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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. TIMELINE ... DEVELOPMENTS JAN. 1, 2011 TO MID-YEAR. So far this year, there have been two major developments that have captured everyone's attention.

First, and most important, is the continuing uncertainty over the short-term and long-term consequences of the inability of our economy to recover. This uncertainty includes what the outcome might be of some of the "helpful" suggestions that some politicians are making for "improving things" by changing tax rates and removing alleged tax breaks and unnecessary benefits "for the rich."

In the latter category, the repeal of the use of LIFO is only one of the many threatened changes that would be most damaging to many of our dealership clients.

Even more disturbing is the fact that usually in the past, when the repeal of LIFO is mentioned - in the same breath - the disallowance of the use of the lower-of-cost-or-market (LCM) method is added to the discussion of tax breaks that should go. Unfortunately, since all recent discussion has been "behind closed doors," it is not known whether repeal of the LCM method has been tacked on.

This uncertain economic and tax future has affected all of our dealership clients, and especially those who are being called upon to make - or who may have already made - significant commitments of capital to expand their facilities. Some dealerships have made these commitments on their own initiative. Others seem to be "backed into a corner" by an insistent manufacturer threatening adverse consequences for the long-term livelihood of the dealership if the dealer does not agree to make certain "improvements and upgrades" in his or her facilities.

The second major development is that we now seem to have reached a point of closure ... after many, many years of IRS-induced uncertainty and chaos ... for ending the impasse (which seemed, at times, to be potentially never-ending) over how automobile dealerships should be capitalizing costs under Section 263A. More about this in Watch Out #2.

The ***Timeline*** on page 2 gives you a quick year-to-date overview of the major tax and other developments affecting dealerships.

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Timeline	JANUARY 1 TO MID-YEAR 2011
January 10	• ***Revenue Procedure 2011-14*** revises and updates the procedures, including those for filing Forms 3115, for taxpayers making designated ***automatic*** changes in accounting methods. ◆ This Revenue Procedure includes the Section 263A safe harbor elections for motor vehicle dealerships that can be made as automatic changes #150 and #151. ◆ This Revenue Procedure supersedes Rev. Proc. 2008-52. • Rev. Proc. 2011-14 is effective for the filing of Forms 3115 on or after January 10, 2011 ... subject to certain, very limited, exceptions.
January	• IRS Motor Vehicle Technical Advisor publishes an *Automotive Alert ... "Rev. Proc. 2010-44 Provides UNICAP Relief for Motor Vehicle Dealerships."*
February 17	• A group of Chrysler dealers affected by Chrysler's bankruptcy in 2009 filed a class action against the manufacturer in the U.S. Court of Federal Claims.
February 21	• A group of General Motors dealers affected by GM's bankruptcy in 2009 filed a class action against the manufacturer in the U.S. Court of Federal Claims.
March 18	• In Field Attorney Advice 20111101F, the IRS held that a dealer was not permitted to deduct goodwill that was associated with two franchises that had been purchased as part of a larger acquisition involving several other franchises. • The dealer unsuccessfully claimed that goodwill assigned to these franchises became worthless when the manufacturer notified the dealer that it was terminating his rights to sell vehicles under his franchise agreements. ◆ No merit or credence was given to the dealer's argument that there is no indication in the Code or in the legislative history that Congress intended to include automobile franchises in the application of Section 197(f)(1) ... i.e., the "spirit" of this provision does not contemplate automobile franchises.
March 18	• TAM 201111004 holds that a taxpayer may defer the gain on an involuntary conversion of inventory if the business is in a Federally-declared disaster area. • This guidance indirectly emphasizes that the provisions of Code Section 1033(h)(2) should not be overlooked by dealerships located in disaster areas. • The broader application of this TAM is that Section 1033(h)(2) could allow a dealership (in a Federally-designated disaster area) to defer reporting gain if (or when) it reinvests insurance or salvage proceeds in other assets used in the business.
March 18	• In ILM 201120021, the IRS held that an employee tool reimbursement plan failed to meet the business connection requirement (i.e., the first requirement of the three-requirement test that plans must satisfy in order to be accountable plans under Section 62(c)). • This guidance adds one more example (to a long list of others) of a tool plan reviewed by the IRS that fails to meet the accountable plan requirements.
March 23	• ***Schedule UTP, Uncertain Tax Positions.*** IRS released "Frequently Asked Questions on Schedule UTP" as an online publication. • These questions came up as a result of the IRS finalizing the Regulations on Dec. 15, 2010. • This document includes 4 questions on reporting aspects and 3 questions on the IRS' so-called "policy of restraint."
June 24	• President Obama's Administration included the repeal of LIFO as a tax break to be eliminated as part of the negotiations to reach a deal on the currently stalled debt limit increase (i.e., debt ceiling) negotiations. • Apparently, this is a follow-up to the President's proposal at the beginning of this year - as part of his "Greenbook" proposals - which included the repeal of LIFO after the year 2012 ... with a 10-year spread period for the recapture of the LIFO reserve into taxable income.
September 15 & October 15	• These are the extended due dates for calendar year 2010 dealership income tax returns to include Forms 3115 to elect to be covered under the Section 263A safe harbor rules provided by Rev. Proc. 2010-44. • Also, these are the dates for filing duplicate (i.e., copies) of Forms 3115 making these elections with the IRS National Office in Washington, DC.
Various	• De Filipps University seminars ... Including *Mid-Year 2011 Dealer Tax Update Tax Strategies & IRS Activities* ... various dates & locations ... See www.defilipps.com and www.krm.com/wjd.

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#2. SECTION 263A ... CLOSURE AT LAST! Filing Forms 3115 to Elect Sec. 263A Safe Harbor Methods for Auto Dealers. Clearly the largest portion of my own time since the beginning of the year has been devoted to developing teaching materials, giving seminars, consulting and answering questions regarding the completion of Forms 3115 for dealerships to file in order to elect the inventory cost capitalization safe harbor methods that the IRS now allows.

These safe harbors include (1) the "retail sales facility" safe harbor, (2) the "reseller without production activities" safe harbor and (3) the "simplified resale method" under Reg. Sec. 1.263A-3(d).

Because compliance with Section 263A and the proper Form 3115 filing mechanics continue to be such hot topics while we are in the "filing season" for 2010 tax returns, I've devoted a major portion of this Edition of the *DTW* to try bring my own kind of "closure" to this whole subject area.

Accordingly, the major focus of this Edition of the *Dealer Tax Watch* is intended to be a summary of all the elements that will be useful on this subject for your reference purposes.

The technicalities and content ... as well as practical observations ... on how to cope with the lack of any guidance from the IRS in this area before the Service issued TAM 200736026, the so-called moratoriums, and Revenue Procedure 2010-44 have all been covered in prior articles. None of this is repeated here in this Edition.

Depending on when you became a subscriber to the *Dealer Tax Watch*, you've been exposed to varying degrees of technical and practical discussions of how Section 263A affects ... or should affect ... dealerships. The very first issue of the *DTW* - written 17 years ago - described what was then known as the "simplified resale method," and described its evolution into the "simplified resale method" as we know it today and as it is described in the Regulations which were finalized in 1994. A complete list of all the articles on this subject appearing in the *Dealer Tax Watch* over the years is included on pages 44-45.

However, I have included a *"25-Year UNICAP Timeline for Dealerships"* covering the years 1986 through 2010 on pages 21-23. This will give you a bird's-eye view or a sense of historical development of what we all have painfully endured.

The *"Completing Form 3115 ... A Page-by-Page Overview,"* (on pages 24-28) reflects my thinking, to date, especially in response to many questions that participants in my audio seminars have raised either in anticipation of filling out Form 3115 or as they actually were doing so.

In addition, I've updated (slightly) some previous material, including the Form 3115 narrative proforma attachment (on pages 29-31). You'll note that I've also incorporated into this *Analysis* references to the issuance of Revenue Procedure 2011-14 (discussed in Watch Out #3 below) which updated all of the IRS' procedures for automatic changes in accounting methods, including those affecting dealerships electing the Section 263A safe harbors.

The sample Form 3115 narrative statement included in the Year-End 2010 Edition of the *Dealer Tax Watch*, referred to changes "in the *Appendix* to Revenue Procedure 2008-52 (as clarified and modified by Rev. Proc. 2009-39)." Subsequently, the IRS revised these procedures in Rev. Proc. 2011-14 in January. The IRS said that Forms 3115 filed on or after January 10, 2011 (subject to certain, very limited, exceptions) were to be filed under these newer procedures.

The materials in this Edition include a 2-page addendum (pages 32-33) to the revised and updated 3-page narrative statement. This addendum calls your attention to several other important issues and filing aspects.

In "one last effort" to summarize everything, I've developed a *"Checklist for Evaluating Dealership Compliance with Sec. 263A."* I've used this in several audio seminars already this year and participants have found it helpful. The *Checklist* is included it on pages 41-43.

There are other supplementary materials pulling things together, and these are identified on page 19 ... along with the *Automotive Alert* on the cost cap safe harbors (pages 38-40) that the IRS Motor Vehicle Technical Advisor issued in January 2011.

#3. UPDATED PROCEDURES FOR AUTOMATIC CHANGES IN ACCOUNTING METHODS ... REV. PROC. 2011-14. Until early this year, Revenue Procedure 2008-52 was the document that contained the procedural rules to be followed when taxpayers are filing Form 3115 to make voluntary, automatic changes in accounting methods.

In January, the IRS issued Revenue Procedure 2011-14 to update, supersede, modify and clarify the procedures previously spelled out in Rev. Proc. 2008-52.

Rev. Proc. 2011-14, which introduced no new substantive changes in the procedures, applies to the filing of Forms 3115 on or after January 10, 2011.

