an eye to the Proposed Regulations
- Taxpayer's are filing Forms 3115 requesting a Change in Accounting Method to re-characterize costs previously capitalized under Sec. 263(a) as currently deductible repairs under Sec.162.

1

Proposed Regulations....
Better Think Twice

- 2008 Notice of Proposed Rulemaking - March 2008 (REG-168745-03 – Proposed Regs)
  - The Preamble to the Proposed Regulations states:
    - Given the continuing evaluation of this area, taxpayers should be particularly aware that no reliance should be placed on the rules provided in these new proposed regulations until such rules are finalized.
    - Because these proposed regulations are not effective until they are published as final regulations, taxpayers may not change their accounting method to conform to a method of accounting provided in these proposed regulations.

2

If It's a Method of Accounting.....
How Can I Change It?

Rev. Proc. 97-27 (Prior to 8-27-2009)

Consent language states costs must....

1. Keep property in operating condition
2. Do not add material value/life
3. Do not adapt property to a new use
4. Do not replace a UOP or major component or structural part
5. Are not part of a plan of rehab
6. Do not result from a prior owner's use

Rev. Proc. 2009-39
(RP 2008-52 Available 8-27-2009)
Form 3115 must include....

The 6 statements contained in the advance consent letters along with:

1. Detailed description of the property
2. Detailed description of the repair work
3. Detailed description of the old UOP method and the new method and the legal authority for the change

3

Statutory Framework

- Section 162(a) – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business
- Section 263(a) – No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

4

Section 263(a) - Capitalization vs. Repair (Expense)

Statutory Framework

- Section 263(a) and Treas. Reg. Sec. 1.263(a)-1 - requires capitalization if amounts paid out:
  - Add to the value of property,
  - Substantially prolong the life of the property, or
  - Adapt property to a new or different use
- Treas. Reg. Sec. 1.263(a)-2 - Capital expenditures include amounts paid or incurred to acquire, construct, or erect:
  - Buildings; Machinery/Equipment; Furniture/Fixtures; Land/Land improvements; Leasehold improvements
- Section 162 & Treas. Reg. Sec. 1.162-4 – Allow a current deduction for incidental repairs that do not:
  - materially add to the value of the property;
  - nor appreciably prolong its life; but
  - *keeps* it in an ordinarily efficient operating condition.

5

From One Extreme to the Other

- Certain Law
  - Repair and maintenance costs are deductible
  - Improvements and alterations are capital expenditures
- Between the extremes (clearly capital and clearly expense) a point is approached at which it can be difficult to determine whether an expenditure can be considered capital or an expense

6

It Seems Simple Enough
Where Do I Start?

- **Key Concepts:**
  - Define the Unit of Property (UOP)
  - Apply of Current Law
- **UOP determination**
  - Issue arises when item is a component of a larger unit of property
  - Which UOP (component or larger item of property) is being "repaired"?
  - Whether expenditure materially adds to the value or appreciably prolongs the life of that UOP

7

Rules and Regulations
What Are The Current Unit of Property Rules?

- Treas. Reg. Sec. 1.263A-10(c)
  - Defines components of tangible personal property as a single unit of property if the components are functionally interdependent.
    - Functionally interdependent ="the placing in service of one component is dependent on the placing in service of the other component"
- Treas. Reg. Sec. 1.167(a)-11(d)(2)(vi)(g)
  - Defines unit of property as each operating unit which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit.

8

Judging the Results
What Have the Courts Said?

- **Court Methodologies - To distinguish deductible repairs and non-deductible capital improvements**
  - Added value, prolonged life, new or different use
  - "Put" versus "Keep"
  - Plan of Rehabilitation Doctrine
  - Plainfield-Union Test

9

Upgrading My Image

- **Will auto manufacturer facility upgrade requirements include addition of new components or structural parts?**
  - New property added to already existing property.
    - Additions are not replacement components nor are they repairs to property, but are newly installed components.
      - Additions need to be capitalized. This applies to both Section 1245 and Section 1250 property.
    - Adding new building components that improve utility are capital.
      - See *RKO Theatres v. United States*, 163 F. Supp. 598 (Ct.Cl. 1958) and Revenue Ruling 2001-4

10

Section 263(a) - Capitalization vs. Repair (Expense)

Upgrading My Image

- Will auto manufacturer facility upgrade requirements include addition of upgrades or modifications to the property?
  - Replacing of existing building *components with upgraded components* (or sub components) that improve utility are capital expenditures.
    - See *Smith v. Commissioner*, 300 F.3d 1023 (9th Cir. 2002).

11

Upgrading My Image

- Will auto manufacturer facility upgrade requirements enhance the value of the property?
  - In *Hotel Sulgrave Inc. v. Commissioner, 21 T.C. 619 (1954)*, the court held an expenditure for a new fire sprinkler system was capital as it gave the building additional protection from the hazard of fire.
    - Even though it may not have increased the value of the property or prolonged its useful life, the property became more valuable for use *in the taxpayer's business* by reason of compliance with the city's order.
    - While an increase in value is indicative of a capital expenditure, the term value is not defined in the Code, regulations, or by case law. There is no bright line test.

12

Capitalize? Or Deduct?

CAPITALIZE	REPAIR
•Improvements that "put" property in a better operating condition	*•Improvements that "keep" the property in efficient operating condition*
•Addition of new components or material sub-components to property	*•Incidental Repair*
•Add upgrades or modifications to the property	*•Restores the property to its previous condition*
•Enhances the value of the property in the nature of a betterment	*•Protects the underlying property through routine maintenance*
•Extends the useful life of the property	
•Improves the efficiency of the property	
•Improves the quality of the property	
•Increases the strength of the property	
•Increases the capacity of the property	
•Adapts the property to a new use	
•Plan of Rehabilitation Doctrine	

13

Cost Segregation/Capitalization/Repairs

- Has the dealership filed a Form 3115 as a result of a cost segregation study?
  - if a dealer has filed for a change in accounting method in order to treat property as a separate asset (UOP) for purposes of MACRS, then
    - that property must continue to be treated as a separate UOP for capitalization purposes.
    - If a component part is treated as a separate UOP and depreciated over a shorter recovery period, the dealer must continue to follow that method of accounting.

14

Cost Segregation/Capitalization/Repairs

- If a dealer relied on a cost segregation study to
  - identify a specific item as a separate asset (UOP), or
  - applied for consent to change a method of accounting for a specific item
    - they are prohibited from using the automatic consent procedure to change their accounting method for the same item.
  - For example:
    - Dealer may not use the automatic consent procedure to "reverse" their treatment of that item as a separate asset (Cost Segregation Study) in order to treat their expenditure for that same item as a deductible repair expense.

15

Consider the Possibilities

- Auto Dealers New Reality (*Wards Dealer Business* - July 2010)
  - Buick wants 400 of its dealers to invest in facility upgrades
  - Hyundai & Kia "encouraging" exclusive showrooms
  - GM now is prodding its nearly 500 stand-alone Pontiac, Buick and GMC franchises to start combining dealerships
  - Etc.....
    - How will facility upgrade requirements be treated for tax --- Capitalize? Repair?
      - **You tell me...**

16

AUTO DEALER FRANCHISES VS. MANUFACTURERS ... LEGAL UPDATE

RICHARD N. SOX, ESQ.

At the AICPA National Auto Dealership Conference in Phoenix (Arizona Grand Resort), Mr. Richard Sox, Esq., of Bass Sox Mercer, presented an *Legal Update - State of the Industry* on October 21, 2010.

Mr. Sox's PowerPoint slides and discussions covered the following ...

- GM and Chrysler arbitrations
- Initial reinstatements
- GM settlements
- GM letters of intent for dealers prevailing at arbitration
- Chrysler settlements
- Chrysler reinstatement requirements
- The next hammer to drop for GM dealers - Participation & reinstated dealers
- The next hammer to drop for Chrysler dealers - Reinstated dealers
- The next hammer to drop for GM and Chrysler dealers - Terminated dealers
- ***Lessons learned from GM and Chrysler arbitrations (see page 2 of 2)****
- Mercury discontinuance
- Ford changes to Lincoln dealer network
- Honda - Notices of default & sales performance cure
- Mahindra & Global Vehicles
- Hyundai & Kia - Expectations for dealers will be on the rise
- New state franchise laws (see below)

* Mr. Sox's Firm represented 74 General Motors & Chrysler dealers seeking reinstatement of their franchises in recent arbitration proceedings. From Mr. Sox's Firm's experience in handling these matters, the overarching summary is that dealers should "Document, Document, Document!" As they say ... "Paper the file."

The importance of having a written record of response to each and every communication to the dealer from the manufacturer cannot be stressed enough. The manufacturer maintains a file and keeps a record of every communication that it sends to the dealer. Accordingly, for each and every such communication to the dealer, there should be a written, documented, appropriate response from the dealer back to the manufacturer.

Note: For other summaries of Mr. Sox's recent presentations appearing in the *Dealer Tax Watch*, see ...

- *"Emerging Manufacturer Initiatives Impacting Automobile Dealerships"* (*DTW*, Dec. 2006, pgs. 24-40)
- *"Dealer-Franchise Issues Update ... Manufacturer-by-Manufacturer"* (*DTW*, Dec. 2007, pg. 12-23)
- *"Latest Manufacturer Initiatives Threatening Dealership Viability"* (*DTW*, Year-End Edition, 2008, pg. 13)

Positive Changes for Many Dealers as a Result of Improved State Dealer Protection Laws

New State Franchise Laws	• Mr. Sox's firm recently assisted dealer associations and state legislators in writing more favorable provisions into dealer franchise protection laws in the following states... ◆ Alabama ◆ Missouri ◆ California ◆ Nebraska ◆ Colorado ◆ North Carolina ◆ Hawaii ◆ Oregon ◆ Illinois ◆ Pennsylvania ◆ Maine ◆ Virginia
Dealer Protections	• Enhanced termination protections (fair market value, facility upgrade cost) • Prohibition on exclusivity & site control • Protection from unreasonable facility demands and unreasonable performance standards • Protection from export chargebacks • Warranty reimbursement from the manufacturer at retail rates
Suggestion	• If you have dealer clients in any of the above states, you might want to become more familiar with the specific provisions which have been enacted and discuss them with the dealer and the dealer's legal counsel.

Lessons (for Everyone) Learned from GM & Chrysler Arbitrations

Document Concerns with Performance Criteria *(Lesson #1)*	• General Motors and Chrysler said that they had considered dealership performance, or lack of performance, to be a major consideration in deciding which dealerships to terminate. ◆ Both manufacturers stressed the adequacy of sales performance. ▪ GM used its Dealership Performance Summary (DPS). ▪ Chrysler used a similar performance measurement - the MSR or Minimum Sales Responsibility - which seemed to involve comparisons of each specific dealership with the "average" Chrysler dealer in that dealer's state. • Both manufacturers communicated to their dealerships over a period of time their evaluations of the dealerships' performance. • In some instances, dealers ignored these communications or did not respond in other meaningful ways. • In the arbitration proceedings, GM and Chrysler would point out that, if the dealer had not responded to these communications, then that lack of response should be taken as evidence that the dealer did not care about whether or not his/her franchise(s) was performing adequately or satisfactorily. • ***The Lesson:*** If the manufacturer alleges that the dealer's performance is subpar, the dealer should write a rebuttal outlining why the dealer believes he or she is performing satisfactorily and explaining where, why or how the criteria used by the manufacturer was inappropriate.
Document Concerns with Changes in Market Area *(Lesson #2)*	• Each manufacturer assigns a market territory to the dealer, and it is within this geographic area that the dealer's performance is measured. • Often, there are flaws in the manufacturer's assignment of market territories to a dealership. In some instances, the manufacturer may add new points adjacent to or within the dealer's market area, without adjusting the assigned market territory to the dealer. • ***The Lesson:*** Dealers should continually review their assigned market territories and correspond with the manufacturer to raise appropriate concerns about the area assigned or the obstacles that may be within the geographic area.
Engage in & Document Discussions re: Dealer Network Plans *(Lesson #3)*	• Manufacturers are continually rolling out incentive programs, image upgrade programs and all sorts of other programs. • After constant exposure to these programs, and sometimes the reintroduction of similar programs under different names, dealers tend to ignore these new programs. • In the arbitration proceedings, GM and Chrysler often contended that the dealer's lack of interest in the manufacturer's programs evidenced the fact that the dealer was not "on the team" and did not seem to care about the best interests of the manufacturer or the residents in the dealership area. • ***The Lesson:*** Dealers should write to the manufacturers when new network plans are introduced to find out how the dealership will be affected and to raise concerns or objections if they are warranted under the circumstances.
Create a Succession Plan *(Lesson #4)*	• Mr. Sox indicated that arbitrators seem to be interested in whether or not the dealer had a successor in place. Apparently, this might be one way of judging the dealer's desire to function and maintain a presence and any built-up goodwill within the community on a long-term basis. • Although not a point of major discussion in the arbitration proceedings, it would appear that if a dealer had a successor in place and an individual and plan approved by the manufacturer, that these factors could only benefit the dealer. • ***The Lesson:*** Dealers should have a realistic, documented succession plan in place or they should at least be able to document that such a plan is a work-in-progress.

Richard N. Sox, Esq. - a partner in the firm of Bass Sox Mercer - is a frequent speaker at industry events, and he is the author of a monthly article on dealer-manufacturer issues in Dealer Magazine. *If you have questions on any of the areas he discussed, Mr. Sox contact information is ... e-mail: rsox@dealerlawyer.com ... phone: (850) 878-6404.*

SCHEDULE UTP ... UNCERTAIN TAX POSITION STATEMENT

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.

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. This was followed by several speeches by Commissioner Douglas Shulman.

On April 19, 2010 (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. See the Mid-Year 2010 Edition of the *Dealer Tax Watch* for more detailed discussions of these earlier developments and the underlying financial reporting considerations, especially those for financial reports for entities related to the corporation.

In September 2010 (in Announcement 2010-75), the IRS released the final version of Schedule UTP and the final Instructions for this Schedule. The filing and reporting requirements for 2010 have been significantly liberalized, and a comparison of the *Draft* and the *Final* versions of Schedule UTP appears below.

	Draft Version of Schedule UTP	Final Version of Schedule UTP
Filing Requirement for Corporations (1120s)	• Who must file? ... Four requirements ... A corporation must file Schedule UTP with its 2010 income tax return if ... 1. The corporation has assets equal to or exceeding $10 million, 2. The corporation files Form 1120 - *U.S. Corporation Income Tax Return,* 3. The corporation or a related party issued audited financial statements reporting 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.	• 5-Year phase-in of the reporting requirement based on the corporation's asset size. • A corporation must file Schedule UTP for 2010 if it has assets that equal or exceed $100 million (and it satisfies requirements #2, 3 & 4). • Starting with 2012 tax years, the total asset threshold will be reduced to $50 million. • Starting with 2014 tax years, the total asset threshold will be reduced to $10 million.
Filing Requirement for Other Entities	• Pass-Through entities (i.e., S-Corps, Partnerships and LLCs filing as partnerships) are not 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.	• No change; same as in Draft version.
Schedule UTP ... 3 Pages	• Pg. 1 - UTPs for current year • Pg. 2 - UTPs for prior years • Pg. 3 - Concise descriptions of UTPs	• Pg. 1 - UTPs for current year • Pg. 2 - UTPs for prior years - Not required to be completed for 2010. • Pg. 3 - Concise descriptions of UTPs
Minimum Tax Adjustment (MTA)	• MTA required to be disclosed (on Page 1, Part I, Column F). • 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.	• No reporting of Minimum Tax Adjustments is required. • In lieu of MTA computations and reporting, taxpayers are instead required to show the "Ranking of Tax Position" on Page 1, Part I in Column F.

	Draft Version of Schedule UTP	Final Version of Schedule UTP
Ranking of Importance of Reported Tax Positions ***(Page 1, Part I, Column F)***	• Not required in Draft version because Draft version had required calculation and disclosure of Minimum Tax Adjustments.	• ***Purpose/Objective.*** This ranking method is expected to allow the IRS to more accurately evaluate the materiality of the issues reported on Schedule UTP, and as a result, this should impose a lesser compliance burden on the reporting corporation than it would have had if the requirements to compute MTAs (as per the Draft version) had been continued. • ***Ranking.*** A corporation is required to rank all of the reported tax positions (including transfer pricing and other valuation positions) based on the U.S. Federal income tax reserve (including interest and penalties) recorded for the position taken in the return. ◆ This ranking is shown on Page 1, Part I in Column F. • The size of the tax position is not required to be reported anywhere on Schedule UTP. • The size of each tax position is ... ◆ Determined on an annual basis, and ◆ The amount of U.S. Federal income tax reserve recorded for that tax position. • ***Multiple tax positions.*** If a reserve is recorded for multiple tax positions, then a reasonable allocation of that reserve among the tax positions to which it relates must be made in determining the size of each tax position. • ***Expectation to litigate.*** If a corporation has "the expectation to litigate," it is not required to determine the size for such uncertain tax positions. • ***Consolidated returns.*** The determination of the size of a tax position taken in a tax return by an affiliated group filing a consolidated return is to be determined at the affiliated group level for all members of the affiliated group.
Ranking of Importance ***(Page 1, Part I, Column E)***	• Not required in Draft version.	• ***"Major tax position."*** A corporation is also required to designate those tax positions for which the reserve exceeds 10% of the aggregate amount of the reserves for all tax positions reported on Schedule UTP. • This designation is made on Page 1, Part I in Column E.
Disclosure of Prior Year UTPs	• Draft version required reporting of prior Years' UTPs on Page 2, Part II.	• Prior Years' UTPs are not required to be disclosed on Schedule UTP filed for 2010.
Other Changes		• ***Less explanation.*** No reporting of the rationale and nature of the uncertainty is required in the concise description of the tax position on Page 3, Part III. • No reporting of administrative practice tax positions is required.
Instructions	• Length ... Nine (9) pages • Examples ... Sixteen (16)	• Length ... Five (5) pages • Examples ... Twelve (12)

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 separate instructions.

OMB No. 1545-0123

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 Section (e.g., "61", "108", etc.)			(c) Timing Codes (check if Permanent, Temporary, or both)		(d) Pass-Through Entity EIN	(e) Major Tax Position	(f) Ranking of Tax Position
				P	T	-	☐	
				P	T	-	☐	
				P	T	-	☐	
				P	T	-	☐	
				P	T	-	☐	

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

This Part II, Schedule UTP (Form 1120) is page [redacted] of [redacted] Part II pages.

Part II **Uncertain Tax Positions for Prior Tax Years. Do not complete for 2010.**

[redacted]

(a) UTP No.	(b) Primary IRC Section (e.g., "61", "108", etc.)	(c) Timing Codes (check if Permanent, Temporary, or both)	(d) Pass-Through Entity EIN	(e) Major Tax Position	(f) Ranking of Tax Position	(g) Year of Tax Position
[redacted]						

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 corresponding UTP number from Part I, column (a). Use as many Part III pages as necessary (see instructions).

UTP No.	Concise Description of Uncertain Tax Position

Practice Guide	***DISCUSSION AGENDA FOR DEALERSHIP YEAR-END REVIEW MEETING FOR XYZ DEALERSHIP*** _____
	• Date of meeting _____ • Participants: _____
Entity (Corporate) Structure	• Have there been any changes during the year in entity or corporate structure? ◆ Review entity or corporate structure chart and update for any other changes ◆ Is there a flowchart that shows all the related entities? ◆ See *"One Man's Game Plan: A Study in Dealer Entity Structuring," Dealer Tax Watch*, September 1996, pages 11-13. • S Corps. ... Do shareholders have adequate basis in stock or loans to absorb losses? • Discuss LIFO elections for (new) dealership entities
Year-End New Vehicle LIFO Inventories	• Will the year-end new vehicle inventory levels be (more than), (less than), or (approximately the same as) the inventory levels at the end of last year? • Will the year-end cost of new vehicles be adjusted to remove trade discounts, floorplan assistance and certain advertising fees and expenses? ◆ Discuss importance of eliminating trade discounts, floorplan assistance payments and certain advertising fees and expenses for local and regional advertising (but not for national advertising) at year end which can be frozen into valuations of LIFO layers. • Discuss year-to-date estimated inflation indexes based on one-of-each item categories • Projection of change in LIFO reserve for the year & related year-end planning (estimated tax payments, etc.) ◆ How detailed? ◆ Timing? ... When will these be needed? • Year-end processing ... Timing needs ◆ Date by which invoices for year-end new vehicle inventory will be available _____ ◆ Date by which LIFO calculations are needed _____ ◆ Are either of these dates (significantly) different from last year?
Used Vehicles	• Approximately how large will the writedown for used vehicles be at year-end? _____ • What is the policy for writing down used vehicles to lower-of-cost-or-market? ◆ Has this policy been consistently followed from year to year?
Section 263A	• What has been the past practice of the dealership for capitalizing inventory costs under Section 263A? • Should Form 3115 be filed for 2010 to elect the safe harbor methods permitted by Rev. Proc. 2010-44?
Federal Income Tax Matters	• What years are still open under the statute of limitations? • Are any audits of Federal income tax returns currently being conducted by the IRS? • See *"Dealership Tax Return Compliance & Planning Opportunities Checklist," Dealer Tax Watch*, December 2004, pages 23-31.
State Income Tax Matters	• What state(s) is (are) the dealership doing business in? • Are there any "nexus" issues relating to the dealership's operations? • Is the dealership conducting operations in any state where it is not filing state income tax returns? If not, why not? • Are any audits of state income tax returns currently being conducted by state authorities?
Dealership Facilities	• Was there any construction, expansion and/or facility upgrades during the current year? ... Or are any anticipated in the next year? How large? ... Area and/or dollars ... How will they be financed? ◆ Status of new construction and other improvements ... current facilities ◆ Previous construction or previously acquired facilities • Does the dealer anticipate acquiring any new dealerships or franchises during the next year? • ***Cost segregation study*** ... benefits & providers ... Is depreciation being maximized? If not, why not?
Notices From the Factory	• Has the dealer received any letters or notices from the manufacturer within the past year regarding CSI, sales, facility upgrades or image enhancements, new points, etc.? ◆ If yes, what areas were addressed by the manufacturer in these letters or notices? ◆ How did the dealer respond to these notices? ◆ What action was taken? ... Written ... Oral

Practice Guide	***DISCUSSION AGENDA FOR DEALERSHIP YEAR-END REVIEW MEETING FOR XYZ DEALERSHIP*** _____
Factory Incentive Programs	• Is the dealership participating in any Factory incentive programs? Which ones? • Are any of these programs new this year? • How are payments that are received from the manufacturer being treated for book and for tax purposes?
Factory Audits	• Have there been any audits of the dealership by the manufacturers regarding either warranty claims or sales incentive program awards? ◆ If any, what audits have occurred in the past year? When did they start? Are they completed yet? ◆ Were there any material adjustments? • Who is in charge of determining compliance with various Factory programs before claims (receivables) are submitted? • Is there a need for some preventative maintenance in the form of self-audits for the dealership to determine compliance with ◆ Various warranty program requirements ◆ Various sales incentive program requirements
Dealership Computers & Software	• Are leases co-terminal? • Is the dealer being billed for items not received? • How much is the dealership paying each month for computers / hardware? • How much is the dealer paying each month for all other software, supplies and services? • When do the current leases expire? • When does the dealer expect to start considering new leases? How far is this in advance of the current expirations? Realistically, is there enough time to deal with this issue?
Books & Records	• Is the accounting software used by the dealership in compliance with the IRS requirements for electronic recordkeeping described in Revenue Procedure 98-25? • Has the vendor met with the IRS to review these Rev. Proc. 98-25 requirements? • Has the IRS issued a "records evaluation" letter to the software vendor that explains the parameters? ◆ If not, why not? • Should any deficiencies in the books and records be discussed in the tax return engagement letter?
Adequacy of Corporate Minutes	• Have the minutes for the previous year been reviewed? ◆ If not, when was the last time the Corporate minutes were updated? • Is the dealer's compensation (salary, bonus, etc.) authorized in the minutes?
Dealer Succession Plan	• Is there a plan in place? What is it? If not, why not? • Has a successor been approved the manufacturer? Who has been approved? • If this step has not been taken, are there any plans to seek manufacturer approval for a successor in the near future?
Life Insurance Matters	• Life insurance … Dealer … Other key employees & family members ◆ Costs and need for independent review • Is there a need for corporate life insurance (on the lives of key persons and/or for shareholder purchaser agreement funding) as well as for individuals outside the corporation?
Other	• ***Form 8300 cash reporting requirements.*** When was the last time there was a review of dealership compliance with the Form 8300 cash reporting requirements? • ***Disaster recovery program.*** What plans, if any, does the dealership have in the event of either a disaster or a pandemic outbreak? • ***Utility usage audit*** … Including what steps has the dealership taken to "go green?" • ***Managing dealership compliance*** … FTC Safeguards Rule for Customer Information … *Gramm-Leach-Bliley Act* requirements ◆ Discuss requirements and risks of identity theft repercussions to the dealership ◆ Who has been named as the designated compliance officer? • Outside interests, activities, hobbies, racing, sports, collections, etc. • Centralized purchasing services • Section 62(c) accountable plans for service department and/or body shop technicians

IRS SECTION 263A GUIDANCE FOR DEALERSHIPS ... SOME GOOD NEWS & SOME BAD NEWS

REV. PROC. 2010-44

On November 9, the IRS finally issued some long-awaited guidance on Section 263A for dealerships. This was issued in the form of Revenue Procedure 2010-44. This article provides an overview and some comments on this guidance, some of which is good news and some of which is not so good (you might say it is "bad news") for dealerships.

IN THE BEGINNING, THERE WAS THE TAM

Three years ago, on September 7, 2007, the IRS shocked the auto dealership / CPA practitioner communities by publishing Technical Advice Memorandum 200736026. This TAM originated out of the IRS' audit of the practices followed by one dealership in applying the Uniform Inventory Cost Capitalization rules (UNICAP - Section 263A) to its new vehicle and other inventories.

The TAM lists 12 basic issues (questions) for which it provides conclusions (answers); however, in reality, it addresses more than a dozen questions. In some instances, the final answers are not definitive, but they are expressed as depending on the outcome of further findings of fact by the examining agent.

In this TAM, the National Tax Office was faced with what many practitioners would consider to be a very poor, or a very bad, fact pattern. This poor fact pattern is further compounded by what appear to be certain deficiencies in the presentation of the facts by the taxpayer. In several instances, the TAM states that the taxpayer provided little or no information, even though given the opportunity to do so in the form of a post-conference submission after the taxpayer's conference of right in the National Office.

As a result, for some of the questions raised, the National Office could only conclude that it was unable to reach a critical determination "based on this lack of information." One overall result is that the TAM left unaddressed many real-world practical problems because of the fact pattern specific to the dealership in the TAM.

The standard disclaimer "... (This TAM) may not be used or cited as precedent" was attached to this document. However, that seemed to make no difference because the IRS' holdings and reasoning in the TAM quickly became the template for all further discussion and the calcification of IRS audit positions with respect to Section 263A for dealerships.

For an extensive analysis of the TAM, see the *Dealer Tax Watch*, September 2007. In addition, subsequent issues of the *Dealer Tax Watch* have continued to report tidbits here and tidbits there as they appeared on the horizon.

Obviously, over the past 3 years, there has been a growing concern by dealers and practitioners about the implications of the IRS' interpretations. It was reported (anecdotally) that a few dealerships whose practices for applying Section 263A were audited by the IRS ended up facing proposed deficiencies in the hundreds of thousands of dollars.

In many presentations, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, patiently interpreted the TAM and advised listeners (i.e., dealers, controllers and their CPAs) that eventually, more formal guidance - which would be precedential - would be forthcoming from the IRS.

NADA and its representatives have expended considerable effort and energy in attempting to bring to the IRS' attention (perceived) flaws in the IRS' interpretations. Throughout this entire period, the overall state of affairs in this regard could best be described as ... *uncertain* and *unpredictable*.

THE FIRST MORATORIUM

In September of 2009, the IRS announced a temporary moratorium on the raising of Section 263A issues in dealership audits. The moratorium was to be effective from Sept. 15, 2009 through Dec. 31, 2010. In its announcement, the IRS said that this 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 comply with the legal reasoning outlined in TAM 200736026."*

The consensus (or conventional wisdom, if it can be described by that term) of the practitioners with whom I spoke was that it did not seem to be in a dealership's best interest to file a Form 3115 (to adopt the so-called "TAM Method") in view of the questionable guidance in the TAM and a host of other related issues.

During the spring and summer months of 2010, the passage of time compounded into more uncertainty over the Section 263A situation.

THE SECOND MORATORIUM

For those following the Section 263A drama, the next development occurred in August 2010, when the IRS unveiled "Son of Moratorium" a.k.a. the "Midsummer *MacGuffin*."

see **IRS SECTION 263A**, page 24

At a Glance

Cost Capitalization (Sec. 263A) Safe Harbors for Dealerships Revenue Procedure 2010-44 & Its Ramifications

Page

I. ***The party's over.*** Revenue Procedure 2010-44 ends the moratorium on the IRS raising cost capitalization issues for dealers more quickly than many expected. 25

II. ***Now you can forget about the "producer" issues.*** The technical and practical problems associated with the so-called "producer" issues can be easily side-stepped by filing Form 3115 for the dealership to make the ***reseller without production activities safe harbor method*** election. 25

III. ***Dealers with just one main facility ... "get out of jail free."*** For many dealerships, some of the broader problems associated with computations for their retail sales facilities can be significantly minimized ... or completely eliminated ... by filing Form 3115 to make the ***retail sales facility safe harbor method*** election. 26

IV. ***There's still significant Sec. 263A exposure for more geographically diverse dealerships.*** Many dealerships won't be able to include all of their facilities within their retail sales facility safe harbor election. As a result, they are still left to struggle with many difficult interpretative questions because the Revenue Procedure does not address the significant other "reseller" issues raised by TAM 200736026. 27

V. ***It's a no-brainer.*** Dealerships will probably want to file Form 3115 to make both safe harbor elections, and both changes in accounting method, generally, can be made (1) at the same time on the same Form 3115 and (2) under the automatic consent provisions of Rev. Proc. 2008-52. 27

VI. ***But, filing Form 3115 may be more complicated than you think.*** The requirements and instructions for completing and filing Form 3115 should not be underestimated. If completed properly, the exercise of filing Form 3115 to elect the safe harbors may not be as "simple" as some think it is.

- Also, a third Section 263A election/change in accounting method may need to be made. 27

VII. ***Which year should be the year of change?*** Because the IRS released the Revenue Procedure so late in the year, a major consideration is whether dealerships should make the changes effective for calendar year 2010 or for calendar year 2011. 30

VIII. ***Nominal Section 481(a) adjustments.*** In many instances, Section 481(a) adjustments under the Rev. Proc. may be relatively small, and simplified approaches or assumptions may have to be made in order to determine the final amount(s). 32

IX. ***Purchasing activities & costs.*** All dealerships - even those whose entire facilities and activities are within the safe harbors above - still have to consider whether or not they are required to capitalize any additional costs under Section 263A in connection with their purchasing activities.

- However, because of a relief provision already in the Regulations, many dealerships may be eligible to avoid this requirement if their employees spend limited amounts of time and effort in connection with their purchasing activities. 33

X. ***Bottom Line:*** For dealerships that still have to capitalize storage and handling costs, the IRS has left many important questions unanswered. 34

Form 3115, Page 1 ... Proper Identification of Changes in Accounting Method (CAM)

If Automatic CAM Provisions Apply	If Advance Permission Is Required for the CAM
• Complete only Part I, Line 1(a) of Page 1 by identifying these changes as ***Change Nos. 150, 151 & 23*** (if applicable). • Do not check the "Other" box or provide any further description of these changes on Page 1.	• Complete the top, right-hand section of Page 1 of Form 3115 entitled "Check the appropriate box to indicate type of change being requested." • Check the ***"Other"*** box. • Describe changes as ***"Section 263A Dealership Safe Harbor Elections & related changes under Rev. Proc. 2010-44."*** • Do not complete Part I, Lines 1(a) or (b) for these changes if advance consent from the IRS is required.
No User Fee Required ... Rev. Proc. 2008-52, et al.	**User Fee Must Be Paid ... Rev. Proc. 97-27, et al.**

(Continued from page 22)

[For those of you who are not fans of Alfred Hitchcock movies and television programs, a "MacGuffin" is "a literary device used frequently in stories, plays and films. It is usually an object that motivates the actions of characters, while having little actual meaning to the plot. The term was coined by director Alfred Hitchcock, and has become a common description for the plot device" (from http://www.wisegeek.com/what-is-a-macguffin.htm).]

The mid-summer 263A MacGuffin was the IRS announcement of a further extension beyond December 31, 2010 of its moratorium on raising Section 263A issues in automobile dealership audits.

In *Tier III - Field Directive on the Planning and Examination of IRC Section 263A Issues in the Auto Dealership Industry #2* (dated August 9, 2010), the IRS extended the existing audit suspension period (i.e., the moratorium) until the date the IRS publishes guidance (on these Section 263A issues) in the *Internal Revenue Bulletin.*

The *Field Directive* explains the reason for the extension as follows... "The IRS Office of Chief Counsel is currently considering additional published guidance related to dealership IRC Section 263A issues. It is expected that the guidance will address many of the issues outlined in TAM 200736026 and will apply to various retail motor vehicle dealerships."

In the *Tax Issues Update* presentation at the AICPA National Auto Dealership Conference in October, Ms. Terri Harris - the IRS Motor Vehicle Technical Advisor - said that she anticipated that guidance would be forthcoming fairly soon. Ms. Harris also said that this guidance might encompass more than just the so-called Section 263A *"producer"* issues.

REV. PROC. 2010-44 ...
PRECEDENTIAL GUIDANCE AT LAST

The long-anticipated guidance from IRS on Section 263A was published on November 9, 2010 in Revenue Procedure 2010-44. Under this Revenue Procedure, motor vehicle dealerships (and many other types of dealerships) will be allowed to elect to use one or both of two safe harbor methods of accounting that should greatly alleviate (some of) their problems in complying with Section 263A.

Dealers may elect to change their Sec. 263A accounting methods in order to (1) treat certain sales facilities as retail sales facilities for purposes of Section 263A, and/or (2) be treated as resellers without production activities for purposes of Section 263A.

The IRS will allow dealerships to use the more-expedited automatic consent change procedures under Rev. Proc. 2008-52 for filing Forms 3115 to implement the accounting method changes to use the safe harbor methods.

The Revenue Procedure is relatively short and almost half of it is boiler-plate background discussion. What remains is rather broad and, to the layman, almost cryptically worded. From people I've talked with so far, reactions after a first reading seem to be (1) "Is this too good to be true?" ... (2) "What is this really saying?" ... (3) "What's the catch?" ... (4) "Where's the rest of the guidance?" ... (5) "What's the big deal over the IRS eliminating the 'producer' issues (since most of us have always dismissed those as far-reaching technicalities that would never see the light of day in the real world)?"

Although some of the technicalities may be confusing to the layman, the discussions of concurrent and/or multiple changes in accounting method may, for all practical purposes, involve negligible amounts of Section 481(a) adjustments, if any are involved at all. Furthermore, in some instances, the Section 481(a) adjustment(s) may end up being net negative amounts which can be taken as a deduction in the year of change (or as practical matter, may be ignored because of their inconsequential amount). More about this later.