Revenue Procedure 2011-14 continues to emphasize the need to coordinate (1) changes in accounting methods with respect to the application of the Section 263A inventory cost capitalization rules

see **DEALER TAX WATCH OUT**, page 5

"Pressure"	*DEALERS UNDER DURESS ... PRESSURE FROM MANUFACTURERS*
Intro	• For many years, Richard N. Sox, Jr. has been a featured speaker at the AICPA National Auto Dealership Conferences in which he provides updates on the latest manufacturer initiatives threatening dealership viability and a wide range of related issues. • Articles in the *Dealer Tax Watch* have summarized his previous presentations. • The firm in which Mr. Sox is a partner - Bass Sox Mercer, Attorneys at Law - publishes the "*The BSM Report ... A Newsletter for Motor Vehicle Dealers and Associations.*"
Chrysler Increasing Sales Performance Warnings	• In its letters to dealers, Chrysler is stressing the "minimum sales responsibility" section of the Chrysler Sales and Service Agreement as its prelude to warning the dealer that he or she is falling short of his or her responsibility and that immediate corrective action is needed. • Chrysler's letter concludes with a request for an "improvement plan." • *The BSM Report* states that "Chrysler dealers should not ignore these warning letters, but instead respond to them with as much substance as possible." • Many other suggestions are included for dealers to consider in their responses.
Uptick in Proposed New Dealer Points	• Many manufacturers appear to be proposing new dealership points in markets across the country. • *The BSM Report* indicates that this includes - among others - Hyundai, Kia, Chrysler, VW and Audi. • Virtually all state franchise laws provide dealers with protections from unwarranted new points being added to their relevant market area. • Attorneys at Bass Sox Mercer are currently handling new dealership point protests in many states including Connecticut, Montana, Nevada, New Mexico and North Carolina. • *The BSM Report* suggests that, and explains why, existing dealers may have strong arguments in protesting these actions by the manufacturers.
Internet Domain Name Disputes	• As dealers continue to "go digital" in their marketing efforts and register Internet domain names, a whole new wave of disputes is coming concerning ... *Cybersquatting*, *Typo Squatting* and *Domain Name Hijacking*. • As a result, "the greatest concentration of Internet-related litigation to date has involved domain name disputes. ... "Depending on what particular domain name dispute (a dealership is) experiencing, there will be different options in how you may elect to attempt to resolve the dispute." • This article discusses the representations that must be made by anyone who registers an Internet domain name. • If certain disputes arise, an arbitration procedure through WIPO (World Intellectual Property Organization) may be a relatively fast and cost-effective means for resolving domain name disputes. • The suggestion is that "no matter what name disputes (a dealership is) forced to address, your least expensive means in addressing any domain name dispute is to be proactive in protecting your domain names."
New Laws & Regulations Effective Immediately	• An article by Shawn D. Mercer, Esq. addresses new regulations that dealers cannot afford to ignore. General summaries include the following... ◆ FLSA - Overtime exemption for service writers ... A new U.S. Dept. of Labor Ruling ◆ Holder in due course change ... referring to amendments made under the *Dodd-Frank Act* ... effective July 21, 2011 ... affecting retail installment contracts where the amount financed is $50,000 or less. ◆ The change, effective July 21, 2011, which will apply the Federal *Truth-in-Lending Act* (or the *Consumer Leasing Act* for leases) to all installment contracts where the amount financed or the total lease obligation is $50,000 or less. ◆ Adverse action notice changes under the *Fair Credit Reporting Act*, ... effective July 21, 2011 ... expand the situations in which, if adverse action is taken against a consumer credit applicant, additional information will have to be provided. ◆ Amendment to Federal *ECOA (Equal Credit Opportunity Act)* which will require the collection of specific information for small businesses, minority-owned businesses and women-owned business credit applications.
Source	• *The BSM Report*, 2nd Quarter 2011 ... Bass Sox Mercer, Attorneys at Law • For further information on these matters, Mr. Sox and his associates can be reached at the firm's Tallahassee, FL office at (850) 878-6404 (rsox@dealerlawyer.com), or the Raleigh, NC office at (919) 847-8632, Shawn D. Mercer (smercer@dealerlawyer.com). • Contact them at www.dealerlawyer.com if you would like to receive *The BSM Report* directly.

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with (2) the requirements for computing adjustments to taxable income in the year of change under Section 481(a).

A list of automatic changes in accounting methods that are frequently encountered in motor vehicle dealerships may be found on page 11. This list is updated to include the Section 263A safe harbor elections that now protect most dealerships.

#4. "WITH FRIENDS (PARTNERS) LIKE THESE, WHO NEEDS ENEMIES?" As if dealerships were not under enough pressure, relations with several of the manufacturers continue to present threats to long-term growth. It is reported that some manufacturers are (unreasonably) proposing to add new dealership points in some areas; other manufacturers are sending out letters to warn dealerships that they are not meeting their minimum sales responsibilities.

It gets worse ... It appears that many dealerships are becoming the subject of Internet domain name disputes. And, there are several new laws becoming effective in July requiring more dealership compliance procedures and reporting paperwork.

These factors, all of which contribute to more stress and duress for dealerships, are discussed in *The BSM Report*, 2nd Quarter 2011. A brief summary appears on the facing page.

It was recently reported that Toyota, and perhaps a few other manufacturers, may initiate broad reorganizations to merge subsidiaries and make their domestic operations more cost-efficient and to address the impact of a stronger yen. As these manufacturers initiate structural changes in their own best interests, it is possible that the ramifications are likely to result in still more pressure on dealers.

Dealer litigation against the manufacturers. Dealers affected by the bankruptcies of General Motors and Chrysler have reached the point of filing class action suits against both manufacturers. A group of Chrysler dealers filed its claim in the U.S. Court of Federal Claims on February 17, 2011. A separate class action suit was filed by GM dealers on February 21, 2011 against General Motors.

The claims asserted against the manufacturers make very interesting reading. How all of this will turn out, remains to be seen. But, it is likely that any judgments that might be beneficial to dealers will produce some interesting tax questions.

#5. TAX PLANNING OPPORTUNITIES FOR DEALERSHIPS IN DISASTER AREAS. Unfortunately, dealerships in many parts of the country have been affected by major weather disruptions and natural disasters ... hurricanes, flooding, fires, high winds, drought, etc. Some of these dealerships may be located in what are technically called "Federally-designated disaster areas."

If they are, a recent Technical Advice Memorandum (TAM) suggests several opportunities that alert CPAs and advisors should consider as practical tax strategies to minimize the consequences of these disasters.

The guidance in recent TAM 201111004 emphasizes that the provisions of Code Section 1033(h)(2) should not be overlooked. These provisions could allow a dealership in a Federally-designated disaster area to defer reporting gain if (or when) it reinvests insurance or salvage proceeds in other assets used in the business.

This TAM is discussed on page 12. In addition, the article includes several other related tax planning considerations. All are intended to help dealerships make the most beneficial tax choices to minimize the impact of these disruptions on business activities.

#6. EVEN IF YOU DON'T HAVE A DEALERSHIP ON LIFO AT THIS TIME, There Are Still a Few Things You Should Be Aware of. Over the years, I've often met CPAs who have basically turned a deaf ear on the benefits of using the LIFO method. This was because either (1) they only had dealership clients who were not on LIFO and/or (2) they - for whatever reason - shy away from that 4-letter word. (LIFO does not mean "Leave It For Others.")

Even if you currently do not have any dealership clients on LIFO, there are several current matters that perhaps you should be aware of. After all, if you meet a dealer who is a potential client ... and if that dealer happens to be on LIFO ... he or she may have some questions, and it would be nice if you didn't have to "bluff your way" through the conversation. Or, worse yet, have a conversation that might lead to a new dealership client abruptly shortened by the dealer because it was evident that you weren't familiar, at least in a general way, with LIFO matters.

So, just in case you're curious, a brief summary follows on pages 6 and 7. These are discussed more fully in the Mid-Year 2011 Edition of the *LIFO Lookout*.

And, if want to skip this material, I won't feel offended. No harm ... no foul.

#7. RECENT IRS GUIDANCE. In the category of "recent IRS guidance," in addition to the TAM above, there are three other items worth mentioning. These don't really contain any major surprises ... and the subject matter of each has been discussed in previous Editions of the *Dealer Tax Watch*.

Dealership non-deductibility of worthless goodwill when a franchise is lost or terminated by the manufacturer. In FAA 201111001F, the IRS

see **DEALER TAX WATCH OUT**, page 8

De Filipps' LIFO Bulletin Board *

1. Status of LIFO ... Will LIFO Be Around Much Longer?

On June 24, 2011, President Obama's Administration included the repeal of LIFO as a tax break to be eliminated as part of the negotiations to reach a deal on the currently stalled debt limit increase (i.e., debt ceiling) negotiations.

Apparently, this is a follow-up to the President's proposal at the beginning of this year - as part of his "Greenbook" proposals - which included the repeal of LIFO after the year 2012 ... with a 10-year spread period for the recapture of the LIFO reserve into taxable income.

In response to this recent threat, the LIFO Coalition immediately generated significant counter-activity, including the sponsoring of a message ad which may be viewed at our website or at www.SaveLIFO.org.

The LIFO Coalition represents hundreds of thousands of businesses and business associations, all of whom have been urged to inundate the President and their own Congressional representatives by phone, fax, e-mail and other media with one simple message ... "Don't Kill More Jobs by Killing LIFO!"

Right now, my focus is on the belief that it is in a client's best interest to maximize its LIFO reserves until such time as political and legislative forces - all well beyond our control - dictate what is really going to happen.

2. Some Dealerships with Summer (Fiscal) Year-Ends May Face Stiff LIFO Reserve Recapture Because of Reduced New Vehicle Inventory Levels

Some dealerships with summer (fiscal) years ending June, July, August and possibly even September may face significant LIFO reserve recapture because of the serious problems created by the inability of manufacturers to get parts from Japan and other sources.

This shortage of inventory problem may be particularly acute for Toyota and Honda dealerships because production for these manufacturers was severely affected by the earthquake and tsunami in Japan in March 2011.

The Year-End 2009 Edition of the *LIFO Lookout* contained an extensive discussion of problems and IRS guidance related to dealers who were low on new vehicle inventory at year-end (at that time, referring to December 31, 2009). Most of what I said in that 24-page discussion bears repeating for dealers currently facing similar mid-yearend inventory shortages.

My expectation for dealerships with 2011 fiscal year-ends facing similar significant inventory shortages is that they will, basically, "take the hit" but still keep their LIFO elections in place.