So you can appreciate the language involved, the text of Rev. Proc. 2010-44 ... with a little tinkering on my part to make it more reader-friendly ... is reproduced as supplementary material on page 35.

CAVEATS ... READER, BEWARE

The following observations and comments probably should be considered as *"Part I"* in an on-going dialogue and series of articles discussing Rev. Proc. 2010-44 and its implications. But first, two general qualifications.

First, please keep in mind that this article is a general summary with observations, and it is not intended to be a substitute for your own critical, independent thinking on all matters discussed herein. For further caveats, please see the disclaimer on the last page of this publication.

Second, many practitioners seem to feel that life will be simpler after the Rev. Proc. since - at most - all they will have to do is continue using *"the"* simplified resale method. As articles in the *Dealer Tax Watch* (and elsewhere) have thoroughly pointed out, there are - in fact - many different approaches used by dealerships which are collectively, and sometimes carelessly, referred to as "simplified resale methods."

In reality, dealerships may be, or could be, using (1) the original simplified resale method, (2) the alternative simplified resale method, (3) the modified

→

simplified resale method and (4) the simplified resale method without historical absorption ratio election ...to name but a few. These variations were enacted along the way since Section 263A came into the Internal Revenue Code in 1986, with the last variation introduced when the cost cap Regulations were amended in 1994. Then there's also various dealership self-developed (simplified) methods, not to mention "zero-UNICAP." For a more complete discussion, see *"Cost Capitalization for Auto Dealers"* in the December 1994 issue of the *Dealer Tax Watch.*

This article is intended to summarize Revenue Procedure 2010-44 and its ramifications. Accordingly, discussion of all of these "simplified resale method" variations is beyond its scope. The preceding paragraph is there to alert you to the fact that over the 25 years or so since the enactment of Section 263A, dealership practices as they relate to cost capitalization have varied from entirely ignoring the provision ... to the ridiculous ... to the sublime, and few practitioners can claim to be masters of the realm.

OBSERVATIONS & COMMENTS

I. The moratorium on the IRS raising cost capitalization issues in dealership audits has ended more quickly than many of us expected.

Revenue Procedure 2010-44 ends the moratorium on the IRS raising cost capitalization issues for dealers.

As discussed in the chronology of the moratoriums, the most recently announced termination of the moratorium was to be the date when the IRS publishes guidance on Section 263A issues in the *Internal Revenue Bulletin.*

Revenue Procedure 2010-44 is schedule to be published in *Internal Revenue Bulletin 2010-49* on December 6, 2010. Accordingly, that will be the date on which the moratorium on the raising of Sec. 263A issues will end.

Ironically, it turns out that the extension of the moratorium wasn't really needed after all; hence, its qualifying technically as a MacGuffin. But, in any event, the clock is definitely running now ... and decisions need to be made.

II. The problems associated with the so-called "producer" issues can be easily side-stepped by filing Form 3115 to make a safe harbor method election provided by the Revenue Procedure.

Many commentators have basically divided the cost capitalization issues raised by the IRS in TAM 200736026 into two groups or "buckets" of issues.

The first group of issues involves what can be generalized as "production" or "producer" issues. These have (or shall we say, "had") the potential to create significantly large deficiencies if a dealership's cost capitalization computations were audited by the IRS.

Basically, these producer issues 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 underlying question in this regard 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 first part of the TAM listed six major issues and some of these were divided into multiple parts.

With respect to customer-owned vehicles, the conclusion in the TAM was that when the dealership (or a subcontractor) installed parts to customer-owned vehicles, that installation activity ***did not*** constitute production activity for purposes of Section 263A. This was because the dealership did not hold the underlying benefits and burdens of ownership of the (customer's) vehicle.

However, the conclusion in the TAM was that, with respect to vehicles that the dealership owned, various activities within the service department ***may*** constitute production activities, and the costs associated with those activities would be handling costs. However, the TAM did not specifically state how the dealership should have treated these costs, and it used vague "either" ... "or" language in wording its conclusion.

Rev. Proc. 2010-44 mercifully provides dealerships with an opportunity to avoid all entanglements with these producer issues. It does so by providing that a dealership may make a safe harbor method election under Section 5.02 of the Rev. Proc. to treat itself as a ***reseller without production activities*** for purposes of Reg. Sec. 1.263A-3.

For this purpose, activities that the dealership performs on vehicles owned by the dealership will be considered to be "handling activities" (under Reg. Sec. 1.263A-3(c)(4)). However, the costs of these handling activities, other than the cost of vehicle parts, are not required to be capitalized to the extent incurred at the dealership's retail sales facility.

This is a huge benefit for dealers and dealerships.

To make this election to use the reseller without production activities safe harbor method, the dealership merely needs to file Form 3115 using the newly-

see **IRS SECTION 263A**, page 26

(Continued from page 25)

introduced automatic change procedure (No. 151) that has been added as Section 11.07 to the *Appendix* to Revenue Procedure 2008-52.

Rev. Proc. 2010-44 does require a dealership to capitalize the cost of vehicle parts that are installed in or added to dealership-owned vehicles as an acquisition cost of its vehicles, regardless of whether the vehicle parts are acquired directly by the dealership or indirectly through a contractor.

The Rev. Proc. also provides that a dealership using this safe harbor method may use the simplified resale method under Reg. Sec. 1.263A-3(d) for its vehicles and other eligible property.

Keep in mind the caveat that, in the past, dealerships may have used multiple approaches which - if one ignores the technicalities - all would fall into the generalization of being "simplified resale methods" but not necessarily qualify under the added proviso that they be "under Reg. Sec. 1.263A-3(d)."

III. For many dealerships, some of the broader problems associated with computations for their retail sales facilities can be significantly minimized ... or completely eliminated ... by making another safe harbor method election.

By way of brief background, the second group or "bucket" of issues raised by the IRS In TAM 200736026 involves what can be generalized as "reseller" issues. These issues relate to the retail activities through which typical dealerships conduct their businesses.

These issues 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. This gets even further into dual-function storage facility questions.

In the TAM, many of the dealership's sales of vehicles and parts were identified as meeting the definition of "off-site" sales ...and that's a bad result for the dealership because from this determination, it would follow that expenses or costs allocable to those "off-site" sales must be capitalized.

The specific dealership in the TAM conducted its operations at two separate and distinct locations. There was a geographic separation of one-half mile between these two locations, and another important factor was that the second location did not have any identification to indicate that the vehicles stored on the property there were owned by, or available for sale by, the dealership conducting business at its main location. Furthermore, the dealership did not have a sales office at this second location, nor were any sales activities conducted there.

For many dealerships whose activities are conducted on more than one plot of land, their facts will significantly differ from facts of the dealership in the TAM. In other words, other dealerships may conduct business on several locations that are much closer to each other geographically (although, not necessarily across the alley from each other as in the Regulation example).

Also, for these dealerships, there may be considerable or significant dealership identification (signage, etc.) and sales activity conducted at the second or other location(s). Depending on the facts and circumstances in each individual case, the result for these dealers with multiple locations could be that considerably fewer dollars would be capitalized as additional Section 263A costs.

In regard to these multiple location considerations, Rev. Proc. 2010-44 mercifully provides dealerships with an opportunity to avoid significant further controversy with the IRS. It does so by providing that a dealership may make a safe harbor method election under Section 5.01 of the Rev. Proc. to treat its entire sales facility from which it normally and routinely conducts on-site sales to retail customers, including any vehicle lot that is an integral part of its sales facility and that is routinely visited by retail customers, as a ***retail sales facility*** under Reg. Sec. 1.263A-3(c)(5)(ii)(B).

Under this Regulation, a "retail sales facility" is defined as "a facility where the taxpayer sells merchandise ***exclusively*** to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site (i) which are customarily associated with and are in integral part of the operations of that retail site, (ii) which are generally open each business day exclusively to retail customers, (iii) on or in which retail customers normally and routinely shop to select specific items of merchandise, and (iv) which are adjacent to or in immediately proximity to other portions of the specific retail site."

In effect, by making the election to use the ***retail sales facility safe harbor method***, the dealership frees itself from any further consideration of whether sales in that facility are on-site or off-site sales. This, apparently, renders moot or unnecessary any further debate or deliberation over such troublesome issues as whether (1) dealer trades, (2) lease sales transactions and/or (3) Internet sales would be classified as

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"wholesale" or off-site sales because, technically, the purchaser was not the end consumer or had not personally visited the showroom.

The opportunity to make this safe harbor election is also a huge benefit for dealers and dealerships.

To make this election to use the retail sales facility safe harbor method, the dealership merely needs to file Form 3115 using the newly-introduced automatic change procedure (No. 150) that has been added as Section 11.07 of the *Appendix* to Revenue Procedure 2008-52.

If the dealership makes the election to use the retail sales facility safe harbor method, it will not be required to capitalize ***handling and storage costs*** incurred at its retail sales facility. As discussed later in this article: (1) purchasing costs are required to be capitalized in accordance with Reg. Sec. 1.263A-3(c)(3), and (2) the dealership may find (significant) relief by electing to use a Special 1/3 - 2/3 Rule.

IV. Many dealerships won't be able to include all of their facilities into their retail sales facility safe harbor. As a result, they are still left to struggle with many difficult interpretative questions because the Revenue Procedure does not address the significant other "reseller" issues raised by TAM 200736026.

In other words, if a dealership's facilities and activities cannot all be encompassed by their being grouped together (with its main retail sales facility) for purposes of the retail sales facility safe harbor method, then if there is an IRS audit, it appears that their CPAs are still left "on their own" to struggle with the on-site/off-site sales determinations and dual-facility rules in the Regulations and as interpreted by the Internal Revenue Service in the TAM. But remember, the TAM in theory has no precedential value!

Unfortunately, Revenue Procedure 2010-44 does not address or discuss how dealer trades, lease sales and Internet sales will be classified in situations where the dealership's facilities/activities are not within the safe harbor election. Are we still left with these unanswered questions?

Furthermore, where the retail sales facility safe harbor method does not apply, how are dealerships using LIFO to apply the results of their Section 263A computations?

V. Dealerships will probably want to file Form 3115 to make both safe harbor elections.

Based on the foregoing, it would appear to be in a dealership's best interest to file Form 3115 to (elect to) change to both of the safe harbor methods offered by the IRS in Revenue Procedure 2010-44. Doing so should afford most dealerships with immediate "audit protection" under Section 8 of the Revenue Procedure if they are not already under audit with Section 263A issues under consideration.

Make both elections at the same time. Both changes in accounting method, generally, can be made (1) at the same time on the same Form 3115 and (2) under the automatic consent provisions of Rev. Proc. 2008-52.

Thanks to another change, Section 11.07 added to the *Appendix* of Revenue Procedure 2008-52 makes it even easier for many dealerships to qualify to make the change as an automatic change in method. This change provides that certain scope limitations will be suspended or treated as "temporarily inapplicable for the dealership's first or second taxable year ending after November 9, 2010."

VI. The requirements and instructions for completing and filing Form 3115 should not be underestimated. If completed properly, the exercise of filing Form 3115 to elect the safe harbors may not be as "simple" as some believe it to be, or wish it were.

So far, the snap reaction by many CPAs will be ... "Great - All we've got to do now is file Form 3115." Now, we want to talk about how simple or complex the exercise of filing that Form 3115 could be. First, you probably should go back and re-read portions of the article (pages 24-40) in the last (Mid-Year) Edition of the *Dealer Tax Watch* which analyzed the new revisions that the IRS made to Form 3115 and the Instructions for that Form.

A considerable amount of information is required to be filed in support of requests for changes in accounting method, regardless of whether those changes are automatic (under Rev. Proc. 2008-52) or require advance consent (under Rev. Proc. 97-27).

That article goes to great lengths to describe the special complications that go along with requesting a change in accounting method (whether automatic or advance-consent) that involves Section 263A. Although the focus of some that discussion was on the filing of Form 3115 in connection with terminating a LIFO election and the related concerns over the impact of the IRS' requirements for further disclosures related to Section 263A, much of that discussion now applies specifically to dealerships that will be filing Forms 3115 to make the safe harbor method elections under Rev. Proc. 2010-44.

see **IRS SECTION 263A**, page 28

(Continued from page 27)

Form 3115 ... Pages 7 & 8 are critical. Part III of Schedule D on Pages 7 and 8 are the critical schedules of Form 3115 that must be dealt with when filing the Form to change Section 263A cost capitalization accounting methods. It would appear from the Instructions for Form 3115 for Schedule D that there would be no entries required to be made on Page 6. In other words, Parts I and II of Schedule D could be left blank.

Part III of Schedule D is divided into 3 Sections (A, B and C). Section A, at the top of Page 7, requires taxpayers to include a detailed description ... including sample computations ... of the present and proposed method(s) that the applicant uses to capitalize direct and indirect costs properly allocable to property acquired for resale.

This detailed description should include a description of the method(s) used for allocating indirect costs to property acquired for resale. In addition, it should include descriptions of (1) the method of allocating direct and indirect costs, (2) the method of allocating mixed service costs and (3) the method of capitalizing additional Section 263A costs.

Section B, the bottom portion of Page 7, lists 28 *Direct and Indirect Costs Required to Be Allocated* and has a two "check the box" columns for the present method and for the proposed method.

Finally, Section C, at the top of Page 8, lists 8 other types of costs that are not required to be allocated, and it also has two "check the box" columns for the present method and for the proposed method.

Pages 7 and 8, Section D, Part III are condensed on the facing page.

One decision that has to be made (by the preparer and by the signer of the Form 3115) is whether all of the information required by Part III will be submitted to the IRS in exactly the manner called for by the Schedules. Alternatively, might that information be submitted by a more general statement or statements? Into how much detail does the IRS want to go in probing (admittedly) imperfect past methods used by the dealership for capitalizing Section 263A costs? Or, is the spirit of compliance with Revenue Procedure 2010-44 by the dealership seeking to sail into the safe harbor method sufficient to permit the dealership to omit disclosure of its past imperfect practices?

Also, it should be emphasized that the "directive" in Schedule A requiring a description includes the (directive?) that the taxpayer filing Form 3115 should also include ***sample computations***. Here again, sample computations are called for in connection with both the (1) present/"old" methods and the (2) proposed/"new" methods.

Some dealerships ... Still in the dark. Some dealerships' facilities and activities will not be covered by the change in method to the retail sales facility safe harbor method election because the facilities are too spread out geographically, or they are otherwise non-contiguous with, or disconnected from, the main retail sales facility qualifying for this election. Accordingly, in order to comply with Section 263A, an analysis of these facilities and activities will require (1) on-site vs. off-site sales determinations, (2) dual-facility allocations and (3) the determination of storage and handling costs - including allocable service costs related thereto - that must be capitalized.

The problem in a nutshell. Dealerships whose entire facilities and activities will not be covered under the retail sales facility safe harbor method election ... i.e., for the portions of their facility that are not within the safe harbor method elections ... will have to "do the computations or calculations" and show or discuss them in an attachment to the Form 3115 when it is filed.

Unfortunately, there is no guidance in Rev. Proc. 2010-44 concerning various interpretations of these critical transactions (such as dealer trades, lease sales and Internet sales). Also, it seems unlikely that there will be any more guidance on how to answer these questions from the IRS either (1) in the form of a Rev. Proc. or something precedential, or (2) in the form of detailed sample computations or worksheets in the "tool kit" providing either a suggested or approved approach.

Query... With respect to these facilities and the determination of Section 263A capitalizable storage and handling costs, aren't these dealerships still as much in the dark and as vulnerable after Rev. Proc. 2010-44 as they were before the IRS issued it?

As a consequence, quite a bit of thought will have to be given to the process of ***"simply"*** filing Form 3115 to make these safe harbor elections. What to say, how much to say, how to say "it," and sample computations ... all require careful thought.

Clearly, it will be necessary to attach to the Form 3115 a narrative statement providing certain explanations and making the desired elections. In this narrative statement, some of the considerations discussed above will need to be addressed.

see **IRS SECTION 263A**, page 30

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.)		

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.)		

(Continued from page 28)

Possible "third election"...? In addition to the dealership's affirmatively electing to change cost capitalization methods to both of the safe harbor methods, the dealership may want to - or have the need to - also confirm that it will continue using the simplified resale method (with or without further elaboration) for any of its activities that are not covered by either or both of the safe harbor elections.

Section 5.02 of Rev. Proc. 2010-44 provides that a dealership using the reseller without production activities safe harbor method ***may*** use the *"simplified resale method under Reg. Sec. 1.263A-3(d)"* for its vehicles and other eligible property. This raises a consideration/concern for dealerships that have used methods to capitalize costs that (possibly) approximate the simplified resale method, but are not exactly the same as the simplified resale method contemplated and referred to in that Regulation.

For these dealerships, it may be that they should include in their Forms 3115 a third (automatic) change in accounting method under Section 263A to elect to use the *"simplified resale method under Reg. Sec. 1.263A-3(d)."* It appears that this would be a automatic change under Section 11.02 of Revenue Procedure 2008-52 as amplified and modified by Revenue Procedure 2009-39.

Section 11.02 of the *Appendix* to Revenue Procedure 2008-52 (as amplified and modified by Rev. Proc. 2009-39) provides that an automatic change may be made by a reseller-producer that wants to change to a *UNICAP* method (or methods) specifically described in the Regulations, and this covers any changes in the identification of costs subject to Section 263A made in connection therewith.

For purposes of this definition, a *UNICAP* method specifically described in the Regulations includes (1) the 90-10 *de minimis* rule to allocate a mixed service department's costs to production or resale activities ..., (2) the 1/3 — 2/3 rule to allocate labor costs of personnel to purchasing activities ..., (3) the 90-10 *de minimis* rule to allocate a dual-function storage facility's costs to property acquired for resale. However, that term does not include any other reasonable allocation method within the meaning of Reg. Sec. 1.263A-1(f)(4).

The Instructions for Form 3115, as well as Revenue Procedure 2008-52 provide that "Ordinarily, a taxpayer must submit a separate application for each change in method of accounting. In some cases, however, the provisions of this Revenue Procedure applicable to particular changes may require or allow a taxpayer to file a single application with respect to two or more changes."

Revenue Procedure 2010-44 does not specifically state whether this third change (i.e., the change to the *"simplified resale method under Reg. Sec. 1.263A-3(d)")* could be made on the same Form 3115 that is being used by a dealership to elect the Sec. 263A safe harbor methods. Although, it appears that it can be included on the same Form 3115.

Another problem for preparers of Forms 3115 could arise in terms of what to say or how to describe the circumstances if the dealership is unable to locate or attach copies of previously filed Forms 3115 that would document the fact that certain "elections" previously were made to reflect the dealership's practices or methods for capitalizing costs under Section 263A.

VII. A major consideration is whether dealerships should make the changes effective for calendar year 2010 or for 2011.

Before discussing this further, for context, we should review the two different Form 3115 filing procedures that we're talking about.

Automatic consent procedures. As mentioned previously, most dealerships should be able to obtain automatic consent from the IRS to elect the safe harbor methods by complying with the filing procedures set forth in Revenue Procedure 2008-52.

Original Form 3115. For Forms 3115 filed under the automatic change provisions, the original signed Form 3115, with attachments, must be attached to the taxpayer's timely filed (including any extension) original Federal income tax return for the year of change.

In other words, for a change effective for calendar year 2010, the original Form 3115 (with attachments) is to be filed by the (extended) due date of the tax return. Taxpayers are not required to pay a user fee in connection with an automatic change Form 3115.

Duplicate copy filing requirement. In this regard, there is a further duplicate filing requirement. A ***copy*** (with signature) of Form 3115 must be filed with the National Office "no earlier than the first day of the year of change and no later than when the original is filed with the Federal income tax return for the year of change."

For the National Office copy of Form 3115, the taxpayer need only include the pages containing Parts I through IV, any applicable schedule(s), and required attachments. Parts I through IV (Pages 1 through the top of Page 4 of Form 3115) require identification of the taxpayer and other specific information, *Information for Automatic Change Requests* (Part I), *Information for All Requests* (Part II), *Information for Advance Consent Requests* (Part III) and *Section 481(a) Adjustment* (Part IV).

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Accordingly, although certain disclosures in response to the questions in Part II may require explanations in an attached narrative statement, it appears that the information required by Schedules A, B, C, D and E are not required to be submitted as part of the ***copy*** of the Form 3115 that is filed with the National Office.

In the past, as a matter of routinely complying with this duplicate copy filing requirement, many practitioners simply have filed a copy of the entire Form 3115 with the National Office. However, a close reading of this requirement (see Rev. Proc. 2008-52, Section 6.02(3)(a)) suggests that filing a copy of the more detailed information called for by Schedules A through E is not required.

Advance consent request procedures. If the dealership is not within the scope of the ***automatic change*** request procedures, then it may be able to file a request to make its change in accounting method under the ***advance consent*** request procedure found in Revenue Procedure 97-27. In this case, Page 6 of the Instructions for Form 3115 has information for advance consent requests and advance consent request scope limitations. Part III (Questions 18-23b), Page 3 of Form 3115 must be completed.

The original of Form 3115 requesting advance consent to change methods of accounting must be filed ***before*** the end of the year of the requested change in method. A user fee (currently $4,200) is required to be paid.

2010 or 2011 ... Which should be the year of change? Overall, it's a no-brainer that dealerships should file Form 3115 to make the safe harbor elections. However, given the complexity and challenges facing many dealers who will still have some of their activities and facilities exposed to cost capitalization, perhaps consideration should be given to making the year the changes become effective 2011 - rather than 2010.

In other words, maybe the dealership should consider giving itself a *"moratorium"* by not filing Form 3115 until January 2011.

One good reason to wait is because little further guidance can or should be expected from the IRS on dealership cost capitalization issues and interpretations. Should one really expect any further guidance in the form of supplemental information in the updating of the "tool kit" which was included as a supplement to the first IRS Directors Directive in 2009 suspending Section 263A audits?

Or, is it more likely that information will filter into the practitioner community on a piece-meal anecdotal basis as the result of hearsay discussions or pirated copies of worksheets developed during IRS audits?

Consider this situation ...Case #1. A dealership desires to protect itself immediately from further Section 263A complications by making both safe harbor elections. It intends to file Form 3115 to make its changes effective for calendar year 2010 under the automatic change procedures. The dealership intends to make the changes by attaching the original of Form 3115 to its Federal income tax return when it timely files its return in March or mid-year 2011. It also intends to send the required duplicate copy of Form 3115 to the National Tax Office when it files its income tax return.

Let's assume that (1) the dealership's tax return for 2010 is not filed until June 15, 2011 and (2) the IRS starts an audit of the dealership on February 1 or May 1.

Case #1 Queries... Does the dealership have immediate "audit protection" with respect to 2010 and prior years? Or, does the "audit protection" not start until the Form 3115 is filed with the IRS? Will an IRS agent "believe" or accept the word of the dealer that he/she ***intends*** to file Form 3115? Can the dealership do anything to avoid this "limbo" state? ... Like, perhaps, filing the copy of the Form 3115 with the National Office right away, or in any event, before December 31, 2010 or right after January 1, 2011?

Section 7.01 of Rev. Proc. 2008-52 and the related exceptions contained elsewhere in the Rev. Proc. are the starting points for getting to answers to these questions. Section 7.01 states that except in certain situations, "When a taxpayer timely files a copy of the application with the National Office in compliance with all the applicable provisions of this Revenue Procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change."

Consider the alternative situation ...Case #2. A dealership desires to protect itself from further Section 263A complications by making both safe harbor elections. However, it is late in the year 2010, and there are only a few more days until January 1, 2011. So far, the dealership has been lucky, and the IRS has not started an audit. Perhaps the dealer is willing to "run out the clock" and take the risk that the IRS will not start an audit before January 1, 2011.

Let's assume that the dealer intends to make the changes (i.e., to make both safe harbor method elections) effective for calendar year 2011. Also, let's assume that this dealership has facilities which cannot all be covered by the retail sales facility safe

see **IRS SECTION 263A**, page 32

(Continued from page 31)

harbor method. Therefore, the dealership is still exposed to capitalizing storage and handling costs, as well as purchasing costs (not to mention allocable mixed service costs) under Section 263A.

In other words, some of the dealership's activities will be subject to the capitalization of storage and handling costs ... so there are real computational questions and issues to be addressed.

This dealership intends to make the changes effective for 2011 by attaching the original of Form 3115 to its Federal income tax return when it is timely filed in 2012. The dealership also intends to send the required duplicate copy to the National Tax Office.

However, let's assume that the dealership files the (requisite duplicate) copy of Form 3115 with the National Office on January 2, 2011.

Case #2 Queries... Does the dealership obtain "audit protection" with respect to 2011 and prior years as soon as it files the copy of Form 3115 with the National Office? Or, does the "audit protection" not start until the Form 3115 is filed?

Note that the copy of Form 3115 may be filed with the IRS National Office "***no earlier than the first day of the year of change*** ... and no later than when the original is filed with the Federal income tax return for the year of change."

Since 2011 is the intended year of change, and January 2 comes after "the first day of the year of change," can the filing of the signed, duplicate copy with the National Office trigger the desired audit protection for 2011 and prior years?

If the answer is, "Yes," then the dealership has "given itself a moratorium" ... or some breathing room to consider more carefully the computations it is required to submit ... because it has postponed the date of reference for the computation of the Section 481(a) adjustment required by the changes from January 1, 2010 (which would be the date of computation if the changes were effective for the year 2010) to January 1, 2011 (which would be the date of computation if the changes were effective for the year 2011).

Once again, if the dealership came under audit, would the IRS agent "believe" or accept the word of the dealer that he/she ***intends*** to file Form 3115 with its income tax return for the year 2011?

In either case, how thorough or complete will the Form 3115 the dealership files with the IRS either before December 31, 2010 (Case #1) ... or shortly thereafter - in January 2011 (Case #2) ... actually be if it is being filed as the result of a rush-to-judgment to file before "the IRS ***might*** start an audit?"

VIII. In many instances, Section 481(a) adjustments under the Rev. Proc. may be relatively small, and simplified approaches or assumptions may have to be made in order to determine the final amount(s).

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year when there is a change in method of accounting to which Section 481(a) is applied.

Income for the ***taxable year preceding the year of change*** must be determined under the method of accounting that was then employed, and income for the ***year of change*** and the following taxable years must be determined under the new method of accounting as if the new method had always been used. The Section 481(a) adjustment is computed notwithstanding that the period of limitations on assessment and collection of tax may have closed on the years (closed years) in which the events giving rise to the need for an adjustment occurred.

In general, for a net positive Section 481(a) adjustment, the spread period is 4 years. In the case of a positive Section 481(a) adjustment, under a *de minimis* rule, the taxpayer may elect to use a one-year Sec. 481(a) adjustment period, in lieu of the 4-year spread period. This is done by simply checking the "Yes" box on Page 4 for Part IV, Line 26 on Form 3115 to elect this treatment.

For a net negative Section 481(a) adjustment, the spread period is 1 year. For dealerships making the ***retail sales facility safe harbor method change***, if this safe harbor covers all of the dealer's facilities, then the Section 481(a) adjustment is likely to be a negative Section 481(a) adjustment.

It would appear that many dealerships will elect to forego the benefits of any negative Section 481(a) adjustments ... even though they may be taken as deductions in the year of change ... just in order to keep things simple.

Similarly, for dealerships making the ***reseller without production activities safe harbor method change***, if the dealership had previously been capitalizing certain service labor costs and profit on gross parts on dealership-owned vehicles, then the Section 481(a) adjustment in this regard is also likely to be a negative Section 481(a) adjustment. Here again, this could be good news for the dealership because a negative Section 481(a) adjustment may be deducted in its entirety in the year of change.

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Some dealerships *do not reflect* the impact of Section 263A in their accounting systems (i.e., on their books); instead, they reflect it only as a Schedule M-1 of Schedule M-3 adjustment. For these dealerships, the calulation of the Sec. 481(a) adjustment should be simple.

For dealerships that *do reflect* the impact of Section 263A in their accounting systems (i.e., on their books), the computation of the Sec. 481(a) adjustment becomes more problematic because of the language in Revenue Procedure 2010-44 that prevents them from using a simplified resale method in order to compute the Sec. 481(a) adjustment. Precisely what this means is not clarified in the Rev. Proc.

As discussed below, a dealership may have to capitalize some costs attributable to purchasing activities either as part of its Section 481(a) adjustment and/or as part of its ongoing Section 263A cost determinations in succeeding years.

IX. Purchasing costs still may have to be capitalized.

Basically, dealerships (as resellers) are required to capitalize four classes of costs ... (1) off-site storage, (2) purchasing, (3) handling and processing and (4) general and administrative expenses allocable to the above. Regardless of which simplified allocation method may be elected, each cost category must be analyzed and appropriately capitalized.

As discussed in connection with the election to use the retail sales facility safe harbor method, to the extent this election is effective, the dealership will not be required to capitalize handling and storage costs incurred at its retail sales facility.

However, the dealership is still required to consider and capitalize, if necessary, purchasing costs and allocable general and administrative expenses related thereto. Allocable general administrative expenses are referred to as "mixed service costs" and are defined in the Regulations.

Purchasing costs are required to be capitalized in accordance with Reg. Sec. 1.263A-3(c)(3). *Purchasing costs* are those related to (1) the selection of merchandise, (2) the maintenance of stock, assortment and volume, (3) the placement of purchase orders, (4) the establishment and maintenance of vendor contracts, and (5) the comparison and testing of merchandise.

The determination of whether an employee is engaged in purchasing activities is based upon the activities performed by the employee, and not upon his or her title or job classification.

see **IRS SECTION 263A**, page 34

Reg. Sec. 1.263A	*PURCHASING COSTS ... ALLOCATION & CAPITALIZATION*
1/3 - 2/3 Rule *[-3(c)(3)(ii)(A)]*	• ***1/3 - 2/3 Rule for Allocation Labor Costs.*** A taxpayer may elect to apply the following rule for allocating labor costs in connection with employees who perform both purchasing and non-purchasing activities. Under this rule, which is based on the person's ***activities*** related to purchasing... ◆ ***If less than 1/3 ... none*** of that person's labor cost is allocated to purchasing activities. ◆ ***If more than 2/3 ... 100% or all*** of that person's labor cost is allocated to purchasing activities. ◆ ***If 1/3 or more or less than 2/3 ... a reasonable allocation*** must be made between activities. • This determination is made on an employee-by-employee basis (not on an overall departmental basis).
Purchasing Activities ***Example*** *[-3(c)(3)(ii)(B)]*	• Taxpayer/reseller employs three persons - A, B, and C - who perform both purchasing and non-purchasing activities. • These persons spend the following time performing purchasing activities: A - 25% ... B - 70% ... and C - 50%. • Under the 1/3 - 2/3 rule... ◆ None of A's labor costs are treated as purchasing costs ... because time is under 1/3. ◆ All (i.e., 100%) of B's labor costs are treated as purchasing costs ... because time is over 2/3. ◆ 50% of C's labor costs are to be allocated as purchasing costs ... because time falls between 1/3 and 2/3.
Purchasing Activities ... *[-3(c)(3)(i)]*	• Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs relating to... ◆ The selection of merchandise, ◆ The maintenance of stock assortment and volume, ◆ The placement of purchase orders, ◆ The establishment and maintenance of vendor contacts, and ◆ The comparison and testing of merchandise.

(Continued from page 33)

Possible relief from having to capitalize purchasing costs. Dealerships may obtain (significant) relief from having to capitalize purchasing costs by making a special election. This election is affectionately known as the "1/3 - 2/3 Rule for Allocating Labor Costs," and it is found at Reg. Sec. 1.263A-3(c)(3)(ii)(A).

Under this election/rule, a taxpayer may elect to apply the following rule for allocating labor costs in connection with employees who perform both purchasing and non-purchasing activities.

If elected, there is a 3-prong test ... (1) if less than 1/3 of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing, (2) if more than 2/3 of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing, and (3) in all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

The example in the Regulations makes it clear that this determination is to be made on an employee-by-employee or individual-by-individual basis, and it is based on time (hours or days?) performing purchasing activities. It is not to be made on an overall departmental basis.

If the purchasing activities ***of any individual or employee*** exceed 1/3 of his or her overall activities, then the dealership is required to capitalize (1) that individual's appropriate labor costs, and (2) an appropriate allocable amount of general and administrative expenses (mixed service costs) allocable to that labor cost.

Under this 1/3 - 2/3 Rule, many dealerships may find that they have insignificant amounts to capitalize or that they have none at all to capitalize because the purchasing activities do not exceed the 1/3 threshold for any individual employee.

X. Conclusion.

The Regulations under Section 263A contain a number of significant provisions that either totally or partially exempt dealerships from having to cope with the cost capitalization provisions.

First, if a dealership has average gross receipts for the last 3 years of less than $10 million, it would be completely exempt from Section 263A ... unless the IRS really pushed the "producer issues" to the hilt (but that now seems to be in the past).

Second, now as a result of the significant liberalizations made by Revenue Procedure 2010-44 and the introduction of the two safe harbor method elections, many more dealerships (after they file Forms 3115) may have no Section 263A or UNICAP costs to capitalize. Although freed from the need to capitalize storage and handling costs, these dealerships still will have to consider and quantify purchasing costs.

However, if the activities of individuals who are involved in purchasing activities at these dealerships are limited so as to fall below the 1/3 threshold provision for eliminating purchasing costs, then the dealership will have arrived at the promised land ... no Section 263A or UNICAP costs to capitalize. So, these dealerships - after they file Forms 3115 to make their safe harbor elections - collectively comprise another group emancipated from Section 263A.

Third, for those dealerships unable to achieve full emancipation from the grasp of Section 263A, the Regulations provide simplified computation methods which dealerships may elect to use to eliminate many of the more detailed requirements that they would otherwise have to follow. Collectively, and perhaps as an oversimplification, these methods are referred to as "the simplified resale method."

Unfortunately for these dealerships, it appears that all of the threatened adverse interpretative problems raised by TAM 200736026 still remain potentially available and at the ready for ambitious Revenue Agents to raise in their audits of dealerships' cost capitalization practices.

Compounding the uncertainty further is the likelihood that further precedential clarification, guidance, or examples will not be forthcoming ... if not for a long time ... in the foreseeable future.

As a final reminder, practitioners should not underestimate the importance of having a signed, written engagement letter. This 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.

REVENUE PROCEDURE 2010-44
COST CAPITALIZATION SAFE HARBOR METHOD ELECTIONS FOR DEALERSHIPS

Summary

- The Revenue Procedure contains guidance from the IRS in the form of two safe harbor cost capitalization methods that dealerships may elect to alleviate many of the issues raised by the IRS in TAM 200736026.
- Changing to the safe harbor methods will require the filing of Form 3115.
- In most instances, dealerships should be able to make the change under the automatic consent provisions.
- The effective date of the Revenue Procedure is Nov. 9, 2010.