3. Sec. 263A CAMs & LIFO Sec. 481(a) Adjustments & Inventory Restatements

This Edition of the *Dealer Tax Watch* includes an article (on pages 9-11) which discusses the recent update that the IRS made in its procedures for automatic changes in accounting methods.

This article (on page 9 of this Edition of the *DTW*) refers to computational issues that dealerships using LIFO have to take into consideration when filing Form 3115 to elect the Section 263A safe harbor methods. The Section 481(a) adjustment that these dealerships are required to make ... if they are using the LIFO method ... may be considerably more complicated than it would be if the dealership were not using LIFO.

CPAs involved with Section 481(a) adjustments for dealerships using LIFO must consider the provisions in Reg. Sec. 1.263A-7 which require the revaluation of the beginning-of-the-year inventories for the year in which the change in accounting method becomes effective. This could possibly result in adjusting each of the annual layers of increment that make up the overall LIFO valuation of the inventory.

4. Deferring "Gain" on Involuntary Conversions of LIFO Inventories

An article in the *LIFO Lookout** discusses the issues and conclusions in Technical Advice Memorandum (TAM) 201111004 with particular focus on the possibility that dealerships in Federal disaster areas might be able to minimize LIFO recapture if they had LIFO inventories that were destroyed by casualty/disaster. The article in the *Lookout* focuses on inventories, whether or not they were valued using the dollar-value LIFO Method.

The article on page 12 of this Edition of the *DTW* - *"Dealerships in Disaster Areas ... Tax Planning Is a Must"* - discusses the implications of this TAM in a far broader context. It suggests that dealerships, when recovering from disasters, consider applying the deferral-of-gain provisions of Section 1033(h)(2) to determine the basis of assets the business purchases or otherwise acquires to replace assets that were destroyed by a casualty/disaster.

In this far broader context, dealerships may find many different scenarios and planning opportunities. The beneficial results of Section 1033(h)(2) are elective, and may involve the consideration of transactions occurring over several years, and their interaction with other tax provisions (such as net operating loss alternatives and/or depreciation alternatives) which, in turn, allow other options.

5. Strategy for a Dealer to Minimize LIFO Recapture When the Manufacturer Terminates a Franchise

The bankruptcies of Chrysler and General Motors in 2009 are now history. In 2009 and 2010, many Chrysler and GM dealers had to deal with the adverse ramifications that losing a franchise had on their LIFO reserves when their year-end new vehicle inventory levels fell, or were entirely eliminated.

It is important not to think of these situations as just being of historical interest and related only to the 2009 General Motors and Chrysler bankruptcy filings.

As discussed in the *LIFO Lookout** article entitled *"Splitting Dollar-Value LIFO Pools ... Procedures, Techniques & Refinement,"* when notified that a manufacturer is going to terminate one of several franchises, automobile dealerships may consider terminating their LIFO election for new vehicles in order to minimize an anticipated recapture of their LIFO reserves as ordinary income. Generally, this would spread the recapture of the LIFO reserve over 4 years.

However, there is a definite alternative strategy that dealers might pursue. This strategy would result in the dealer keeping the LIFO election in place for those franchises which are not terminated, while terminating the LIFO election ***only*** for the vehicles related to the franchise(s) that was terminated.

Essentially, a "pool-split and partial LIFO termination" strategy would require a dealership to file two Forms 3115. The first Form 3115 would be filed with the IRS ***before*** the end of the year. This would request advance permission from the IRS to split the new vehicle dollar-value LIFO pool. This Form 3115 would be filed under Rev. Proc. 97-27 and would require the payment of a user fee.

The second Form 3115 would request permission to terminate the LIFO election only for the pool(s) related to the new vehicles for the franchise(s) that was being terminated by the manufacturer. This Form 3115 would be filed ***after*** the end of the year, and would be an automatic change in accounting method filed under Rev. Proc. 2011-14.

The pros and cons of this strategy - and a number of variations - are discussed as part of the case study in the *LIFO Lookout** dealing with splitting dollar-value LIFO pools.

*** The items discussed in this *Bulletin Board* are summaries taken from articles appearing in the Mid-Year 2011 Edition of the *De Filipps LIFO Lookout.***

The table of contents of the Mid-Year 2011 Edition of the *LIFO Lookout* can be viewed at www.defilipps.com.

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held that where a manufacturer terminated a dealer's franchise rights to sell certain vehicles, the dealer could not take a deduction for worthless franchise costs. Instead, any amount attributable to the terminated franchises had to be included in the basis of the remaining franchises that had been acquired in the same original transaction. See page 16.

Employee tool plans. In ILM 201120021, the IRS threw yet another employee tool plan "under the bus." This ILM does not involve a dealership, but it does reinforce the IRS' continuing disdain for these plans.

In the ILM, the IRS concluded that a reimbursement / expense allowance arrangement that paid an amount to employees regardless of whether an expense was paid or incurred (or reasonably expected to be paid or incurred) violated the business connection requirement that must be satisfied in order to qualify as an accountable plan under Section 62(c).

Accordingly, payments made under the arrangement were required to be treated as made under a nonaccountable plan. This means that the amounts the employer paid to the employees (1) must be included in the employee's gross income for the taxable year, (2) are subject to withholding and payment of employment taxes, and (3) must be reported as wages or other compensation on the employee's Form W-2.

The details are on pages 46-47.

Update on Schedule UTP for reporting uncertain tax positions. On March 23, 2011, the IRS discussed several Frequently Asked Questions on Schedule UTP in an online publication. These questions came up as a result of the IRS finalizing the Regulations late last year.

This document includes 4 questions on reporting aspects and 3 questions on the IRS' so-called "policy of restraint." None of these appear to be of special application to dealerships, but if you want to view the entire text, it is available at www.irs.gov (http://www.irs.gov/businesses/article/0,,id=237538,00.html).

#8. UPDATED INDEX OF *DEALER TAX WATCH* ARTICLES THROUGH DEC. 31, 2010. We have updated our Index of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December 2010. This electronically searchable and user-friendly Index is available on our web site (www.defilipps.com) for your reference purposes. As with last year's Index, you can search the Index by keyword(s), and you can also save the 68-page Index on your computer for handy reference and printing.

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

The ten sections of our Index of Articles are listed below.

A Periodic Update of Essential Tax Information

DEALER TAX WATCH

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IRS UPDATES PROCEDURES FOR AUTOMATIC CHANGES IN ACCOUNTING METHODS

Form 3115, *Application for Change in Accounting Method*, is the form that taxpayers must file with the IRS when they are changing most accounting methods. This Form (8 pages) and the separate Instructions (17 pages) were both updated in Revisions dated December 2009.

This Form is filed for changes in accounting methods that require advance permission from the IRS as well as for making changes in accounting methods that do not require permission from the IRS before the change can be made.

Until early this year, Revenue Procedure 2008-52 was the document that contained the procedural rules to be followed when taxpayers are filing Form 3115 to make voluntary, automatic changes in accounting methods under the "automatic consent procedures."

REVENUE PROCEDURE 2011-14

In January, the IRS issued Revenue Procedure 2011-14 to update, supersede, modify and clarify the procedures previously spelled out in Revenue Procedure 2008-52.

Rev. Proc. 2011-14 is effective for the filing of Forms 3115 on or after January 10, 2011 (subject to certain, very limited, exceptions).

Basically, there are no substantial changes between "old R.P. 2008-52" and "new R.P. 2011-14." The Sections in "old R.P. 2008-52" have been carried forward pretty much intact. For a detailed discussion of these procedures see: *"Revised Procedures for Securing Automatic Consent from the IRS to Make Changes in LIFO & Other Methods of Accounting,"* in the Year-End Edition of the *Dealer Tax Watch*, on pages 14-44.

NOTIFYING THE IRS OF AN AUTOMATIC CHANGE

One of the ramifications of making the changes to elect the safe harbor methods involves following the procedural rules and requirements (listed in Revenue Procedure 2011-14) for filing Form 3115 to notify the IRS that the changes are being made. It is important to follow exactly the "Timely Duplicate Filing Requirements" for Form 3115 set forth in Rev. Proc. 2011-14, Section 6.02(3)(a)(i) and (ii).

Original application. The original application Form 3115 must be attached to the taxpayer's timely filed (including any extension) original Federal income tax return implementing the change in method of accounting for the year of change.

National Office copy of application. A copy of the application (with the original signature or a photocopy of the original signature) must be filed with the National Office (National Office copy) no earlier than the first day of the year of change and no later than the date the taxpayer files the original with the Federal income tax return for the year of change. There is a minor exception provided in Section 6.02(3)(a)(ii)(B). 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.

The National Office copy of Form 3115 must be addressed to the Internal Revenue Service, Attn: CC:ITA - Automatic Rulings Branch, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044. If the National Office copy is not mailed, and a designated private delivery service is used instead, the address is: Internal Revenue Service, Attn: CC:ITA - Automatic Rulings Branch, 1111 Constitution Avenue, NW, Room 5336, Washington, D.C. 20224).

No user fee. A user fee is not required for an application for an automatic change in method filed under Rev. Proc. 2011-14. Generally, the IRS will not send an acknowledgment of the receipt of Form 3115.

SECTION 481(a) ...
TRANSITIONAL ADJUSTMENTS

Another ramification where voluntary changes in accounting method are being made involves calculating the adjustment under Section 481(a).

Revenue Procedure 2011-14 continues to emphasize the need to coordinate (1) changes in accounting methods with respect to the application of the Section 263A inventory cost capitalization rules with (2) the requirements under Section 481(a) for computing adjustments to taxable income in the year of change.

Basically, 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

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then employed. The computation of (taxable) 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.

One example of where a dealership is required to make a Section 481(a) adjustment is when the dealership makes an automatic change in accounting method to eliminate trade discounts (i.e., Factory floorplan assistance payments) from its inventory costs in accordance with Reg. Sec. 1.471-3(b) and Revenue Ruling 84-481. This is automatic change #53.

Similarly, a Section 481(a) adjustment is required when the dealership makes an automatic change in accounting method to eliminate certain advertising costs from its inventory costs. This is automatic change #139.

SEC. 263A CAMs REQUIRE SEC. 481(a) ADJUSTMENTS

Unfortunately, the (automatic) changes in Section 263A methods of accounting to be made under Rev. Proc. 2010-44 require the taxpayer to compute a Section 481(a) adjustment.