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- ***Sec. 10 ... Drafting Information*** ..... Omitted

		Citations & Comments
Section 1 Purpose	• This Revenue Procedure provides that certain motor vehicle dealerships may use either or both of the safe harbor methods of accounting provided by this Revenue Procedure to ... ◆ Treat certain sales facilities as retail sales facilities for purposes of Sec. 263A of the Internal Revenue Code, and ◆ Be treated as resellers without production activities for purposes of Sec. 263A. • This Revenue Procedure also provides procedures for obtaining automatic consent to make accounting method changes to use the safe harbor methods.	
Section 2 Background	• A taxpayer subject to Section 263A is required to include in inventory costs direct costs and indirect costs properly allocable to the taxpayer's produced and acquired inventory property.	• Section 263A(a), Reg. Sec. 1.263A-1(a)(3)(i)
	• A taxpayer that acquires property for resale (reseller) is required to capitalize the acquisition cost of, and the indirect costs that are properly allocable to, property acquired for resale. ◆ The indirect costs most often incurred by resellers are purchasing, handling, and storage costs.	• Reg. Sec. 1.263A-3(c)(1)
	• However, a reseller is not required to capitalize handling and storage costs incurred at a retail sales facility.	• Reg. Sec. 1.263A-3(c)(4)(i), Reg. Sec. 1.263A-3(c)(5)
	• Handling costs include the costs of processing, assembling, repackaging, transporting, and other similar activities that do not come within the meaning of the term *"produce."*	• Reg. Sec. 1.263A-3(c)(4) • The term "produce" is defined in Reg. Sec. 1.263A-2(a)(1).

		Citations & Comments
Section 2 Background *(continued)*	• A *"retail sales facility"* is defined as a facility where a taxpayer sells merchandise ***exclusively*** to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site ... ◆ That are customarily associated with and are an integral part of the operations of that retail site, ◆ That are generally open each business day ***exclusively*** to retail customers, ◆ On or in which retail customers normally and routinely shop to select specific items of merchandise, ***and*** ◆ That are adjacent to or in immediate proximity to other portions of the specific retail site.	• Reg. Sec. 1.263A-3(c)(5)(ii)(B)
	• Two lots of an automobile dealership that are physically separated by an alley or an access road are generally considered one retail sales facility, ***provided that*** customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.	• Reg. Sec. 1.263A-3(c)(5)(ii)(B)(2)
	• A *"retail customer"* is defined as the final purchaser of the merchandise.	• Reg. Sec. 1.263A-3(c)(5)(ii)(E)
	• The Treasury Department is empowered to prescribe such Regulations as may be necessary or appropriate to carry out the purposes of Section 263A. ◆ This includes providing for simplified procedures for the application of Section 263A to property acquired for resale.	• Section 263A(i)
	• The Regulations provide a simplified resale method for determining the additional Section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.	• Reg. Sec. 1.263A-3(d) • The term *"additional Section 263A costs"* is defined in Reg. Sec. 1.263A-1(d)(3).
	• The Conference Report accompanying the legislation which enacted Section 263A directed the Treasury Department to create a simplified method for applying the uniform capitalization rules of Section 263A to resellers (resulting in the simplified resale method in Reg. Sec. 1.263A-3(d)). • The Treasury Department was also authorized to modify the simplified method or to permit the use of other methods by rules or Regulations for property acquired for resale.	• Section 263A was enacted as part of the Tax Reform Act of 1986, Public Law No. 99-514 (100 Stat. 2085 (1986)). • Citation for Conference Report is H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-308 (1986).
	• Except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for Federal income tax purposes.	• Section 446(e), Reg. Sec. 1.446-1(e)(2)
	• Rev. Proc. 2008-52 (as amplified, clarified and modified by Rev. Proc. 2009-39) provides procedures for a taxpayer to obtain ***automatic consent*** of the Commissioner to change to a method of accounting described in the ***Appendix*** of Rev. Proc. 2008-52. • Rev. Proc. 97-27 (as amplified, clarified and modified in other Rev. Procs. *[citations omitted]* including Rev. Proc. 2009-39), provides procedures for a taxpayer to request ***non-automatic consent*** of the Commissioner to change a method of accounting.	

		Citations & Comments
Section 3 ***Scope***	• Except as provided below, any motor vehicle dealership (as defined in Section 4) may use either or both of the safe harbor methods described in Section 5. • A motor vehicle dealership that removes Section 471 costs from ending inventory by treating them as negative amounts in the numerator of either the simplified resale method formula or the simplified production method formula, may not use either safe harbor method of accounting described in this Revenue Procedure. ◆ If a motor vehicle dealership currently removes Section 471 costs from ending inventory in that manner (i.e., employing negative amount adjustments), it must change from that method of accounting in accordance with Section 7 of this Revenue Procedure in order to use the safe harbor methods.	
Section 4 ***Motor Vehicle Dealership Includes...***	• A motor vehicle dealership is a dealership that primarily purchases and resells to retail customers, one or more of the following categories of new or used motor vehicles: ◆ Automobiles ◆ Light-duty trucks ◆ Medium-duty trucks ◆ Heavy-duty trucks ◆ Farm machinery and equipment ◆ Construction machinery and equipment ◆ Recreational vehicles ◆ Motorcycles ◆ Boats	
Section 5.01 ***Retail Sales Facility Safe Harbor Method***	• A (motor vehicle) dealership may treat its entire sales facility from which it normally and routinely conducts on-site sales to retail customers, including any vehicle lot that is an integral part of its sales facility and ***that is routinely visited by retail customers***, as a retail sales facility under Reg. Sec. 1.263A-3(c)(5)(ii)(B). • A dealership using this retail sales facility safe harbor method is not required to capitalize handling and storage costs incurred at its retail sales facility.	• Purchasing costs are required to be capitalized in accordance with Reg. Sec. 1.263A-3(c)(3). See Special Rule at -3(c)(3)(ii).
Section 5.02 ***Reseller Without Production Activities Safe Harbor Method***	• A (motor vehicle) dealership may treat itself as a reseller without production activities for purposes of Reg. Sec. 1.263A-3. • For this purpose, activities that a dealership, or a contractor, perform on dealership-owned vehicles and customer-owned vehicles are handling activities under Reg. Sec. 1.263A-3(c)(4). ◆ However, the costs of these handling activities, other than the cost of vehicle parts, are not required to be capitalized to the extent incurred at the dealership's retail sales facility. • A dealership must capitalize the cost of vehicle parts used on dealership-owned vehicles as an acquisition cost of its vehicles, whether the vehicle parts are acquired directly by the dealership or indirectly through a contractor. • ***A dealership using this safe harbor method may use the simplified resale method under Reg. Sec. 1.263A-3(d) for its vehicles and other eligible property.***	• Reg. Sec. 1.471-3, Reg. Sec. 1.263A-3(c)(1)

		Citations & Comments
Section 6 ***Change in Method of Accounting***	• A motor vehicle dealership that wants to change its method of accounting under Section 263A to either or both of the safe harbor methods described in Section 5 of this Revenue Procedure must use the automatic change in method of accounting provisions in Rev. Proc. 2008-52, as further modified by this Revenue Procedure, if the dealership is within the scope of Rev. Proc. 2008-52. • Otherwise, a motor vehicle dealership may request to change its method of accounting using the non-automatic provisions of Rev. Proc. 97-27, if the dealership is within the scope of Rev. Proc. 97-27.	• Generally, the change(s) in accounting method to elect the safe harbor method(s) will be made as automatic changes (i.e., not requiring advance consent from the Commissioner).
Section 7 ***Effect on Other Documents***	• Rev. Proc. 2008-52 is modified to add new Section 11.07 to the ***Appendix***. • Modifications include ... ◆ The addition of the two safe harbor methods in Section 5 of this Rev. Proc. to the list of automatic changes. ◆ Temporary suspension of certain scope limitations. ◆ The addition of provisions related to concurrent automatic changes and multiple adjustments. ◆ The assignment of designated automatic accounting method change numbers for dealership changes to the safe harbor methods (SHMs) ▪ Retail sales facility SHM ... ***No. 150*** ▪ Reseller without production activities SHM ... ***No. 151***	• Full text of Section 11.07 added to the ***Appendix*** is on Page 5 of 5.
Section 8 ***Expanded Audit Protection***	• A motor vehicle dealership that changes its method of accounting under either the automatic provisions of Rev. Proc. 2008-52 or the non-automatic provisions of Rev. Proc. 97-27 to use a method of accounting consistent with the safe harbor methods described in section 5 of this Revenue Procedure receives the audit protection described in section 7 of Rev. Proc. 2008-52 or section 9 of Rev. Proc. 97-27, as applicable. • Alternatively, if a motor vehicle dealership uses a method of accounting consistent with the safe harbor methods described in Section 5 of this Revenue Procedure on a Federal income tax return filed before November 10, 2010, the Service will not assert that these methods are not proper methods of accounting for such taxable year(s).	• Rev. Proc. 2008-52, Section 7 • *Audit Protection for Taxable Years Prior to Year of Change* • ***7.01 - In general.*** Except as provided elsewhere (i.e., in Sections 4.02(7)(b), 6.03(5), 6.03(6), 6.04, 6.05, 7.02 or in the *Appendix* ...), when a taxpayer timely files a copy of the application with the National Office in compliance with all the applicable provisions of this Rev. Proc., the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change. • ***7.02 Exceptions*** ... The IRS may change a taxpayer's method of accounting for prior taxable years if ... (1) (c) the method of accounting is changed or modified because there has been a misstatement or omission of material facts, or (2) the taxpayer is changing a sub-method of accounting within the method.
Section 9 ***Effective Date***	• This Revenue Procedure is effective November 9, 2010.	• The Rev. Proc. is to be published in Internal Revenue Bulletin 2010-49 on December 6, 2010.

New Section 11.07 Added to the Appendix of Revenue Procedure 2008-52
By Section 7 of Revenue Procedure 2010-44
To Provide Automatic Change in Accounting Method Treatment for
Safe Harbor Methods under Section 263A for Certain Dealerships of Motor Vehicles

Description of Change ***Sec. 11.07(1)***	• This change applies to a motor vehicle dealership (as defined in Section 4 of Rev. Proc. 2010-44) that is within the scope of Section 3 of Rev. Proc. 2010-44 and wants to change its method of accounting to ... ◆ Treat its sales facility as a retail sales facility, or ◆ Be treated as a reseller without production activities. • ***A motor vehicle dealership that wants to make an automatic change*** in method of accounting to use one or both safe harbor methods described in Section 5 of Rev. Proc. 2010-44 ***may make any corresponding changes in the identification of costs subject to Section 263A that will be accounted for using the new method*** (for example, to remove internal profit from inventory costs or to no longer include negative amounts as additional Section 263A costs in the numerator of the simplified resale method formula or the simplified production method formula). ◆ However, except as provided in the preceding sentence, a change under this Section does not include a change for purposes of recharacterizing "Section 471 costs" as "additional Section 263A costs" (or vice versa) under the simplified resale method or the simplified production method.
Certain Scope Limitations Temporarily Inapplicable ***Sec. 11.07(2)***	• ***For the motor vehicle dealership's first or second taxable year ending after November 9, 2010, the scope limitations*** in Sections 4.02(1) through (4) and (7) of Rev. Proc. 2008-52 (as modified and clarified by Rev. Proc. 2009-39) ***do not apply*** to a motor vehicle dealership that changes to one or both of the safe harbor methods in Section 5 of Rev. Proc. 2010-44. • *Note: The scope limitations in "Sections 4.02(1) through (4) and (7)" referred to above relate to...* *(1) Taxpayers under examination* *(2) Consolidated group members* *(3) Partnerships and S-corporations (including limited liability companies)* *(4) Taxpayers engaging in Section 381(a) transactions* *(7) Taxpayers involved in prior 5-year item changes in methods*
Concurrent Automatic Changes ***Sec. 11.07(3)***	• A motor vehicle dealership making an automatic change in method of accounting to one or both safe harbor methods described in Section 5 of Rev. Proc. 2010-44 ***and*** another automatic change in method of accounting under Section 263A for the same taxable year may file one Form 3115 to make both changes, provided that the dealership... ◆ Enters the designated automatic change numbers for all such changes in Part I on that Form 3115, and ◆ Complies with the ordering rules of Reg. Sec. 1.263A-7(b)(2).
Multiple Adjustments ***Sec. 11.07(4)***	• In the event that a motor vehicle dealership is taking into account a Section 481(a) adjustment from another accounting method change in addition to the Section 481(a) adjustment required by a change to a safe harbor method described in Section 5 of Rev. Proc. 2010-44, the Section 481(a) adjustments must be taken into account separately. ◆ For example, a motor vehicle dealership that changed to comply with Section 263A in 2009 and was required to take its Section 481(a) adjustment into account over four years must continue to take into account that adjustment over the remainder of that four-year Section 481(a) adjustment period even though the dealership changed to a safe harbor method described in Section 5 of Rev. Proc. 2010-44 in 2010 and has an additional Section 481(a) adjustment required by that change.
Designated Automatic CAM Numbers ***Sec. 11.07(5)***	• ***No. 150*** ... For a change to treat certain sales facilities as a ***retail sales facility*** (as described in Section 5.01 of Rev. Proc. 2010-44). • ***No. 151*** ... For a change to be treated as a ***reseller without production activities*** (as described in Section 5.02 of Rev. Proc. 2010-44).
Contact Info	• Contact Kari Fisher at (202) 622-4970 for further information regarding a change under this Section.

Form 3115: Application for Change in Accounting Method

w/r/t Taxable Year Ending December 31, xxxx

Template for Form 3115: Narrative Statements & Other Information

Changes in Accounting Methods under Section 263A

This request is for changes in Taxpayer's methods of accounting for capitalizing inventory costs in accordance with Section 263A.

- ***No. 150 ... Change to Treat Certain Sales Facilities as Retail Sales Facilities (as Described in Section 5.01 of Revenue Procedure 2010-44)***
- ***No. 151 ... Change to Be Treated as Reseller Without Production Activities (as Described in Section 5.02 of Revenue Procedure 2010-44)***
- ***No. 23 ... Change to Use the Simplified Resale Method under Reg. Sec. 1.263A-3(d) for all other inventories that may not be subject to the safe harbor elections above.***

These changes are to be effective for Taxpayer's calendar year beginning ***[Jan. 1, ____]*** and ending ***[Dec. 31, ____]*** *[Indicate beginning and end of year for which changes are to be effective ... i.e., 2010 or 2011].*

The changes to the safe harbor cost capitalization methods allowed by Revenue Procedure 2010-44 are being made under Section 11.07 of the *Appendix* to Revenue Procedure 2008-52, as modified by Section 7 of Revenue Procedure 2010-44.

The change to use the simplified resale method under Reg. Sec. 1.263A-3(d) for all other inventories that may not be subject to Taxpayer's safe harbor elections above is described in Section 11.02 of the *Appendix* to Revenue Procedure 2008-52 (as clarified and modified by Rev. Proc. 2009-39).

In connection with determining purchasing costs after making these changes, Taxpayer ***[elects to][will]*** use the ***"1/3 - 2/3 Rule for Allocating Labor Costs"*** as set forth in Reg. Sec. 1.263A-3(c)(3)(ii)(A).

All of the above changes in accounting method related to Section 263A costs are interrelated and are being made as concurrent changes on this single Form 3115 (as provided in Section 7 of Revenue Procedure 2010-44). Taxpayer requests a conference with the IRS National Office if the IRS proposes an adverse response to this Form 3115.

These are automatic accounting method changes, and applicants filing Form 3115 under designated automatic change procedures are not required to pay a user fee.

The original of Form 3115 ***[is][will be]*** attached to Taxpayer's timely filed (including extension of time) income tax return for the year of change.

A duplicate copy of this Form 3115 ***[has been][will be][is being]*** sent to the IRS National Office in Washington, D.C.

Taxpayer is not under IRS audit examination at the time of filing this Form 3115.

Taxpayer reports on the basis of a calendar year-end, and it employs the accrual method of accounting for maintaining its books and records and for filing its Federal and State income tax returns. Taxpayer's business code for its principal business activity is 441110. Taxpayer is a franchised automobile dealer engaged in the purchase and retail sale of new automobiles and light-duty trucks. Taxpayer also buys and sells used vehicles, and it provides parts, repair and maintenance services on the vehicles it sells, as well as on vehicles customers have purchased from other dealers. ***Accordingly, Taxpayer is a motor vehicle dealership as described in Section 4 of Revenue Procedure 2010-44.***

Method for Valuing Inventories

*[Insert **description of methods for valuing new vehicles, used vehicles, parts & accessories and other inventories** here.]*

Section 263A Inventory Cost Capitalization Matters

Taxpayer has been subject to the provisions of the Section 263A Inventory Cost Capitalization Rules in prior years.

Reason for making changes. On November 9, 2010, the IRS issued Revenue Procedure 2010-44 in which it provided two safe harbor methods that dealerships may elect to use in connection with the application of Section 263A to their inventories. Taxpayer is making the above elections and changes in its Section 263A methods in order to significantly reduce expensive and time-consuming disagreements that might otherwise arise over the acceptability of its present methods for capitalizing costs under Section 263A.

Description of Section 263A method previously used. Taxpayer has used a ***[insert description of method previously used, such as the "Simplified Resale Method" (without historical absorption ratio election,) or one of the other methods described in the accompanying article]*** as its method of accounting to reflect the application of the Section 263A Uniform Cost Capitalization Rules to its year-end inventories.

Taxpayer will continue to use the *Simplified Resale Method* for any of its other activities to the extent that they are not covered by the safe harbor methods elected as automatic changes (No. 150 and No. 151).

Taxpayer ***[has][has not]*** previously filed any Forms 3115 with the IRS in connection with its accounting methods under Section 263A.

Part IV, Page 3 - Computation of Net Section 481(a) Adjustment

The net Section 481(a) adjustment relating to the amount of change in the inventory costs capitalized under Section 263A ... ***[has not been determined at the time of filing this Form] [is estimated to be not more than $_____] [is $_____ . (See below)]***

COMPUTATION OF SECTION 481(a) ADJUSTMENT				
	Change No. 150	**Change No. 151**	**Change No. 23 (If Applicable)**	**Total**
Section 263A costs capitalized in the beginning inventory for the year of change under the ***proposed*** method	*A*	*D*	*G*	*(A + D + G)*
Section 263A costs capitalized in the beginning inventory for the year of change under the ***present*** method	*B*	*E*	*H*	*(B + E + H)*
Positive or Negative Section 481(a) adjustment for each change	*C = (A - B)*	*F = (D - E)*	*I = (G - H)*	*(C + F + I)*
Net (Positive or Negative) Section 481(a) Adjustment				*(C + F + I)**
* Net increase/decrease in computing taxable income due to the change in Section 263A costs capitalized as of the beginning of the year of change				

ESTATE TAX REPEAL FOR 2010 MEANS HEADACHES FOR TAX RETURN PREPARERS IN 2011

At the present time, or at least for the time being, there is no Estate Tax. For more than a year (actually for almost 10 years), Congress knew this was going to happen. Predictably, it did nothing about it, and even as 2009 drew to a close, it failed to take any action to prevent the problems that have been created. And, now as we near the end of 2010, Congress still has done nothing to "fix" this mess.

The stage for this debacle was set many years ago as part of the "Bush Tax Cuts" when Congress included various transitional adjustments over the years, capped-off with the "temporary" sunset of the Estate Tax for one year only ... and that year is 2010.

As a result, for any dealers (or anyone else, for that matter) who died on or after January 1, 2010, there is no Federal Estate Tax, and there is no generation-skipping transfer tax (GST). This void in the Estate Tax 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 2010, the Gift Tax is still in effect with its $1 million Gift Tax exemption and annual Gift Tax exclusions (currently, $13,000 per donee). Gifts in excess of these amounts are taxed at the rate of 35% (not 45%) and Gift Tax Returns are required for gifts in excess of the annual exclusion amount.

Let's return to the Estate Tax, or more accurately, to the void created by the repeal of the Estate Tax.

For the survivors of decedents who died in 2010 with taxable estates, although there is no Federal Estate Tax or GST, there is a corresponding downside. Not only does one inherit the property, he, she or it (i.e., a trust or an estate) also inherits the decedent's cost basis for that property. However, if the fair market value of the property is lower than the decedent's cost basis, then this lower fair market value is inherited as the carryover basis.

So, unless a person dying after January 1, 2010 has left his or her estate entirely to charity, significant problems exist for heirs, executors and professionals advising these estates. The significant problems are created by the "carryover basis" provisions in Section 1022.

CARRYOVER BASIS PROVISIONS

When the Estate Tax was in effect, heirs receiving property obtained a step-up in the basis of that inherited property. The basis of the inherited property was increased, or stepped-up, from the decedent's cost basis (or other adjusted tax basis) to the fair market value of the property as of the date of death (or as of the 6-month later alternative valuation date). This step-up in basis was allowed because the decedent's property had been subjected to the Estate Tax.

Section 1022 was added to the law as part of the *Economic Growth & Tax Relief Reconciliation Act of 2001* by Public Law 107-16. This Code Section applies to property acquired from a decedent dying after December 31, 2009. The effect of this provision is to prevent 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).

The complex provisions in Section 1022 are intended to compensate for the nonpayment of an Estate Tax with respect to inherited property. Under Section 1022(a), an heir receiving property from a decedent will receive a tax basis in that property that is 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.

This Section applies only to inherited property acquired as a result of deaths during calendar year 2010 because it becomes unnecessary when the Estate Tax is reinstated on January 1, 2011.

Exceptions. There are some exceptions to the carryover basis provisions, and these exceptions allow for increases in the tax basis, subject to certain limitations on those increases.

The first $1.3 million of appreciation is exempt from the carryover provisions. Also, an additional $3 million in appreciation on assets inherited by a surviving spouse is exempt. That's the good news.

The good news gets (just) a little bit better. The allowable increase in basis of $1.3 million mentioned above is increased by the amount of unused capital losses, net operating losses and certain "built-in" losses of the decedent.

If the amount of the increase in basis is less than the fair market value of the assets whose bases are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase. In other words, the executor will make the allocation of the increased basis amount among the eligible assets. And, this allocation of the increased basis amount is to be →

made on a special information return (Section 1022(d)(3)(A)).

However, in no case can the basis of an asset be adjusted above its fair market value in the hands of the decedent as of the date of death (Section 1022(d)(2)).

Certain property is not eligible for a basis increase. Property not eligible for a basis increase includes (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death and (2) property that constitutes a right to receive income in respect of a decedent.

Carryover or lack of carryover for certain attributes. Property acquired from a decedent is treated as if that property had been acquired by gift. Thus, the character on the gain of the sale of the property received from a decedent's estate is carried over to the heir. This means, for example, that real estate that has been depreciated and would be subject to recapture (under Section 1250) if sold by the decedent will be subject to recapture if it sold by the heir. In other words, the "taint" of ordinary income recapture carries over from the decedent to the heir receiving the property.

Also, generally, the automatic long-term capital gain holding period provided under Section 1223(9) for property whose basis is determined under Section 1014(a) does not carry over. In other words, if inherited property was sold before it was held for 12 months, when the Estate Tax regime was in place, that property automatically was treated as long-term capital gain. That is no longer the case; although, in certain instances, a portion of the decedent's holding period may be carried over.

HOW DOES THE IRS FIND OUT ABOUT CARRYOVER BASIS ADJUSTMENTS?

Somehow, the IRS needs to be "notified" about the impact of these carryover provisions on the basis of inherited property to which they apply. Is this "notification" to the IRS to be made when an Estate Tax Return would have been required to be filed by the decedent (i.e., six months after the date of death)?

Or, is the "notification" to the IRS of the amount of carryover basis simply made at the time when the inherited property is sold and reported in Schedule D of the income tax return filed by the person who inherited the property? If that were the case, then the carryover basis simply would be reflected (as a separate amount in the "basis" column) in computing the gain or loss on the sale of the property.

The problem in a nutshell. With the introduction of carryover basis, some form of notification to the IRS ... like the filing of a supplementary schedule to Form 706 ... would have to be filed with the IRS. Otherwise, the change in the basis provisions affecting inherited property would only become apparent to the IRS when the heirs sold the inherited property and reported gains or losses in Schedule D ... and that could be many years in the future, when memories might have faded and/or records or other documentations of the amounts have been lost.

THE SOLUTION: SECTION 6018 ... BOTH SIMPLE & COMPLICATED

The short answer is that the IRS becomes apprised of carryover basis amounts as a result of information that is required to be included in the final income tax return (Form 1040) filed for the decedent.

Section 6075(a) provides that the return required by Section 6018 with respect to a decedent shall be filed with the return of the tax imposed by Chapter 1 for the decedent's last taxable year or such later date specified in Regulations prescribed by the Secretary.

Section 6018, entitled *"Returns Relating to Large Transfers at Death"* was also added to the Code by the *Economic Growth & Tax Relief Reconciliation Act of 2001* (P.L. 107-16).

Form 8939 ... Where are you? If a decedent dies in 2010 with carryover basis property (other than cash) in excess of the $1.3 million aggregate basis adjustment amount, the ***executor*** must file a return with the IRS. To date, Form 8939 has not been released in final form by the IRS. Section 6018(a) also applies to transfers of certain gifts received by the decedent within 3 years of death.

A tax return preparer who has to prepare a Form 1040 for an individual who died during 2010 will have to cope with Form 8939 in order to report the details of the carryover basis adjustments for property in the decedent's estate.

In June, the IRS issued Form 8939 in *Draft* Form. However, the IRS subsequently withdrew the *Draft* Form because the IRS realized that it had not fully considered all of the ramifications. Accordingly, we have no idea of what the final Form 8939 will look like. However, the *Draft* Form 8939 (which was withdrawn) is included here to give you some indication of what to expect.

It should be noted that the filing of the information return (Form 8939) is the responsibility of the executor ... not the preparer of the tax return. As a practical matter, the executor and the professional preparing the final income tax return for the decedent will have to coordinate their efforts ... as well as the timely filing aspects of these requirements. There may be signifi-

see **ESTATE TAX REPEAL**, page 44

(Continued from page 43)

cant problems in determining the decedent's adjusted tax basis for property owned at the time of his/her death. Expect delays ... expect extensions.

Information required. The "Return" relating to large transfers at death must include the following information... (1) the name and TIN of the recipient of such property, (2) an accurate description of such property, (3) the adjusted basis of such property in the hands of the decedent and its fair market value at the time of death, (4) the decedent's holding period for such property, (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income, (6) the amount of basis increase allocated to the property under Subsection (b) or (c) of Section 1022, and (7) such other information as the Secretary may by Regulations prescribe (Section 6018(c)).

Statements to recipients. In addition to the above, the executor filing the information report is also required to furnish to each person whose name is included in the report, a written statement showing (1) the name, address, and phone number of the person required to make such return, and (2) the information with respect to property acquired from, or passing from, the decedent to the person required to receive such statement.

This statement is required to be furnished not later than 30 days after the date that the information is filed (Section 6018(e)).

Penalties. Any person required to report these carryover basis amounts who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Section 6716(a) provides for this penalty, and it also includes a penalty of $50 for each failure to furnish a statement to the recipients of the property.

What if the assets included in the estate are less than $1.3 million ... Is a return required? If the fair market value at the date of death for carryover basis property is less than $1.3 million, it appears that the executor is not required to make a report or other allocations. However, it may be advisable to document or identify what those assets are and their fair market value as of the date of death, since this may become important in computing the tax liabilities of estate beneficiaries in subsequent years.

Incomplete data. What if the executor can't file the return on time? If the executor is unable to make a complete return as to any property acquired from or passing from the decedent, the executor shall include in the return a description of such property and the name of every person holding a legal or beneficial interest therein. Upon notice from the Secretary, such person will be required to make a return as to such property "in like manner." (Section 6018(b)(4)).

OBSERVATIONS

Although references have been made to the provisions of carryover basis as applying to heirs, they also apply to situations where property is transferred by death from the decedent to the decedent's estate or to a trust set up by will.

Deciding which inherited assets should receive the allowable stepped-up amounts could create (significant) conflicts among the heirs. (It's been said that you never really know your relatives until you have to divide someone's estate with them!)

It's possible that, in certain instances, the repeal of the Estate Tax for 2010 will create more problems and planning difficulties for estates that are in the range of $1.3 to $4.3 million (i.e., mid-range estates) than for the estates of the extremely wealthy.

State tax implications ... What about your state? It is important to determine whether the State of residence or domicile of the decedent has instituted or accepted carryover basis provisions in connection with their own structures for taxing estates. Some states have their own Estate Tax provisions and these may or may not contain similar provisions.

In this regard, complexities may be increased if the decedent died a resident of one state while owning real estate in a different state.

HOW WILL CONGRESS FIX THIS MESS?

Speculation is rampant that Congress might try to reinstate the Federal Estate Tax and GST retroactive to January 1, 2010, even though some have questioned the Constitutionality of such legislation, should it be passed.

Another possibility is that Congress might allow executors for the estate to make an election to either (1) to use the carryover basis provisions or (2) to apply the same levels, rates and exemptions that were available before 2010. Other blends of rates and phase-ins have been suggested.

Whatever the outcome, it's clear that coping with carryover basis problems will cause extra work for tax return preparers in 2011 and require considerable additional communication and coordination with the executor of the estate and with the decedent's survivors.

For an excellent article on this subject, see *"The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010"* by Jonathan Blattmachr, Mitchell Gans, Howard Zaritsky and Diana Zeydel, in the *Journal of Taxation*, February 2010 (pages 68-95).

Form **8939**

Department of the Treasury
Internal Revenue Service

Allocation of Increase in Basis for Property Received from a Decedent

To be filed for decedents dying after December 31, 2009, and before January 1, 2011.

OMB No. 1545-XXXX

2010

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)

1b Decedent's last name

2 Decedent's Social Security No.

3a County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death

3b Year domicile established

4 Date of birth

5 Date of death

6a Name of executor (see instructions)

6b Executor's address (number and street including apartment or suite no, city, town, or post office, state, and ZIP code) and phone no.

6c Executor's social security number (see instructions)

Phone no. ( )

Part 2—Basis Allocation Computation

7 Marital status of the decedent at time of death:

- ☐ Married
- ☐ Widow or widower—Name, SSN, and date of death of deceased spouse ▶
- ☐ Single
- ☐ Legally separated
- ☐ Divorced—Date divorce decree became final ▶

8a Surviving spouse's name

8b Social security number

8c Amount received (see instructions)

9 Individuals (other than the surviving spouse), trusts, or other estates who receive property from the estate (do not include charitable beneficiaries) (see instructions).

Name of individual, trust, or estate	Identifying number	Amount (see instructions)

10	Built-in loss (see instructions). For non-resident alien decedents, enter zero	10	
11	Capital loss carryover (see instructions). For non-resident alien decedents, enter zero	11	
12	Net operating loss carryover (see instructions)	12	
13	Unadjusted aggregate basis increase. For non-resident alien decendents, enter zero. All others, enter $1,300,000	13	
14	Add lines 10 through 13. Non-resident aliens enter $60,000	14	
15	Spousal basis increase limit	15	$3,000,000 00
16	Total aggregate basis increase limit. Add lines 14 and 15	16	
17	Enter the amount from Schedule A, line 6	17	
18	Subtract line 17 from line 16. Enter the result but not greater than line 14	18	
19	Enter the total of the amounts from each Schedule B, line 6	19	
20	Subtract line 19 from line 18	20	

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

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶ ☐ Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ EIN ▶

Phone no. ( )

For Paperwork Reduction Act Notice, see the separate instructions for this form. Cat. No. 37755W Form 8939 (2010)

Form 8939 (2010)

Estate of: Decedent's Social Security Number

SCHEDULE A—Property Acquired by Surviving Spouse

Part I General Information

1a Name of Executor

1b Executor's address (number and street including apartment or suite no., city, town, or post office, state, and ZIP code) and phone no.

1c Executor's social security number

Phone no. ( )

2a Name of Recipient

2b Recipient's social security number

Part II Property Information

3 For all property acquired from the decedent (other than stock of a foreign personal holding company, DISC or former DISC, foreign investment company, or passive foreign investment company) the basis of which at the date of death is equal to or greater than its fair market value at the date of death, provide the following information:

Item No.	(a) Accurate description of the property	(b) Date decedent acquired the property (mm/dd/yyyy)	(c) Acquired by gift	(d) Adjusted basis at death	(e) Fair market value at death	(f) Check if any gain would be ordinary (Attach statement)
			☐			☐
			☐			☐
			☐			☐
			☐			☐
			☐			☐
			☐			☐
			☐			☐
3a Total for columns (d) and (e)						

4 Subtract the amount in line 3a, column (e) from the amount in line 3a, column (d)

5 For all property acquired from the decedent (other than stock of a foreign personal holding company, DISC or former DISC, foreign investment company, or passive foreign investment company) the basis of which at the date of death is equal to or greater than its fair market value at the date of death, provide the following information:

Item No.	(a) Accurate description of the property	Check as applicable: Outright transfer	Check as applicable: QTIP	(b) Date decedent acquired the property (mm/dd/yyyy)	(c) Acquired by gift	(d) Adjusted basis at death	(e) Fair market value at death	(f) Basis increase allocated to property	(g) Amount of gain that would be ordinary (Attach statement)
		☐	☐		☐				
		☐	☐		☐				
		☐	☐		☐				
		☐	☐		☐				
		☐	☐		☐				
		☐	☐		☐				

6 Add the amounts in line 5, column (f). Do not enter a number greater than page 1, line 16. Enter this amount on page 1, line 17

Form 8939 (2010)

Estate of: Decedent's Social Security Number

SCHEDULE B—Property Acquired Other Than by Surviving Spouse

Part I General Information

1a Name of Executor

1b Executor's address (number and street including apartment or suite no., city, town, or post office, state, and ZIP code) and phone no.

1c Executor's social security number

Phone no. ( )

2a Name of Recipient

2b Recipient's social security number

Part II Property Information

3 For all property acquired from the decedent (other than stock of a foreign personal holding company, DISC or former DISC, foreign investment company, or passive foreign investment company) the basis of which at the date of death is equal to or greater than its fair market value at the date of death, provide the following information:

Item No.	(a) Accurate description of the property	(b) Date decedent acquired the property (mm/dd/yyyy)	(c) Acquired by gift	(d) Adjusted basis at death	(e) Fair market value at death	(f) Check if any gain would be ordinary (Attach statement)

Summary

De Filipps "Uncertainty" Outline

THE PRACTITIONER'S NIGHTMARE: UNCERTAINTY & DEALERSHIP TAX ISSUES
As Presented at the AICPA National Auto Dealership Conference

Willard J. De Filipps, CPA ... October 22, 2010

I. ***Introductory Comments ... Presentation Outline***

A. Why are these the top tax issues for which there is uncertainty?
- Some issues affect all dealerships ... Others affect only dealerships using the LIFO inventory method

B. Where does uncertainty come from? ... How does uncertainty arise?

C. Some recent developments in 2010 worth noting, but about which there seems to be little uncertainty

D. What suggestions, advice and/or guidance can I offer?

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

III. ***Revised Form 3115 for Changes in Accounting Methods & Revised Instructions***

IV. ***Importance of the Concept of "Separate Trades or Businesses"***

V. ***Terminated Dealerships & Franchises: Writing Off Intangibles (Franchise Cost, Goodwill, etc.)***

VI. ****Reporting Uncertain Tax Positions in Income Tax Returns***

VII. ****Tax Issues for Survivors of Dealers Who Have Died After December 31, 2009***

VIII. ***IRS Movement to Deputize CPAs to Become More Like IRS Agents ... Resolving Doubts Against the Taxpayer in Favor of the IRS (in Order to Mitigate or Avoid Exposure to Preparer Penalties)***

IX. ***Major Tax Planning Opportunity Is Still Available for 2010 for 15% Preferential Tax Rate for Qualified Dividend Income and Long-Term Capital Gains***

X. ***LIFO (Last-In, First-Out) Inventory Valuation Matters***

A. ***Uncertainty ...*** Over how much longer will LIFO be around (i.e., the long-term status of LIFO)

B. ***Uncertainty ...*** Over procedures for combining LIFO pools when dealerships convert to the Vehicle-Pool Method for 2009 (or for prior years) ... Some surprising results

C. ***Uncertainty ...*** Over whether to "preemptively" terminate LIFO elections as the impact of manufacturer bankruptcy/restructurings in 2009 continues to be felt as we near the end of 2010

D. ***Uncertainty ...*** Over the implications of Section 263A issues in connection with Forms 3115 filed by dealerships to terminate LIFO elections for new vehicles. Will the IRS permit the termination of the LIFO election if the dealerships do not make concurrent changes in their Section 263A methodologies?