As a result, motor vehicle dealerships filing Form 3115 to elect the Section 263A safe harbor methods must consider how they have previously applied the Section 263A rules to their inventories and how that treatment affects their computation of a Section 481(a) adjustment for the year of change.

Section 263A did not come into the law until 1986. However, when it was enacted, most dealerships immediately became subject to its provisions. Over the years, many dealerships followed the practice of taking the Section 263A amounts into income as net adjustments each year in order to reconcile their off-the-books Sec. 263A calculations (i.e., their calculations on spreadsheets) with adjustments to taxable income on Schedule M-1 or M-3 of their income tax returns.

For these dealerships, it would appear that their Section 481(a) adjustment (required at this time in electing the Section 263A safe harbors) would simply involve the reversal of the net amounts previously capitalized through their Schedule M-1 or M-3 adjustments. It would appear that they would not have to deal with the revaluation provisions in Reg. Sec. 1.263A-7. However, the IRS has not provided any specific guidance as to whether this approach would be acceptable.

Dealerships using the LIFO (Last-In, First-Out) method to value their inventories. Some dealerships that were using the LIFO method to value their vehicle inventories have embedded the results of their Section 263A computations into their annual LIFO layers. Other dealerships using LIFO have not embedded those costs into their LIFO layers. Computational issues related to the Section 481(a) adjustment for dealerships using LIFO are discussed more fully in the Mid-Year 2011 Edition of the *LIFO Lookout,* in the article *"Section 263A CAMs & Section 481(a) Adjustments for LIFO Inventory Restatements."*

CUT-OFF METHOD IN LIEU OF SEC. 481(a) ADJUSTMENT

In many situations involving automatic changes in accounting methods, the IRS may allow the use of the cut-off method instead of requiring the computation of a Section 481(a) adjustment.

When a change in method of accounting is made on a cut-off basis, in general, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting. Because no amounts are duplicated or omitted when a change in method of accounting is made on a cut-off basis, no Section 481(a) adjustment is necessary.

In essence, this means that the dealership does not have to go back and compute an adjustment for the year-of-change in order to reflect the effect of using the new method as if that new method had been used in all prior years.

FREQUENTLY ENCOUNTERED DEALERSHIP CAMs

A list of automatic changes in accounting methods that are frequently encountered in motor vehicle dealerships appears on page 11.

This list is updated to include the Section 263A cost capitalization safe harbor method automatic change elections (#150 and #151) as well as two other related automatic changes (#22 & #23) that now protect most dealerships. These changes are now included in the *Appendix* to Rev. Proc. 2011-14.

"Automatic" Changes in Methods		AUTOMATIC CHANGES IN ACCOUNTING METHODS FREQUENTLY ENCOUNTERED IN MOTOR VEHICLE DEALERSHIPS*		
IRC Code Section	*Designated Automatic CAM #*	*Change in Method Relates to ...*	*LIFO Inventory Changes*	*Auto Dealership Changes*†
471	*53*	Qualifying volume-related trade discounts	✓	✓
	54	Impermissible methods of inventory valuation	✓	✓
472	*56*	Change from LIFO inventory method (LIFO terminations)	✓	✓
	57	Determining current-year cost	✓	✓
	58	Alternative LIFO Inventory Method (for *New* Vehicles)	✓	✓
	59	*Used* Vehicle Alternative LIFO Method	✓	✓
	60	Determining the cost of used vehicles purchased or taken as trade-ins	✓	✓
	61	Change to IPIC inventory method	✓	✓
	62	Changes within IPIC inventory method	✓	✓
471 & 472	*63*	Replacement cost method for auto dealers' parts inventory	✓	✓
	96	Replacement cost method for heavy equipment dealers' parts inventory	✓	✓
472	*112*	Changes to the Vehicle-Pool Method	✓	✓
471	*139*	For new vehicle retail dealerships, elimination of certain invoice advertising association costs from inventory	✓	✓
472	*140*	Changes within the Used Vehicle Alternative LIFO Method	✓	✓
Various	*7*	Depreciation or amortization (impermissible)		✓
56 & 167	*8*	Depreciation (permissible)		✓
Various	*10*	Sale or lease transactions		✓
263	*21*	Costs incurred in retirement and removal of depreciable assets		✓
263A	*22*	Certain uniform capitalization methods used by small resellers, formerly small resellers, and reseller-producers		✓
	23	Certain uniform capitalization methods used by producers and reseller-producers		✓
	150	***Retail sales facility safe harbor method*** (Rev. Proc. 2010-44)		✓
	151	***Reseller without production activities safe harbor method*** (Rev. Proc. 2010-44)		✓
267	*26*	Related party transactions		✓
446	*31*	Multi-year insurance policies for multi-year service warranty contracts (more commonly referred to as the SWIM - Service Warranty Income - Method)		✓
461	*43*	Timing of incurring real property, personal property and state income tax liabilities		✓
	45	Timing of incurring payroll tax liabilities		✓
471	*48*	Cash discounts		✓
263(a)	*78*	Costs of intangibles and certain transactions		✓
168 & 1400L	*105*	Additional first year depreciation deduction		✓
Various	*107*	Depreciation or amortization for dispositions of depreciable or amortizable property		✓
461	*113*	Payroll tax liabilities		✓
168	*116*	Depreciation of MACRS property acquired in a like-kind exchange or as a result of an involuntary conversion		✓
167 & 168	*119*	Change from depreciating land and/or land improvements		✓
446	*125*	Multi-year service warranty contracts		✓
118	*129*	Nonshareholder contributions to capital under Section 118		✓
461	*133*	Timing of incurring liabilities for bonuses		✓
	134	Timing of incurring liabilities for vacation pay		✓
	135	Rebates and allowances		✓
467	*136*	Section 467 rental agreements re: uneven vs. fixed rents/deferrals		✓
471	*137*	Permissible methods of inventory identification and valuation		✓
	138	Change in the official used vehicle guide utilized in valuing used vehicles		✓
168	*146*	Dispositions of structural components of a building		✓
	147	Dispositions of tangible depreciable assets (other than a building or its structural components)		✓
461	*149*	Ratable accrual of real property taxes		✓

* ***Revenue Procedure 2011-14.*** *These changes may be made without advance consent (permission) from the IRS by filing Form 3115 ("Application for Change in Accounting Method," Rev. Dec. 2009). The IRS will continue to designate additional changes in accounting method as eligible to be made by the "automatic" change procedures in subsequent Revenue Procedures, other guidance and announcements.*

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

TAX PLANNING OPPORTUNITIES FOR DEALERSHIPS IN DISASTER AREAS

Unfortunately, dealerships in many parts of the country have been affected recently by major weather disruptions and natural disasters ... i.e., hurricanes, flooding, fires, high winds, drought ... and the list goes on. Some of these dealerships may be located in what are technically referred to as "Federally-designated disaster areas."

If they are, a recent Technical Advice Memorandum (TAM) suggests several opportunities that alert CPAs and advisors should consider as practical tax strategies to minimize the adverse affects of these disasters.

For these dealers, it is critical to not overlook the many tax planning strategies and opportunities that may be available ... and to stretch them as far as legally possible.

The guidance in recent TAM 201111004 emphasizes that the provisions of Code Section 1033(h)(2) should not be overlooked. These provisions could allow a dealership in a Federally designated disaster area to defer reporting gain if (or when) it reinvests insurance or salvage proceeds in other assets used in the business.

Section 1033 of the Code deals with "Involuntary Conversions." It provides that gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent that the taxpayer purchases property similar or related in service or use to the converted property within the applicable "replacement period."

The taxpayer's basis in the replacement property generally is the cost of such property to the taxpayer, reduced by the amount of gain which is not recognized under Section 1033. In other words, the cost basis of the new (i.e., the replacement) property is reduced by the amount of the gain that the taxpayer has elected to defer.

The applicable period for the taxpayer to replace the converted property begins with the date of disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain from a conversion is realized.

There are several special rules that extend the replacement period for certain types of business assets damaged by a Federally-declared disaster. For example, the replacement period for replacing converted property is extended from two years to five years in the case of property that is in the Hurricane Katrina disaster area and that is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina.

A special rule provides that any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to property that (1) was held for investment or for productive use in a business and (2) was involuntarily converted as a result of a Federally-declared disaster.

RECENT CLARIFICATION BY THE IRS

In TAM 201111004, the IRS examined this special rule in some detail and concluded that inventory that is involuntarily converted in a Presidentially-declared disaster is property held for productive use in a trade or business for purposes of Section 1033(h)(2).

In other words, the TAM holds that, if the fact pattern is right, a taxpayer is able to defer the recognition of income of the sale of inventories if the taxpayer qualifies under special, non-recognition of gain rules available to businesses affected by "Federally-declared disasters." This TAM is dated December 13, 2010 and released March 18, 2011.

Under Section 1033(h)(3), the term "Federally-declared disaster" refers any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the *Robert T. Stafford Disaster Relief and Emergency Assistance Act.* Prior to January 1, 2008, the term used in the application of Section 1033(h)(2) was "***Presidentially***-declared disasters" rather than "***Federally***-declared disasters."

THE FACTS IN THE TAM

This TAM involved (1) a group of affiliated corporations that filed consolidated Federal income tax returns and (2) an operating limited partnership which was wholly-owned by members of the group. The nature of the taxpayers' businesses is redacted from the TAM.

The operations of some of the taxpayer's business units were damaged by the 2006 Gulf Coast hurricanes, which were Presidentially (Federally) declared disasters. The taxpayer received insurance and salvage proceeds relating to property involuntarily converted as a result of the hurricanes, and more than half of the insurance and salvage proceeds related to the lost or damaged inventory. The tax-

see **DEALERSHIPS IN DISASTER AREAS...**, page 14

National Tax Office Analysis of Section 1033 & Applicable Regulations

Section 1033(a)(2) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money and if the taxpayer during the statutory replacement period, for the purpose of replacing the converted property, purchases other property similar or related in service or use to the converted property, then, at the election of the taxpayer, the gain must be recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property.

Under Section 1033(a)(2)(B), the replacement period generally ends two years from the close of the first taxable year in which any gain from a conversion is realized.