E. ***Uncertainty ...*** Over the proper application of the IPIC LIFO Method to automobile dealerships

F. ***Uncertainty ...*** Over the validity of the LIFO election by an auto dealership if trade discounts are not eliminated from inventory costs ... Also, a planning opportunity for dealerships not using LIFO

G. ***Uncertainty ...*** S Corporation Q-Sub groups ... Integrating LIFO opportunities and avoiding pitfalls

* The discussions in Sections II., VI. & VII. have been updated in three articles appearing in this Edition of the *Dealer Tax Watch*. These articles supersede my October presentation discussions at the AICPA Conference. Therefore, these sections of the original outline have not been reproduced.

Note: The *Attachments* listed on the last page and referenced throughout this outline have not been reproduced.

THE PRACTITIONER'S NIGHTMARE: UNCERTAINTY & DEALERSHIP TAX ISSUES

Willard J. De Filipps, CPA ... October 2010

I. Presentation Outline

A. The "long-form" title for this presentation is

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

B. Why are these the top tax issues for which there is uncertainty?

- Some issues affect all dealerships ... Others affect only dealerships using the LIFO inventory method

C. Where does uncertainty come from? ... How does uncertainty arise?

D. Some recent developments in 2010 worth noting, but about which there seems to be little uncertainty ... See *[Attachment #1] ... Timeline Jan. 1, 2010 to Date.*

E. What suggestions, advice and/or guidance can I offer?

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

- [Text Omitted] ... See pages 22-41 of this Year-End Edition of the *Dealer Tax Watch*

III. Revised Form 3115 for Changes in Accounting Methods & Revised Instructions

A. New revisions for Form 3115 and the Instructions are dated Dec. 2009 ... and must be used for all Forms 3115 filed with the IRS after June 1, 2010.

B. List of automatic changes in accounting method (included in the Instructions) increased to 149.

1. See *[Attachment #4] ... Frequently Encountered Automatic Changes in Accounting Methods in Automobile Dealerships.*

C. Although there appear to be no major changes to Form 3115, there are a number of subtle differences and points that require emphasis.

1. Scope limitations are not the same as audit protection limitations.
2. Separate trades or businesses ... distinctions still need to be made, and could be important, especially where dealership loss of franchises are involved (i.e., if LIFO reserves are to be recaptured as a result of LIFO election terminations) and/or where Q-Subs and/or single member limited liability companies (SMLLCs) are involved.

III. ***Revised Form 3115 for Changes in Accounting Methods & Revised Instructions*** *(...continued)*

C. 3. ***Uncertainty*** ... Major uncertainties relate to the application of the rules for changing a method of accounting under Section 263A to a situation where the dealership terminates its LIFO election.

a. Dealerships not on LIFO now, but who recently filed Forms 3115 to terminate their LIFO elections ... Will the IRS permit the terminations of the LIFO elections if the dealerships do not make concurrent changes in their Section 263A methodologies?

b. *See discussion of these issues in Section X.D. of this outline on pages 9-10.*

D. Suggestions for Forms 3115 filings

1. See ***[Attachment #5]*** ... *Obtain a Signed Engagement Letter.*

2. See ***[Attachment #6]*** ... *10 Suggestions for Form 3115 Filings.*

3. See ***[Attachment #7]*** ... *What if the Tax Return for the Year of Change is Due Before the IRS Grants the Dealership Approval to Make the Change?*

IV. ***Importance of the Concept of "Separate Trades or Businesses"***

A. 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.

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. The trades or business of the taxpayer ***will not be considered to be separate and distinct 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.

B. Importance in resolution of Section 263A issues in the current controversy with the IRS, particularly in terms of the IRS emphasis on trying to identify dealership production activities in contrast to its reselling activities.

1. Can the separate departments in an automobile dealership be considered separate trades or businesses, or are all these activities considered an integrated single activity?

C. Planning opportunity in connection with disregarded entities ... especially single-member LLCs

1. 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

D. In TAM 199911044, 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

3. Separate sales force for new vehicle sales and service mechanics

IV. *Importance of the Concept of "Separate Trades or Businesses"* *(...continued)*

E. In connection with dealerships losing their franchises and/or terminating their LIFO elections because of significantly reduced inventories, the "trade or business" concept is significant.

1. Will the dealership stay in business just selling used vehicles and/or maintaining an active service department?

2. There will be no acceleration of a Section 481(a) adjustment if the dealership continues to operate remaining portions of its trade or business ... See discussion of Situation 1 in ILM 200935024.

V. *Terminated Dealerships & Franchises: Writing Off Intangibles (Franchise Cost, Goodwill, etc.)*

A. Franchise acquisition costs

1. In some cases, dealers have paid specific amounts directly to the manufacturer for the acquisition of a franchise.

2. In other cases, dealers may have acquired a franchise by purchasing it from another dealer (with the consent of the manufacturer), and in the overall acquisition, they have paid more than dollar-for-dollar for the tangible assets in the business/franchise they acquired. As a result, they have capitalized on their books amounts paid for a franchise or payments referred to as "goodwill" that are associated with the acquisition of the franchise or a business.

a. *Frontier Chevrolet, Inc.* involved the acquisition of a 75% interest (i.e., a majority interest) in a dealership, where the interest in the dealership was acquired indirectly by the other shareholders as a result of a redemption of stock ... Section 197 was held to apply.

b. *Recovery Group, Inc.* involved the indirect acquisition of a 23% interest (i.e., a minority interest) in the business ... Section 197 was held to apply.

c. *West Covina Motors, Inc.* ... Supplemental Tax Court opinion (Dec. 16, 2009) shows how professional fees paid in connection with the acquisition of a dealership should be allocated to different classes of assets with different recovery periods, with the remainder allocated to 15-year amortizable assets under Section 197.

B. Amortization periods

1. If the franchise, or certain other intangible rights, was acquired before August 10, 1993, they may have been amortized over a fairly short number of years.

2. If the franchise was acquired after August 10, 1993, Code Section 197 prescribes specific rules for amortizing over 15 years the cost of those intangibles - including goodwill and covenants not to compete.

3. Section 197 also includes rules for determining whether or not the unamortized cost associated with the franchise is permitted to be written off for tax purposes if the franchise is lost.

C. Intangibles subject to the provisions of Sec. 197 (i.e., amortizable Sec. 197 intangibles) include...

1. ***Any franchise, trademark or trade name***

2. ***Goodwill***

3. ***Any covenant not to compete ... or other arrangement*** to the extent such arrangement has substantially the same effect as a covenant not to compete ... entered into in connection with the direct or indirect acquisition of an interest in a trade or business

V. ***Terminated Dealerships & Franchises...*** *(...continued)*

C. 4. Going-concern value

5. Workforce in place

6. Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)

7. Any customer-based intangible

8. Any supplier-based intangible

9. Any license, permit or other right granted by a governmental unit or an agency

D. If a dealership's franchise to sell a specific make of vehicle is lost or terminated by the manufacturer...

1. It may be appropriate for the dealership to take an income tax deduction for the unamortized amounts of franchise costs, goodwill and other intangibles, including non-compete agreement obligations between the dealership and key employees, officers and/or shareholders.

2. Generally, if a dealer(ship) has paid for goodwill in the acquisition of ***a single franchise***, the unamortized amounts of the intangibles would be deductible in the year when the dealership loses the franchise, and it has no value.

a. The timing or the year of the deduction for the write-off may be altered by announcements in December 2009 by Chrysler and General Motors.

(1) Chrysler announced that it has unilaterally established a binding independent review process for rejected dealers, and

(2) General Motors announced that it has established a binding arbitration process for wind-down dealers.

(3) Some dealers may have to postpone their write-offs until the year 2010 when the negotiation processes have been completed.

(4) Some dealers may be fortunate enough not to have any write-off because, upon review, they will be entitled to retain their franchise after all.

b. Some dealers previously lost a franchise (in 2009), but they subsequently regained that franchise (in 2010) as a result of a favorable arbitration proceeding (that was concluded in 2010) or by other changes made by the Factory/manufacturer in its franchise termination procedures.

(1) If the dealership wrote off the loss in 2009, the dealership should file an amended income tax return for 2009 to reverse the deduction(s) claimed in that return.

(2) Some dealerships may try to rationalize the deduction that was claimed in 2009 and make other compensating adjustments in their tax returns and financial statements for 2010.

3. A deduction (under Section 165) for the "abandonment" of a franchise may be very difficult to sustain.

4. If (1) a dealer has acquired ***more than one franchise in a single transaction*** and paid for goodwill or other intangibles in connection with acquiring those franchises, and if subsequently (2) the dealer loses or incurs the termination of one of those franchises, then Section 197 does not permit a deduction for any unamortized goodwill or other intangibles (as of the date of the termination) if the other franchise (or franchises) are still retained. (Section 197(f)(1)(A)(i))

V. ***Terminated Dealerships & Franchises...*** *(...continued)*

D. 4. a. *Adjust the basis of the retained intangibles* ... The dealership is required to make appropriate adjustments to the adjusted tax basis of the retained intangibles (i.e., the intangibles that are associated with the remaining franchises) for any loss that is not recognized on the intangibles associated with the franchise that was terminated or lost. (Section 197(f)(1)(A)(ii))

E. Rules for reporting gains on dispositions

1. Revenue Ruling 2007-37 addresses the tax treatment of the resulting gain in connection with the receipt of a payment (or payments) for the cancellation of a distributor agreement between a manufacturer and a distributor of the manufacturer's products.

   a. Generally, when a dealer receives a cancellation payment from the distributor, the dealer would prefer to treat any gain as long-term capital gain, rather than as ordinary income.

   b. Revenue Ruling 2007-37 identifies the Sections of the Code that could treat portions of that gain as ordinary income.

2. In Private Letter Ruling 200218034, the IRS held that the cancellation of a distributor agreement between a manufacturer and a distributor of its products is a sale or exchange of property ... ***if*** the distributor has made a substantial capital investment in the distributorship ***and*** the investment is reflected in physical assets (i.e., such as inventory).

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

VI. ***Reporting Uncertain Tax Positions in Income Tax Returns***

- [Text Omitted] ... See pages 17-19 of this Year-End Edition of the *Dealer Tax Watch*

VII. ***Tax Issues for Survivors of Dealers Who Have Died After December 31, 2009***

- [Text Omitted] ... See *"Estate Tax Repeal for 2010 Means Headaches for Tax Return Preparers in 2011"* on pages 42-45 of this Year-End Edition of the *Dealer Tax Watch*

VIII. ***IRS Movement to Deputize CPAs to Become More Like IRS Agents ... Resolving Doubts Against the Taxpayer in Favor of the IRS (in Order to Mitigate or Avoid Exposure to Preparer Penalties)***

A. Where is this coming from?

B. The IRS is not responsible for the accuracy or for the reliability of its own Forms and Instructions.

1. Letter Ruling 200328001 dealt with the (in)adequacy of disclosures on Form 3115.

2. Footnote #2 in LTR 200328001 states, "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. [Citations of *Dixon*, *Adler*, *Zimmerman* and *Green* cases omitted.] ... ***Therefore, taxpayers who rely solely on IRS forms and instructions are at risk.***"

3. Not very comforting, is it? ... Why does the IRS hold itself to a lesser standard of competency than it expects from CPAs?

VIII. ***IRS Movement to Deputize CPAs to Become More Like IRS Agents...*** *(...continued)*

C. Registration of paid tax return preparers ... New PTIN registration requirements and restrictions

1. Initial on-line registration requirements are expected to take effect on or about Sept. 15, 2010.
2. Anyone who prepares all or substantially all of a return (or claim for refund) will be required to have a PTIN, regardless of whether they are required to sign the return.
3. Failure to provide a valid PTIN may result in penalties under Section 6695(c).
4. Eventually, anyone registering for or renewing a PTIN will undergo an automatic suitability and compliance check at that time.

D. Effect of codification of the *Economic Substance Doctrine* by Section 7701(o) ... Allows IRS to disregard any transaction entered into for which the taxpayer cannot demonstrate a business purpose.

1. At a recent Tax Forum, representatives of the IRS LMSB division said that the process for coming up with appropriate guidance (with respect to the absence of Regulations under Section 7701(o)) depends on a give-and-take between the IRS and taxpayers to understand the questions ... although the Treasury is open to public comments.
2. Some practitioners have expressed concern about tax planning now that the *Economic Substance Doctrine* could apply more extensively to long-standing practices.
3. The *Act* also imposes a unique "strict liability penalty" under Section 6662(b)(6).
   a. This penalty is 40% of the underpayment of tax attributable to a transaction lacking economic substance or failing to satisfy a similar rule of law.
   b. The penalty is reduced to 20% if the relevant facts affecting the tax treatment of the questionable transaction are adequately disclosed on the tax return or on a statement attached to the tax return.
   c. The penalty is unique because it lacks a reasonable cause defense ... There is no reasonable cause exception or other means to avoid the penalty.

E. Increasing imposition of preparer penalties under Section 6662 despite relaxation of standards for tax return preparer penalties by the *Tax Extenders & Alternative Minimum Tax Relief Act of 2008.*

1. If the position taken on an issue is not adequately disclosed in the tax return, then the standard for the conduct of the preparer is met if there is "substantial authority" for the position taken in the tax return.
   a. ***"Substantial authority"*** ... means less than a 1 out of 2 chance of prevailing (i.e., less than 50%), but greater than a "realistic possibility of success" (i.e., a 1 out of 3 chance of prevailing).
   b. Some say "substantial authority" equates with a 40% or better chance of prevailing.
2. If the position taken on an issue is adequately disclosed in the tax return, then the standard for the conduct of the preparer is "reasonable possibility of success" (i.e., the position taken has a one-in-three chance of success of being sustained).
3. These liberalized standards do not apply where tax shelters and/or reportable transactions (involving "transactions of interest") are involved. For these tax avoidance situations, the more-likely-than-not or over 50% chance of success standard continues to apply.
4. The preparer conduct standard applies on a position-by-position basis to each tax return.
5. Some states may not recognize the lower threshold (i.e., the substantial authority standard) and still apply the more stringent more-likely-than-not standard to the reporting of all transactions.
6. ***Caution: Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority.***

VIII. ***IRS Movement to Deputize CPAs to Become More Like IRS Agents...*** *(...continued)*

E. 7. Only the sources listed in Reg. Sec. 1.6662-4(d)(3)(iii) are authority for purposes of determining whether "substantial authority" exists for the tax treatment of an item in a tax return. These sources are:

a. Applicable provisions of the Internal Revenue Code and other statutory provisions
b. Proposed, temporary and final Regulations construing such statutes
c. Revenue Rulings
d. Revenue Procedures
e. Tax treaties and related Regulations and Treasury or other official explanations of such treaties
f. Court cases
g. Congressional intent as reflected in committee reports and other enumerated like sources
h. ***Private Letter Rulings and Technical Advice Memoranda issued after October 31, 1976***
i. Actions on Decisions
j. General Counsel Memoranda issued after March 12, 1981 and certain other GCMs
k. Internal Revenue Service information or press releases
l. Notices, Announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin

IX. ***Major Tax Planning Opportunity Is Still Available for 2010 for 15% Preferential Tax Rate for Qualified Dividend Income and Long-Term Capital Gains***

A. ***Uncertainty ...*** Should one go ahead with transactions intended to lock-in the favorable tax treatment ... or wait and see if the so-called "Bush tax cuts," which include this preferential treatment, are extended to 2011.

B. How does this really work?

C. How to explain the "tax savings" aspects of the calculations buried in the forms, schedules and software.

X. ***LIFO (Last-In, First-Out) Inventory Valuation Matters***

A. ***Uncertainty ...*** Over how much longer will LIFO be around (i.e., the long-term status of LIFO) ... Don't count it out yet.

1. Will the use of the LIFO method be legislated out of existence by Congress as part of new tax legislation? ... If so, would the repeal of LIFO be for years after 2011 (i.e., starting in 2012)?

2. Will U.S. convergence of GAAP with iGAAP shorten LIFO's life?

a. International Financial Reporting Standards (IFRS) ... The move to adopt IFRS by U.S. companies reporting to the SEC seems to be losing momentum as a force or catalyst for terminating LIFO elections by U.S. taxpayers.

3. *LIFO Coalition* ... Significant lobbying efforts to prevent loss of LIFO for U.S. taxpayers

4. How big are auto dealers' LIFO reserves?

a. ***Real world information on dealership LIFO reserves.*** Our survey of the LIFO reserves for New Vehicle Inventories for 105 dealerships using the Alternative LIFO Method shows the amounts and ratios of LIFO reserve balances to year-end inventory costs as of Dec. 31, 2008 & 2009.