However, special legislation has extended the replacement period from two years to five years for property in the Hurricane Katrina disaster area that is compulsorily or involuntarily converted on or after August 25, 2005 by reason of Hurricane Katrina, but only if substantially all of the use of the replacement property is in such area.

[Note: Section 1033(h)(1)(B) extends the replacement period from two years to four years for principal residences converted in a Federally declared disaster. This four year replacement period does not apply to trade or business or investment property.]

Section 1033(h)(2) provides that if a taxpayer's property held for productive use in a trade or business or for investment is located in a disaster area and is compulsorily or involuntarily converted as a result of a Federally-declared disaster, then tangible property held for productive use in a trade or business ***is treated as property similar or related in service or use to the converted property.***

Wording of the statute. Section 1033(h)(2) does not contain any specific language relating to inventory, stock in trade or property held primarily for sale. The express language of Section 1033(h)(2) ... unlike Section 1031(a)(1)(A) and Section 1033(g) ... does not exclude conversions of inventory from its application.

Had Congress intended to exclude inventory from the language "held for productive use in a trade or business or for investment" in Section 1033(h)(2), it would have expressly done so just as it did in the wording of Sections 1033(g) and 1031(a)(2)(A). Obviously, Congress knows how to make clear distinctions between inventory and other forms of business and investment property. Nevertheless, Congress has made no such distinction in Section 1033(h)(2).

Although it is arguable that inventory is not property held for productive use in a trade or business or for investment because inventory does not "produce" property or services within the plain meaning of that term, the use of the term "productive" does not necessarily exclude inventory.

Consistency with Congressional intent. The position that Section 1033(h)(2) applies to conversions of inventory is also consistent with Congress's explanation of its purpose for enacting Section 1033(h)(2). The legislative history of Section 1033(h)(2) does not exclude inventory from the deferral treatment accorded a conversion of the property described in Section 1033(h)(2).

There is no indication of Congressional intent to deny inventory businesses the benefit of the special rule in Section 1033(h)(2).

Consistency with Notice 2003-18. The position that Section 1033(h)(2) applies to conversions of inventory is also consistent with Notice 2003-18 (2003-1 C.B. 699) which provides guidance on the treatment of certain types of World Trade Center grant payments to businesses to aid in the recovery from the Sept. 11, 2001, terrorist attacks.

Conclusion

Based on the foregoing, Section 1033(h)(2) applies to inventory that is involuntarily converted in a Presidentially-declared disaster. Accordingly, inventory held by the taxpayer that is involuntarily converted in a Presidentially-declared disaster is "property held for productive use in a trade or business" for purposes of Section 1033(h)(2).

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payer realized gain in excess of basis from these recoveries. (Note: the TAM does not state whether this taxpayer used the LIFO (Last-In, First-Out) method to value any of the inventories that were destroyed.)

The taxpayer reinvested most of the insurance and salvage proceeds in new store construction property (i.e., the proceeds were invested in assets that were depreciable Section 1245 and Section 1250 property). The taxpayer included statements in its tax returns that identified the replacement property. The taxpayer also reduced the basis of the new property by the amount of the deferred gain.

The TAM stated that the taxpayer expected to reinvest the remaining proceeds within the five-year replacement period for property damaged by Hurricane Katrina. Since the 2006 hurricanes, the taxpayer purchased and sold inventory, but did not designate any acquired inventory as replacement property for the inventory destroyed.

TAM HOLDINGS

The National Tax Office concluded that the inventory that was involuntarily converted was property held for productive use in a trade or business for purposes of Section 1033(h)(2).

The National Office's analysis of the applicable Code and Regulations is summarized on page 13.

BROADER APPLICATION OF THE TAM

Implications of the TAM ... Might there be a "silver lining" for some dealerships? For dealerships that suffer losses of property in Federally-declared disaster areas, this TAM serves as a reminder that there may be some tax strategies to at least minimize the adverse impact of the business disruption and reassembly of its operations. Dealerships should keep these provisions in mind when replacing assets that were destroyed in these casualties (Federally-declared disasters).

The legislative intent of Section 1033(h)(2) is to help businesses recover after disasters. The legislative history of Section 1033(h)(2), explains the reason for adding paragraph (h)(2), as follows:

> "The property damage in a Presidentially-declared disaster may be so great that businesses may be forced to suspend operations for a substantial time. During that hiatus, valuable markets and customers may be lost. If this suspension causes the businesses to fail, and the owners of the business wish to reinvest their capital in a new business venture, the involuntary conversion rules will force them to recognize gain when they buy replacement property that is needed for the new business but not similar to that used in the failed business.
>
> "This provision will offer relief to such businesses by allowing them to reinvest their funds in ***any*** tangible business property without being forced to recognized gain. No such deferral of gain is available now, if the taxpayer decides not to reinvest in tangible business property." (See S. Rep. 104-281, at 14.)

Claiming non-recognition of gain is elective. The deferred gain is calculated as the difference between (1) the salvage and/or insurance proceeds and (2) the adjusted tax basis of the property that was destroyed. This may be a small or a large amount.

Section 1033(h)(2) is an elective provision. A dealership may ***elect*** ... it is not required ... to reduce the basis of replacement property by the amount of any deferred gain. When a casualty occurs and property is converted into money by the receipt of insurance or salvage proceeds, the election can be made to have all or a part of the gain not be recognized (Reg. Sec. 1.1033(a)-2(c)). This is the first of several important considerations.

Also, the election may be made by the filing of an amended income tax return for the year after the casualty in incurred.

The income or loss for more than one year may be affected by the election. Also note that the replacement property may be acquired in a subsequent year. Accordingly, this calls for hindsight and looking at the potential benefits over a period of several years.

Net operating losses ... and carryback years ... may be affected. Furthermore, making or not making a deferral election could have an impact on increasing (or decreasing) net operating losses and their potential carryback against different years. There are also additional elections that may allow the dealership to carry back its net operating losses to a sequence of previous years that might result in a larger refund of previously paid income tax.

Selecting replacement assets whose basis will be reduced by non-recognized gain. It seems clear that any tangible property of a type "held for productive use in a trade or business" will be treated as property that is "similar or related in service or use" to business property that is located in a disaster area and is compulsorily or involuntarily converted as a result of a Federally-declared disaster.

It may be advantageous to make the deferral of gain election with respect to the longer-lived assets (i.e., buildings with longer depreciable lives - possibly a 39-year life), rather than to the shorter-lived assets →

(i.e., machinery and equipment with 5- or 7-year lives or eligibility for special or bonus depreciation benefits).

It may be advantageous to defer the year in which assets will be replaced. Dealerships in Federally-declared disaster areas may elect not to recognize gain with respect to involuntarily converted property/inventory if the tangible business or investment property is acquired within the appropriate replacement period ... which is usually two years. Although the "gain" is recognized in the year of the involuntary conversion, the impact of the adjustment on the basis of the replacement assets will occur in the year in which the assets are replaced.

Depending on the depreciation scenarios that might be involved, taxable income again may be significantly increased or decreased. Also, in some instances, the delay in replacing assets may be a relatively short period (i.e., replacement in November of 2011 versus replacement in January of 2012) so that, as a practical matter, only the difference in the taxable years will matter.

Manufacturer-induced image and/or facility upgrades. It is possible that a dealership experiencing a loss in a disaster area may be involved in a significant rebuilding process not necessarily related to the restoration of assets destroyed by the casualty. However, if the "timing" is right and the upgrades occur during the "replacement period" otherwise available for assets destroyed in the casualty, might the basis reductions arising out of gains on the involuntary conversion of some assets be applied against the new facility upgrades?

APPLICATION TO LIFO INVENTORY SITUATIONS

As noted previously, the TAM does not state whether this taxpayer used the LIFO (Last-In, First-Out) method to value any of the inventories that were destroyed.

Dealerships doing business in Federally-declared disaster areas might avail themselves of the deferral benefits available under Section 1033 with respect to major repayments of their LIFO reserves related to the destruction of their LIFO inventories by casualty ... if their inventory declines can be made to fit within the general fact pattern presented in the TAM.

The general fact pattern would have to involve (1) a major decrease in the inventory level at year-end attributable to a Federally-declared disaster and (2) the taxpayer's reinvestment of the sales and/or insurance proceeds within the applicable replacement period in property (inventory or other assets) held for productive use in the same trade or business.

LIFO inventories generally have an adjusted tax basis which is considerably lower than the current cost, not to mention selling price, of the inventory. Depending on how long the inventories have been valued under LIFO, the LIFO reserve (or built-in gain) on that inventory may be extremely large. In most circumstances, the sale or other depletion of LIFO inventory at year-end will result in the recapture of a significant portion - if not all - of the LIFO reserve.

Under these circumstances, should a taxpayer realistically expect to be able to rely on the rationale in this TAM to avoid immediate LIFO recapture resulting from a decline/loss of LIFO inventory?

Some would argue, "Why not?" ... because under the dollar-value method for valuing LIFO inventories, the entire dollar amount of investment in the inventory is considered to be a single asset, notwithstanding the individual inventory items and pools which are aggregated in the overall computations.

Furthermore, if the replacement property consists of other depreciable assets, such as equipment or buildings - instead of inventory - can the gain (which would otherwise be recognized as the LIFO reserve recapture) be deferred and offset against the cost basis of these tangible replacement assets?

APPLICABLE REGULATIONS

The rules for recognizing gain and/or permitting the deferral of gain in these situations are included in Reg. Sec. 1.1033(a)-2. This Regulation provides that "All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized."

Among other special conditions and rules, the Regulation further provides ...

> "If, after having made an election under Section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an 'amended return.' If a decision is made to make an election under Section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is real-

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FAA 20111101F

Worthlessness Deduction Prohibited for Goodwill Linked to Dealership's Franchise Intangibles

In a recent Field Attorney Advice (FAA 20111101F), the IRS held that a dealer was not permitted to deduct goodwill that was associated with two franchises that had been purchased as part of a larger acquisition involving several other franchises. The dealer unsuccessfully claimed that goodwill assigned to these franchises became worthless when the manufacturer notified the dealer that it was terminating his rights to sell vehicles under his franchise agreements. No merit or credence was given to the dealer's argument that there is no indication in the Code or in the legislative history that Congress intended to exempt automobile franchises from the application of Section 197(f)(1).

The holding in this FAA should come as no surprise to readers of the *Dealer Tax Watch.* Many articles in this publication have discussed Code Section ... Section 197(f)(1) ... which clearly calls for the conclusion reached by the IRS.

Issue ... "Deductibility of Purportedly Worthless Goodwill"

In this case, when a manufacturer terminated a dealer's franchise rights to sell W and Y2 automobiles, the dealer argued that the goodwill allocated to those franchises became worthless. The question or issue was whether the dealer was permitted to deduct ... as purportedly worthless ... the goodwill associated with those franchises.

Facts

The dealer sells and services Manufacturer's products pursuant to franchise agreements. The dealer previously purchased certain assets from another auto dealer, and this purchase included $39x which the dealer paid for goodwill related to franchise rights to sell (including parts) and service W, X, Y1, Y2, and Z automobiles.

Although the dealer claims that $4x of goodwill was allocated to the W franchise purchase, there is nothing in the contract that makes any such allocation. The information provided by the dealer is an unsigned, undated summary.

Subsequently, the dealer received notice that the manufacturer was terminating its franchise to sell W products.

After that, the dealer also received notice that that manufacturer was terminating the dealer's franchise to sell Y2 automobiles. In consideration for these franchise terminations and the dealer's covenants, releases, waivers, and transfer to the manufacturer of a non-exclusive right to use the dealer's customer lists and service records, the dealer received from the manufacturer payment of approximately 1.8% of $39x. (The tax treatment of the amounts the dealer received as consideration for the W and Y2 franchise terminations is not in dispute in this case.)

The dealer therefore claims that the goodwill associated with its terminated W and Y2 franchises became worthless on the dates the manufacturer sent notices to the dealer that the franchises were being terminated.

Law & Analysis

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. The amount of any such deduction is subject to any provision of the Code that prohibits it or limits the amount. (Reg. Sec. 1.165-1(a))

Section 197(a) allows a taxpayer to amortize an "amortizable Section 197 intangible" ratably over a 15-year period. If an asset is an "amortizable Section 197 intangible," it is amortizable over a 15-year period, even if the asset might have a different useful life. (See, e.g., *Frontier Chevrolet Co. v. Comm.* - noting that the enactment of Section 197 in 1993 to govern the amortization of intangibles superseded older rules about amortizing an intangible over its life).

An "amortizable Section 197 intangible" means any "Section 197 intangible" that is acquired by the taxpayer after August 11, 1993 and is held in connection with the conduct of a trade or business or an activity described in Section 212. (I.R.C. Section 197(c)(1))

Law & Analysis *(continued)*

A "Section 197 intangible" includes goodwill and any franchise, trademark, or trade name. For purposes of Section 197(d)(1)(F), the term "franchise" has the same meaning as in Section 1253(b)(1). Under Section 1253(b)(1), a franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Section 197(f)(1) states that, if there is a disposition of any amortizable Section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable Section 197 intangibles acquired in such transaction or series of related transactions are retained, then (i) no loss may be recognized, and (ii) appropriate basis adjustments must be made to the retained intangibles. See Reg. Sec. 1.197-2(g)(1). The abandonment of an amortizable Section 197 intangible, or any other event rendering an amortizable Section 197 intangible worthless, is treated as a disposition of the intangible for purposes of Section 197(f)(1).

The dealer's situation falls within Section 197(f)(1). The dealer acquired the franchises and goodwill after the enactment of Section 197, so the goodwill is an amortizable Section 197 intangible. (In a case where a dealer acquired the franchise after January 1, 1970 but before the effective date of Section 197, it appears that I.R.C. Section 1253 would govern the tax treatment of this type of situation. [Section 1253 was effective January 1, 1970.])

The dealer claims that the goodwill associated with the W and Y2 franchises became worthless. But, under Section 197(f)(1), the taxpayer cannot deduct any such loss. Instead, the dealer must make appropriate adjustments to the basis of the retained amortizable Section 197 intangibles.

The dealer makes two principal arguments in support of deducting the goodwill associated with the W and Y2 franchises. First, the dealer claims that the asset purchase agreement separately stated a goodwill value for the W franchise. The dealer reasons that the remainder of the goodwill was, therefore, allocable to the X, Y1, Y2, and Z franchises. We have reviewed the purchase agreement and find no such allocation. The allocation that the dealer provided for review was on a summary sheet that is undated and unsigned. There is no evidence that this summary was ever included in the original agreement.

However, even if the goodwill was separately stated for each franchise, Section 197(f)(1) would still apply, as all of the goodwill was acquired in a single transaction or series of related transactions. The dealer even admits that the manufacturer required alignment of certain franchises and considered multiple franchises as one "unit" for franchising purposes.

The dealer's second argument is that Section 197(f)(1) does not apply to its special situation and that the "spirit" of Section 197(f)(1)(A)(i) does not contemplate automobile franchises. We find no support for this argument.

Section 197 clearly defines the intangibles to which it applies and allows limited exceptions. The goodwill that the dealer wishes to deduct as worthless is included in the definition of "amortizable Section 197 intangible" and is not excluded by any exception. There is no indication in the Code or Section 197's legislative history that Congress intended to exempt automobile franchises from Section 197(f)(1).

Summary

The goodwill that the dealer wants to deduct as worthless is an amortizable Section 197 intangible; ***however,*** the dealer retains other Section 197 intangibles that were acquired in the same transaction or in a series of related transactions as the worthless goodwill. Section 197(f)(1) clearly prohibits any deduction for the worthlessness of goodwill in this case.

The amount of any alleged worthless amortizable Section 197 intangibles (i.e., the goodwill associated with the terminated franchise agreements) instead becomes an adjustment to the basis of its remaining goodwill ... It is included in the basis of any remaining amortizable Section 197 intangibles.

FILING FORMS 3115 FOR SEC. 263A SAFE HARBOR ELECTIONS FOR AUTO DEALERSHIPS

I have devoted a major portion of this Edition of the *DTW* to try bring my own kind of "closure" to this whole subject area of compliance with Section 263A and the proper Form 3115 filing mechanics. This article and the following materials are what I consider to be a summary of all the elements that will be useful on this subject for your reference purposes.

The technicalities and content ... as well as practical observations ... on how to cope with the lack of any guidance from the IRS in this area before the Service issued TAM 200736026, the so-called moratoriums, and Revenue Procedure 2010-44 have all been covered in prior articles. (See pages 44-45.) None of this is repeated here in this Edition.

BACKGROUND

In Revenue Procedure 2010-44, the IRS permitted motor vehicle dealerships to elect safe harbor methods that are related to the application of the Section 263A inventory cost capitalization rules to the dealerships' operations and activities. These safe harbors include (1) the "retail sales facility" safe harbor, (2) the "reseller without production activities" safe harbor and (3) the "simplified resale method" under Reg. Sec. 1.263A-3(d).

In the Year-End 2010 Edition of the *Dealer Tax Watch*, I analyzed the impact of Rev. Proc. 2010-44 on dealership inventory cost capitalization practices under Section 263A. I have also presented several 3-hour audio seminars on these developments. My article and other presentations emphasize the advisability/need for filing Forms 3115 to make appropriate elections so that dealerships protect themselves under the Section 263A safe harbor rules that the IRS now allows.

On page 21, you will find a *"25-Year UNICAP Timeline for Dealerships"* covering the years 1986 through 2010. This will give you a bird's-eye view or a sense of historical development of what we all have painfully endured.

The walk-through analysis ... *"Completing Form 3115 ... A Page-by-Page Overview"* ... reflects my thinking to date on filling out Form 3115 to make these changes.

Narrative statement. I've updated (slightly) some previous material, including the Form 3115 narrative proforma attachment. I've also incorporated into the *Overview* references to the issuance of Revenue Procedure 2011-14 which updated all of the IRS' procedures for automatic changes in accounting methods, including those affecting dealerships electing the Section 263A safe harbors. (For more on Revenue Procedure 2011-14, see the article - *"IRS Updates Procedures on Automatic Changes in Accounting Methods"* - on page 9.)

The sample Form 3115 narrative statement included in the Year-End 2010 Edition of the *Dealer Tax Watch* referred to changes "in the *Appendix* to Revenue Procedure 2008-52 (as clarified and modified by Rev. Proc. 2009-39)." Subsequently, when the IRS revised these procedures in Rev. Proc. 2011-14, the IRS said that Forms 3115 filed on or after January 10, 2011 (subject to certain, very limited, exceptions) were to be filed subject to these newer procedures.

A 2-page addendum to this revised narrative statement calls your attention to several other important issues and filing aspects.

Supplementary materials. Included in the supplementary materials are the full texts of the dealership CAMs involved in the current Section 263A filings. (These are from Section 11 of the *Appendix* to Revenue Procedure 2011-14.) Also, the IRS did have something further to say on the cost cap safe harbors ... The IRS *Automotive Alert* - issued in January 2011 - is on page 38.

Checklist for evaluating dealership compliance with Sec. 263A. Finally, in "one last effort" which attempts to summarize everything, I've developed a summary or *Checklist* for evaluating dealership compliance with Sec. 263A. This *Checklist* begins on page 41.

FORM 3115 FILING REQUIREMENTS

Notification procedures. One of the ramifications of making the changes to elect the safe harbor methods involves following the procedural rules and requirements (listed in Revenue Procedure 2011-14) for filing Form 3115 to notify the IRS that the changes are being made. These are also discussed in detail in the article on page 9.

Section 481(a) ... Transitional adjustments. Another ramification where voluntary changes in accounting method are being made involves calculating the adjustment under Section 481(a) ... these are also discussed in a general way in the R.P. 2011-14 article on page 9.