X. *LIFO (Last-In, First-Out) Inventory Valuation Matters* *(...continued)*

A. 4. b. All of the survey data is included in the Mid-Year 2010 Edition of the *LIFO Lookout.*

c. Survey results ... [Text omitted]

d. My conclusions

(1) This sample is representative of a far larger number of dealerships ... despite the dissimilarities of the dealerships included in our survey, including the differences in the number of years that these dealerships have been on LIFO, coupled with the diversity of manufacturers new vehicles sold by the dealerships. The significant diversity of the 105 dealerships included in the survey is what strengthens its representativeness of a larger number of dealerships.

(2) If any other CPA firm were to draw a comparable composite or survey of 50, 100, 250 or more of their dealerships using the Alternative LIFO Method for New Vehicles, the overall results would not be significantly different from the results of our survey.

B. ***Uncertainty*** ... Over procedures for combining LIFO pools when dealerships convert to the Vehicle-Pool Method for 2009 (or for prior years) ... Some surprising results.

1. Usually, the benefit (i.e., the ability to have a larger LIFO reserve) obtained by changing to the Vehicle-Pool Method results from being able to reduce the LIFO reserve recapture impact where there has been a significant decrement in one (or both) of the two new vehicle pools.

2. In 2008, the IRS published guidance on how pools should be combined when dealerships changed to the Vehicle-Pool Method ... Impact of CCM 200825044 ... what to do about it.

a. Sequence of steps for combining pools: combine the two pools (first), then rebase the combined pool (second)

b. Alternate sequence: rebase each separate pool (first), then combine the two rebased pools (second)

c. Difference in results ... depends on the facts ... Numerous examples and case studies have been included in the *LIFO Lookout* in 2008 and 2009.

d. Shift in contribution to the LIFO reserve among prior year layers as of the beginning of the year of change

e. "Clear reflection of income" standard ... Should it apply?

C. ***Uncertainty*** ... Over whether to "preemptively" terminate LIFO elections as the impact of manufacturer bankruptcy/restructurings in 2009 continues to be felt as we near the end of 2010.

1. This uncertainty is not so much due to a lack of IRS guidance as it is to the lack of having a crystal ball.

2. Impact of reductions in dealer franchises on LIFO calculations for dealerships that survived

a. Importance of year-end projections, especially if year-end inventory levels are expected to be lower

3. Planning to mitigate loss of LIFO benefits ... Different dealership scenarios

a. *"When to hold and when to fold"*

(1) It is important to accurately project the amount of the "big hit" in the year when a significant portion of the LIFO reserve will be recaptured and evaluate that recapture against the alternative of terminating the LIFO election (as of the beginning of the year) which would result in the repayment of the entire LIFO reserve over 4 years, with no realistic possibility of re-electing LIFO for at least 5 years.

(2) ILM 200935024 addresses Section 481(a) adjustments in LIFO termination situations for three specific fact patterns.

X. *LIFO (Last-In, First-Out) Inventory Valuation Matters* *(...continued)*

C. 3. b. ***Possibility #1.*** Dealership with multiple franchises, only one (or two or three) of which are being terminated

(1) All of the basic LIFO considerations are important; do not overlook the planning opportunities here

(a) Benefit of dollar-value LIFO treating inventory as an investment of dollars

(b) Advantages of Alternative LIFO Method for New Vehicles

(c) Benefit of electing to combine pools for new cars and trucks into a single pool under the Vehicle-Pool Method in Rev. Proc. 2008-23

c. ***Possibility #2.*** Dealership with a single franchise which is being (or was) terminated, either directly or indirectly, by manufacturer. However, the dealership will stay in business just selling used cars and/or maintaining an active service department.

(1) Possible acquisition of another new vehicle franchise to replace lost franchise

(2) Importance of the concept of "separate trades or businesses" in connection with the dealership's continuation of relatively limited activities

(3) Possibility of electing the IPIC LIFO Method to defer impact vs. immediate repayment of entire LIFO reserve for new vehicles

d. Other possibilities...

D. ***Uncertainty ...*** Over the implications of Section 263A issues in connection with Forms 3115 filed by dealerships to terminate LIFO elections for new vehicles. Will the IRS permit the termination of the LIFO election if the dealerships do not make concurrent changes in their Section 263A methodologies?

1. ***Background.*** Termination of LIFO elections has become easier as a result of the elimination the previous uncertainties over "permitted methods" definitions by Revenue Procedure 2008-52.

a. Generally, the termination of a LIFO election can be made as an automatic change (i.e., advance consent from the IRS to make the change is not required).

(1) "Audit protection" usually is not available for a LIFO termination (change in method).

(2) Watch out for scope limitation exceptions (found in Rev. Proc. 2008-52, Section 4) that may prevent termination from being an automatic change.

b. Where LIFO elections are being terminated, the Form 3115 filing mechanics are straight-forward.

(1) Determine whether the change in method is automatic or requires advance consent from the IRS ... "Scope limitations" may apply.

(2) Different filing date requirements for Form 3115 ... before year-end vs. after year-end

(3) Different procedural mechanics

(4) Payment of a user fee is not required for automatic changes.

(5) Payment of a user fee is required for advance consent changes ... Currently, $4,200.

(6) If an extension of time to file Form 3115 is requested, the user fee for the IRS to consider the extension request is $5,000 (in addition to the user fee for consideration of the change request ... for a total of $9,200).

2. ***Uncertainty ...*** Implications of Section 263A issues in connection with Forms 3115 filed for termination of LIFO elections

X. ***LIFO (Last-In, First-Out) Inventory Valuation Matters*** *(...continued)*

D. 2. a. Schedule D, Part II (Page 6 of Form 3115)

(1) Question 3a ... "Is the applicant subject to Section 263A?" ... The answer to this usually will be answered, "Yes."

(2) Question 3b ... "Is the applicant's present inventory valuation method in compliance with Section 263A?" ... The answer to this may be problematic (especially in view of the current IRS "moratorium").

(3) Page 8 of the Form 3115 Instructions for Line 3 contains the statement: "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."

(a) ***The potential implications of this statement/requirement for automobile dealerships terminating their LIFO elections are unclear.*** How might the IRS apply this in LIFO termination situations?

(b) This statement should not be interpreted as having little significance. It does not contradict the statement in Rev. Proc. 2008-52 in connection with "permitted methods" 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 Sec. 263A which governs the types and amounts of costs required to be included in inventory cost. [Section 22.01(1)(b)(iii)]

(4) Schedule D, Part II states ... "Also complete Part III on Pages 7 and 8."

b. Schedule D, Part III (Pages 7-8 of Form 3115)

(1) The Instructions on page 8-9 for the completion of Schedule D, Part III merely refer to the Regulations without further discussion.

(2) ***Uncertainty ...*** Whether or how you complete Form 3115, Pages 7-8, Schedule D, Part III (Sections A, B & C) will depend on how you are handling matters related to the application of the Sec. 263A inventory cost capitalization rules to the dealership's inventories.

(3) ***Uncertainty ...*** The more recent heightened emphasis by the IRS concerning proper capitalization of costs under Section 263A and its moratorium (originally schedule to end on Jan. 1, 2011, but now extended until IRS publishes guidance in the *Internal Revenue Bulletin*) on raising Sec. 263A issues in audits 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 costs under Sec. 263A.

(4) ***Uncertainty ...*** At this time, given the uncertainties and the lack of specific, precedential guidance from the IRS on these matters, it is unclear what the specific, proper responses to Part III of Schedule D would be. In this regard, note particularly ...

(a) "Handling, processing, assembly and repackaging costs" ... Section B *(Costs Required to Be Allocated)* ... Line 9.

(b) "Offsite storage and warehousing costs" Section B *(Costs Required to Be Allocated)* ... Line 10.

(c) "On-Site storage" Section C *(Costs Not Required to Be Allocated)* ... Line 9

E. ***Uncertainty ...*** Over the proper application of the IPIC LIFO Method to automobile dealerships

1. See ***[Attachment #9]*** ... *Possible Causes of Confusion Over How Dealerships Should Set up Their LIFO Pools under the IPIC Method.*

2. See ***[Attachment #10]*** ... *Need for IRS Guidance to Reduce Variations in LIFO Computations by Auto Dealers Electing to Use the IPIC Method.*

X. ***LIFO (Last-In, First-Out) Inventory Valuation Matters*** *(...continued)*

F. ***Uncertainty*** ... Over the validity of the LIFO election by an auto dealership if trade discounts are not eliminated from inventory costs

1. Trade discounts (i.e., Factory floorplan assistance payments)

a. - d. Background discussion ... [Text omitted]

e. Apparently taxpayers using the LIFO method are not required to eliminate these volume-related trade discounts from inventory cost in order to comply with the requirement for LIFO purposes that inventories on LIFO must be stated at cost.

(1) Everyone (except me) seems to be relying on informal opinion expressed by IRS National Office. No official or authoritative sources, citations or explanations have been given in support of this opinion.

(2) But might some IRS technician some day raise the question over technical compliance with the "inventory at cost" requirement in Reg. Sec. 1.471-3(b) and Rev. Rul. 84-481?

2. IRS Legal Memorandum (ILM) 200945034 (July 2009) discusses the proper treatment of "member satisfaction merchandise allowances."

a. Background facts

(1) The taxpayer involved in this situation was engaged in the business of selling merchandise, some of which was purchased for resale and was occasionally determined to be defective. Merchandise was discovered to be defective in one of three ways... (1) when it is unloaded from the delivery truck at the taxpayer's distribution centers, (2) when the item is unpacked from its shipping container in either the distribution center or in the store, or (3) when the item is returned to the taxpayer by a customer who purchased the item.

(2) One of the vendors to this business adopted a policy (i.e., a "member satisfaction merchandise allowance") under which the taxpayer received "returned/defective merchandise vendor allowances" at the time when the merchandise was purchased. This allowance by the vendor was stated as a fixed percentage of total purchases, and this allowance was intended to cover the estimated costs of defective merchandise sold to the taxpayer.

(3) In connection with this policy, the taxpayer was generally not required to actually return the defective merchandise or otherwise notify the vendor or file a claim with the vendor for the amount of merchandise found to be defective.

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

(1) In other words, the IRS held that the vendor allowances in question for defective merchandise should be treated as trade discounts that reduce inventory costs.

(2) The underlying facts in the ILM are analogous to situations involving auto dealership trade discounts.

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

d. Some of the taxpayer's inventory was valued using the LIFO method and some inventory was valued using FIFO. Since one of the "eligibility" requirements for the election to use the LIFO method is that the inventory on LIFO must be valued at cost, this ILM resurrects - but does not consider - a potentially troublesome issue ... What are the consequences if the inventory on LIFO has not been reduced by the vendor allowances which were held to be trade discounts?

X. *LIFO (Last-In, First-Out) Inventory Valuation Matters* *(...continued)*

F. 2. e. This touches other nerve endings ... because all auto dealers, whether they are using LIFO or not, receive trade discounts from the manufacturers in connection with floorplan assistance payments and/or certain advertising fees.

3. ***Uncertainty*** ... If the IRS Chief Counsel recently held that vendor allowances of the type analyzed in the ILM should be treated as reductions of inventory cost, why wouldn't the IRS Chief Counsel apply the same logic to hold that trade discounts received by automobile dealerships (i.e., floorplan assistance payments, etc.) should also reduce inventory cost?

a. Does ***"should*** reduce inventory cost" equal ***"must*** reduce inventory cost"?

b. What are the implications, if any, of the ILM for auto dealerships (all of whom receive trade discounts) who have elected LIFO, for which there is a requirement that inventory valued using the LIFO method must be stated at cost? Is there a possible violation of the cost eligibility requirement if inventory amounts are not reduced by trade discounts?

4. When a change in accounting method is made (and when Form 3115 is filed) to eliminate trade discounts from inventory costs, a Section 481(a) adjustment is required.

a. The cut-off method cannot be used for these changes.

b. This is usually beneficial, because the Sec. 481(a) adjustment is a negative adjustment which can be taken into income (i.e., deducted) in the year of change.

c. Taxpayers on LIFO are required to make a detailed recalculation of the layer history for each pool affected by this change (i.e., the LIFO layers must be revalued to reflect the Section 481(a) adjustment. Note: This is beneficial because it spreads (or embeds) the amount of the Section 481(a) adjustment proportionately over all the LIFO layers.

(1) In practice, short-cut methods are often used for this calculation

d. There is also a corresponding effect on the amounts of cost capitalized under Section 263A.

(1) In other words, the overall net Sec. 481(a) adjustment involves a Sec. 263A adjustment component.

(2) In practice, the Section 263A adjustment usually is not allocated to the LIFO layers - instead, it is treated as a separate amount affecting cost of goods sold (or as a Schedule M adjustment).

e. Revenue Procedure 2008-52 now permits changes to eliminate trade discounts ... and to eliminate certain advertising fees and expenses ... from inventory costs to be made as "automatic changes."

(1) These are two distinct changes in accounting methods; dealerships usually make both changes at the same time.

(2) Costs eliminated ... average in the range of 2-2½% of ending inventory cost.

(3) Advance permission from the IRS to make both changes is not required. Previously, if a dealership wanted to eliminate both trade discounts and advertising costs from inventory costs, it was able to make the change to eliminate trade discounts as an automatic change in method (by filing Form 3115 after year-end and paying no user fee), but it was required to request advance permission from the IRS to make the change to eliminate certain advertising association costs from inventory (by filing Form 3115 before year-end and paying a user fee).

(4) For the elimination of trade discounts, the designated accounting method change number is #53 ... Section 21.04 of the Appendix to Rev. Proc. 2008-52 contains the specifics for this change.

(5) For the advertising fees CAM, the designated accounting method change number is #139... Section 21.13 of the Appendix to Rev. Proc. 2008-52 contains the specifics for this change.

X. LIFO (Last-In, First-Out) Inventory Valuation Matters *(...continued)*

F. 4. e. (5) (a) Advertising costs must meet certain criteria to qualify for this automatic change... Basically, the fees collected by the manufacturer are paid to ***local*** advertising associations that promote and advertise the manufacturer's products in the dealership's market area (i.e., the fees are not paid for ***national*** advertising campaigns). Also, three other criteria must be met.

(b) Note: The IRS uses the conjunction ***"and"*** in listing the above criteria.

(c) Under the new method of accounting for these advertising costs, etc., the dealership will exclude advertising costs (that meet the above criteria) from the cost of new vehicles, and it will deduct the advertising costs under Section 162 as the advertising services are provided to the dealership (see Reg. Sec. 1.461-4(d)(2)(i)).

(6) For dealerships that have not already changed accounting methods to eliminate trade discounts (and advertising fees) from inventory costs, 2010 might be a good year to make the change.

(7) Just follow the Form 3115 filing instructions and watch the technicalities.

G. ***Uncertainty*** ... S Corporation Q-Sub groups ... Integrating LIFO opportunities and avoiding pitfalls

1. Tax returns, LIFO elections & election terminations

a. Overall combination of assets, per statute. Nothing in the instructions indicates what to do

b. No IRS formal guidance on how to combine all assets of Q-Sub group

(1) Initial LIFO elections ... Do all Q-Subs have to be on LIFO?

(2) Terminating LIFO elections for Q-Sub members

2. LIFO calculations, pooling & reserve recapture implications

a. Should each Q-Sub's inventory constitute a separate pool?

b. Is each Q-Sub a "separate trade or business?"

(1) If so, separate pooling implications.

(2) Resolution may depend on whether the Q-Sub is operated as a "separate trade or business"

c. If, in initial return, all LIFO inventories of all Q-Subs were combined, that approach obviously provides greater protection against reductions in inventory resulting in LIFO reserve recapture.

(1) Method of accounting and change in method of accounting implications

d. How Q-Sub inventories have been treated in the initial S corp. return filed to include the Q-Subs could have "method of accounting" implications.

e. To date, the IRS has not issued any instructions or guidance on these LIFO/pooling inventory questions. Accordingly, there is no official IRS position requiring that Q-Sub inventories should be treated separately.

Supplementary Discussions Materials ... Attachments Omitted

The ***Supplementary Discussion Materials*** (i.e., the *Attachments*) listed on the following page have been selected from Mr. De Filipps' publications the *DEALER TAX WATCH* (from June 1994 through Year-End 2010) and the *LIFO LOOKOUT* (March 1991 through Year-End 2010).

Indexes of all articles (which include these supplementary materials) appearing in these publications are available as electronically searchable documents at www.defilipps.com. These Indexes can be reviewed for listings of other articles providing further background for remarks included by Mr. De Filipps in his presentation.

Attachments

THE PRACTITIONER'S NIGHTMARE: UNCERTAINTY & DEALERSHIP TAX ISSUES

Supplementary Discussion Materials ... Reproduced from Previous De Filipps Articles

1. ***Timeline*** ... January 1, 2010 to Date
2. ***UNICAP*** ... IRS "Audit Tool Kit" Attached to Notice of IRS Moratorium on Raising Dealership Sec. 263A Issues
3. ***UNICAP*** ... The Case Against Dealerships "Jumping the Gun" to File Forms 3115 to Change Cost Capitalization Methods Based on IRS' TAM 200736026
4. ***CAMs*** ... Frequently Encountered Automatic Changes in Accounting Methods in Automobile Dealerships
5. ***CAMs*** ... Practice Suggestion: Obtain a Signed Engagement Letter
6. ***CAMs*** ... 10 Suggestions for Form 3115 Filings
7. ***CAMs*** ... What if the Tax Return for the Year of Change is Due before the IRS Grants Approval to Make the Change?
8. ***UTP*** ... ***Uncertain Tax Position Statement*** ... Schedule UTP - IRS Draft Version
9. ***IPIC LIFO Methods Used by Dealerships*** ... Possible Causes of Confusion Over How Dealerships Should Set up Their LIFO Pools under the IPIC Method
10. ***IPIC LIFO Methods Used by Dealerships*** ... Need for IRS Guidance to Reduce Variations in LIFO Computations by Auto Dealers Electing to Use the IPIC Method

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