Unfortunately, the (automatic) changes in Section 263A methods of accounting to be made under Rev. Proc. 2010-44 require the taxpayer to compute

see **FILING FORMS 3115...** page 20

Forms 3115 to Elect Section 263A Safe Harbor Methods
Procedures, Practice Guides & Suggestions
(Walking Through the Completion of Form 3115)

- ***25-Year UNICAP Timeline for Dealerships ... 1986 - 2011*** 21
- ***Completing Form 3115 ... A Page-by-Page Overview*** 24
  - ***Sample Transmittal Letter to IRS National Tax Office in Washington, DC*** 28
- ***Template for Form 3115 Narrative Statement Attachment*** (3 pages) 29
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- ***Supplementary Information and Attachments***
  - Dealership-Related Automatic Changes in Method of Accounting under Section 263A
    - #22 ... Certain UNICAP Methods Used by ***Resellers*** & Reseller-Producers 34
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  - IRS *Automotive Alert* (January, 2011) ... *"Rev. Proc. 2010-44 Provides UNICAP Relief"* 38
- ***Checklist for Evaluating Dealership Compliance with the Section 263A Inventory Cost Capitalization Rules*** 41
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Executive Summary

- ***Changes to be made.*** In Revenue Procedure 2010-44, the IRS has provided two safe harbor methods that it will accept for a dealership's Section 263A calculations. It is hard to think of a situation where it would not be in a dealership's best interests to file Form 3115 to elect to protect itself by changing to these methods...
  - Change to treat certain sales facilities as retail sales facilities (i.e., the "retail sales facility" safe harbor method) ... Automatic change no. 150.
  - Change to be treated as a reseller without production activities (i.e., the "reseller without production activities" safe harbor method) ... Automatic change no. 151.
  - Change to use the "simplified resale method" under Reg. Sec. 1.263A-3(d) for all other inventories not subject to the safe harbor elections above ... Automatic change nos. 22/23.
- ***Dealerships electing to change to the safe harbor methods must compute a Section 481(a) adjustment.*** In many instances, this adjustment will be a negative amount, and dealerships will be able to reduce taxable income (or increase a net operating loss) by this amount for the year when they make the change.
- ***Certain purchasing costs must be capitalized.*** Notwithstanding the ability to avoid having to make Section 263A calculations because of the protection afforded by the safe harbors, all dealerships are still responsible for determining whether they are required to capitalize purchasing costs. In this regard, the 1/3-2/3 rule may eliminate or significantly reduce the amount to be capitalized. However, if a dealership is required to capitalize any purchasing costs, it must also capitalize an allocable portion of mixed service costs ... and this may be a complicated computation resulting in only a few additional dollars of difference.
- ***"Get out of jail free."*** For many dealerships, all of their operations and activities will be covered and protected by the safe harbors. For these dealerships, Rev. Proc. 2010-44 is their "get out of jail free" card and Form 3115 is their insurance policy against future hassles with the IRS over cost cap.
- ***Activities outside the safe harbors.*** For dealerships which still have a portion of their operations and activities that remain outside the safe harbors, careful consideration must be given to how they will make their calculations under Section 263A of the storage, handling and mixed service costs related to these operations.
  - In these situations, one should expect an IRS agent to compare a dealership's methods and computations with the guidance that the IRS provided in (1) TAM 200736026 and (2) the "Tool Kit" 12-Step Audit Program which was included as part of its first moratorium announcement in September 2009.
  - Several IRS interpretations in TAM 200736026 produce very unfavorable results for dealerships. If a dealership is not going to reflect these interpretations in determining on-site or off-site sales, consideration should be given to what disclosures, if any, should be made in this regard in tax returns filed.

(Continued from page 18)

a Section 481(a) adjustment. Therefore, dealerships filing Form 3115 to elect the Section 263A safe harbor methods must consider how they have previously applied the Section 263A rules to their inventories and how that treatment affects their computation of a Section 481(a) adjustment for the year of change.

Section 263A did not come into the law until 1986. However, when it was enacted, most dealerships immediately became subject to its provisions. Over the years, many dealerships followed the practice of taking the Section 263A amounts into income as net adjustments each year in order to reconcile their off-the-books Sec. 263A calculations (i.e., their calculations on spreadsheets) with adjustments to taxable income on Schedule M-1 or M-3 of their income tax returns.

For these dealerships, it would appear that their Section 481(a) adjustment (required at this time in electing the Section 263A safe harbors) would simply involve the reversal of the net amounts previously capitalized through their Schedule M-1 or M-3 adjustments. It would appear that they would not have to deal with the revaluation provisions in Reg. Sec. 1.263A-7. However, the IRS has not provided any specific guidance as to whether this approach would be acceptable.

SECTION 263A ... CLOSURE AT LAST FOR MOST DEALERSHIPS

For many dealerships, all of their operations and activities will be covered and protected by the safe harbors. If they are fortunate enough not to have to capitalize any "purchasing costs," they are free and clear of Section 263A and all its potential entanglements.

Rev. Proc. 2010-44 is their "get out of jail free" card ... Filing Form 3115 now can be their insurance policy against further controversies.

BUT, FOR SOME DEALERSHIPS ... PROBLEMS STILL REMAIN

However, some dealerships still have a portion of their operations and activities that remain outside the safe harbors. They may have off-site storage and/or dual-function storage facilities. If they do, careful consideration must be given to how the dealership will make its calculations for these operations under Section 263A. These dealerships will have to "do the computations or calculations" and decide whether and/or how to 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 certain wholesale sales, dealer trades, lease sales and sales made over the Internet).

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.

Therefore, it appears that with respect to these facilities and the determination of Section 263A capitalizable storage and handling costs, these dealerships are still as much in the dark and as vulnerable to the IRS insisting on its interpretations in the TAM as they were before the TAM was issued ... because the IRS has not commented any further on what is to be done - or what it will do - with respect to these interpretations.

Dealerships using LIFO. Some dealerships are using the LIFO (Last-In, First-Out) method to value their vehicle inventories. Some of these dealerships have embedded the results of their Section 263A computations into their annual LIFO layers. Other dealerships might not have embedded those costs into their LIFO layers. Computational issues related to the Section 481(a) adjustment for dealerships using LIFO are discussed in the Mid-Year 2011 Edition of the *LIFO Lookout* in the article, *"Section 263A CAMs & Section 481(a) Adjustments for LIFO Inventory Restatements."*

LOOKING FORWARD

Hopefully, for most dealerships, after they have filed Form 3115, they can basically anticipate that the IRS will not bother them any further on Section 263A matters. They have audit protection via the Form 3115 "insurance policy" they have filed. Therefore, unless a dealership's operations expand in the future to include off-site storage and/or dual-function storage facilities, few further problems should be anticipated.

If a dealership is required to capitalize costs for activities not covered by the safe harbors, it seems reasonable to expect - based on the guidance so far - that the IRS will look to (1) the Section 263A audit program which was part of the "tool kit" and (2) its interpretations of TAM 200736026 as the factors against which a dealership's Section 263A calculations will be tested.

Sec. 263A Timeline	***UNICAP TIMELINE FOR DEALERSHIPS ... 1986 TO DATE***
1986	• The new cost capitalization rules apply to inventories for the first taxable year ***beginning after December 31, 1986***. These rules are provided for in Code Section 263A enacted by the Tax Reform Act of 1986. ◆ The new inventory cost capitalization rules apply to all taxpayers except resellers (retailers, wholesalers and distributors) of personal property with average annual gross receipts for the last three years of under $10 million. ◆ All ***opening inventories*** for the first cost capitalization year have to be adjusted (stepped up or increased) by an amount equal to the additional costs which would have been capitalized if the new rules had been applicable in all prior years. This results in an adjustment under Section 481(a). ◆ For taxpayers using the ***dollar value LIFO method*** to value inventories, this revaluation/restatement of the opening inventory must be done either by (1) an actual "facts and circumstances" recomputation applying the new, more detailed and specific Sec. 263A rules to all years, or (2) estimating restatement amounts under a ***3-year average method***. • Retailers who do not meet the $10 million gross receipts exception are required to capitalize off-site storage, purchasing, handling and processing costs, as well as allocable general and administrative expenses. This represents a major departure from prior generally accepted accounting principles and practices under which all such costs were directly expensed as incurred. • Simplified alternative procedures, in some cases, may be elected instead of going through much burdensome detail work. However, in many instances, the result or trade-off from using these simplified methods is likely to be that the taxpayer will end up capitalizing more costs than would be capitalized if a more detailed analysis of all of the underlying records had been made.
1987	• Proposed Regulations under Section 263A were issued in March, 1987. • These proposed Regulations were clarified in August, 1987.
1988	• IRS Notice 88-86 authorizes the use of an *Alternative Simplified Resale Method.* • A second alternative simplified resale method, referred to as the *Modified Resale Method*, is authorized under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). ◆ These two alternative methods, plus the original simplified resale method included under the proposed Sec. 263A Regulations, result in three different potential "***simplified resale methods.***" • IRS Notice 88-92 Provides Section 263A Checklist for attachment to Forms 3115 filed by taxpayers with the IRS to make changes in accounting method in order to comply with Section 263A inventory cost capitalization rules.
1994	• Final Regulations under Section 263A are issued. ◆ The previous *Modified Resale Method* (permitted under TAMRA) becomes the "new" ***Simplified Resale Method*** ... as set forth in Reg. Sec. 1.263A-3(d)(3). ◆ Because of considerable complaints about the costly and time-consuming computations that had to be made every year, the final Regulations permitted taxpayers to make an election to use a "*historic absorption ratio election*" in connection with the simplified resale method. This method is described as the "*Simplified Resale Method **With** Historic Absorption Ration Election*" (sometimes referred to as *HAR*) at Reg. Sec. 1.263A-3(d)(4). ◆ The *HAR* method allows taxpayers to carry over a historical capitalization percentage for several years without having to recompute UNICAP every year. ◆ In general, there is a "3-year test period" which results in a capitalization ratio that may be used for the next five years ... but there are several troublesome details connected with the use of this short-cup method. • The final Regulations provide that "for taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their Federal income tax returns when applying Section 263A. ...A reasonable position is a position consistent with the temporary Regulations, Revenue Rulings, Revenue Procedures, Notices and Announcements concerning Section 263A applicable in taxable years beginning before January 1, 1994." Reg. Sec. 1.263A-1(2)(ii) • IRS issues Revenue Procedure 94-49 (June 28, 1994) to offer taxpayers last-chance relief to make necessary adjustments and corrections to certain Section 263A methods.
2004 - 2007	• Repeated comments by IRS representatives emphasize that the IRS has determined that automobile dealerships (on an industry-wide basis) are non-compliant with the rules of Section 263A requiring additional costs to be capitalized to their year-end inventories.

2007	• ***September 7, 2007 ... TAM 200736026*** became available to the public after it 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, the TAM 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 might be certain deficiencies or shortcomings 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, this disclaimer seems to have made no difference because the IRS' holdings and reasoning in the TAM have quickly become the template for all further discussion and the calcification of IRS audit positions with respect to Section 263A for dealerships. • ***October, 2007 ...*** At the AICPA National Auto Dealership Conference, the IRS Motor Vehicle Technical Advisor stated that if dealerships are treated as producers or, through other interpretations, are required to use the Simplified Production Method, there will be huge potential adjustments made on what IRS examining agents have been reporting from the field.
2008	• ***January, 2008 ... IRS Automotive Alert*** issued by Motor Vehicle Technical Advisor discusses dealership UNICAP issues and conclusions in TAM 200736026. ◆ Under discussion of "What Does This Mean for Dealerships?", the *Alert* states that "the Department of the Treasury and IRS Chief Counsel included auto dealership UNICAP issue in the 2007-2008 Priority Guidance Plan. Thus, precedential guidance on these two general issues (i.e., [1] "Production" issues and [2] "Storage and Handling Costs" issues) will be forthcoming." • ***March 26, 2008 ... National Automobile Dealers Association (NADA)*** submits letter to IRS requesting Industry Issue Resolution (IIR) consideration with respect to the "producer issues" raised by the IRS in TAM 200736026.
2009	• ***September 15, 2009 ... IRS declares first moratorium on raising Section 263A issues in dealership audits.*** ◆ In a Directive from the Industry Director (Heavy Manufacturer and Transportation), the IRS announced that it will suspend examination of auto dealership Section 263A issues effective September 15, 2009 and continuing through December 31, 2010. ◆ This Industry Director Directive states that the IRS is declaring this moratorium "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." ◆ During this moratorium period, examiners are instructed not to raise Sec. 263A issues. ◆ Directive includes an *Audit Tool Kit* for examiners to use when moratorium ends on Jan. 1, 2011. This *Audit Tool Kit* consists of (1) Information Document Requests, (2) a 12-Step Audit Plan, (3) multiple Key Terms and Definitions documents keyed to the audit plan steps, and (4) a computational spreadsheet. • ***Revenue Procedure 2009-39*** updates the IRS official list of automatic accounting method changes to include a few Section 263A definition clarifications. • ***December 1, 2009 ...*** NADA submits letter to IRS requesting relief from IRS "four year process [of addressing dealership Section 263A issues] that remain fragmented and unsettled for Revenue Agents and dealers alike."

2010	• ***May, 2010 ... Form 3115 and Instructions for Form 3115 are revised.*** (Announcement 2010-32) ◆ The new revision date for both Form 3115 and Form 3115 Instructions is December 2009. • ***August 9, 2010 ... IRS further extends 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." • ***November 9, 2010 ... Revenue Procedure 2010-44*** offers dealerships the opportunity to elect Sec. 263A safe harbor cost capitalization methods. ◆ 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. ◆ Other Section 263A changes in accounting method to be considered with respect to Form 3115 filing... ▪ 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. ▪ Inclusion (or exclusion) of labor costs and internal profit capitalized in previous years with respect to Section 263A in the computation of the Section 481(a) adjustment. ▪ Clarification that in determining storage, handling and purchasing costs to be capitalized after making these changes, the "1/3 - 2/3 rule for allocating labor costs" and other 90%-10% *de minimis* rules will be used. ◆ 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. ▪ The changes to the safe harbor cost capitalization methods allowed by Revenue Procedure 2010-44 are 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 Sec. 11.02 of the *Appendix* to Rev. Proc. 2008-52 (as clarified and modified by Rev. Proc. 2009-39). ◆ A dealership may make these changes (assuming dealership qualifies for automatic change provisions) for calendar year 2010 ... but a dealership may want to make changes effective for calendar year 2011 instead.
2011	• ***January 10, 2011 ... Revenue Procedure 2011-14*** revises and updates the procedures for taxpayers to secure designated automatic changes in accounting methods. ◆ This Revenue Procedure includes safe harbor elections under Section 263A for motor vehicle dealerships as automatic changes #150 and #151 ◆ This Revenue Procedure supersedes Rev. Proc. 2008-52 • ***January, 2011 ...*** IRS Motor Vehicle Technical Advisor publishes an *Automotive Alert ... "Rev. Proc. 2010-44 Provides UNICAP Relief for Motor Vehicle Dealerships."*

Dealership electing to come under the protection of the safe harbor methods and provisions which the IRS offers in Revenue Procedure 2010-44 are technically changing their methods of accounting for costs required to be capitalized in connection with their inventories under Section 263A of the Code.

These changes in methods are automatic changes that may be made concurrently in the same Form 3115 simply by following all of the procedures set forth by the IRS. These new methods were initially stated in Revenue Procedure 2010-44 (November 2010), and they were restated, without change, in Section 11.07 of the Appendix to Revenue Procedure 2011-14 (January 2011).

This discussion summarizes many conversations and Form 3115 reviews, and it includes some observations, comments and cautions for consideration in completing Forms 3115 in electing the safe harbor methods.

Dealership-Related Automatic CAMs Involving Section 263A Cost Cap

Where a dealership's changes in methods of accounting (CAMs) under Section 263A are made in order to avoid the potential onerous application of the IRS' holdings in TAM 200736026, there are four potential automatic CAMs to be considered.

The first two CAMs (i.e., No. 150 and No. 151) are fairly obvious and they are the subject of Revenue Procedure 2010-44. However, there are two other potential CAMs to be considered (i.e., No. 22 and No. 23). All of these are included in Section 11 of the *Appendix* to Revenue Procedure 2011-14. A more complete description of each of these CAMs is included as supplementary material.

- No. 150 ... Change to Treat Certain Sales Facilities as Retail Sales Facilities (as described in Section 5.01 of Rev. Proc. 2010-44 and Section 11.07 of the *Appendix* to Rev. Proc. 2011-14)
- No. 151 ... Change to Be Treated as Reseller Without Production Activities (as described in Section 5.02 of Rev. Proc. 2010-44 and Section 11.07 of the *Appendix* to Rev. Proc. 2011-14)
- No. 22 ...Certain UNICAP Methods Used by ***Resellers*** & Reseller-Producers (as described in Section 11.01 of the *Appendix* to Rev. Proc. 2011-14)
- No. 23 ...Certain UNICAP Methods Used by ***Producers*** & Reseller-Producers (as described in Section 11.02 of the *Appendix* to Rev. Proc. 2011-14)

Changes No. 22 and 23 are suggested to be made (concurrently and as part of the filing of Form 3115 to make changes No. 150 and 151) in order to correct any flaws, errors and/or inappropriate short-cuts that may have been previously reflected in the dealership's efforts to use the Simplified Resale Method under Reg. Sec. 1.263A-3(d). In other words, these changes No. 22 and 23 apply to all other inventories related to the operations and activities of the dealership that may not be subject to the safe harbor elections above.

Although some dealerships may have no costs that are required to be capitalized under Section 263A, other dealerships may (1) be capitalizing purchasing costs or (2) have off-site or dual-function storage facilities, for which costs must be capitalized. Because of the complexity and potential adverse interpretations that might be made (as suggested by previous positions of the IRS in TAM 200736026 and elsewhere), it is recommended that both automatic changes No. 22 and No. 23 also be designated as concurrent changes, because of their potential overlap with the uncertain interpretations suggested by the TAM.

Complete descriptions of these four dealership-related automatic CAMs involving the capitalization of inventory costs under Section 263A are on pages 34-37.

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 & 22/23*** (if applicable). • Do not check the "Other" box or provide any further description of these changes on Page 1. • No user fee is required ... Rev. Proc. 2011-14, et al.	• 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 & Section 11.07 of the Appendix to Rev. Proc. 2011-14."*** • Do not complete Part I, Lines 1(a) or (b) for these changes if advance consent from the IRS is required. • User fee must be paid ... Rev. Proc. 97-27, et al.

Page 1, Part I, Line 1(a) ... Reflecting Multiple Automatic CAMs

Certain problems are presented if the Form 3115 is prepared using software and/or the dealership's income tax return is to be filed electronically with the IRS.

Some software will allow one or two, but not more than two, automatic change numbers to be entered on Part I, Item 1(a). If using the .pdf Form 3115 available from www.irs.gov, no more than 3 elections (with dashes or commas separating them) can be entered in the field provided.

Furthermore, if e-filing the tax return, often more than one automatic change on the line for Item 1(a) will be not accepted or allowed, and it will frustrate the e-filing.

First, do not make any entries on Form 3115 either on Line 1(b), for "Other." Second, do not make any entries in the right-hand half of the boxes above Part I for "Other (specify)." The Instructions and the Form itself are quite clear that the only place on which the automatic change numbers should be entered are on Line 1(a) if the IRS has assigned an automatic change number to the change(s) in method being made.

Suggestion: On the copy being filed, enter "150" followed by an asterisk [*]. Then, at the bottom of the page, handwrite in wording to the following effect ... "See statement attached for other permitted concurrent changes that are being made." The reason for this approach is that the copy of the income tax return that the dealership will keep as part of its permanent tax records (and the copy of that tax return that you will retain as preparer) will indicate that more than one ***concurrent*** change is being made at this time.

If you are not electronically filing the copy of the Form 3115 with the National Office of the IRS, then you can simply handwrite in all 4 automatic change numbers on Line 1(a).

Page 1, Part II, Item 9a ... If Forms 3115 Were Filed in Previous Years

This question asks the applicant to identify any changes in accounting method (either automatic or through a procedure requiring advance consent ***and/or made by a predecessor or a related party***).

Note that the timeframe that the IRS is looking at here is "within the past 5 years (including the year of the requested change)." The information required to be submitted is (1) identification of the (requested) change in method of accounting, (2) the tax year for which the change was effective and (3) whether the applicant received consent. (If the change made was under an automatic consent procedure, the response for this will be obvious.)

Page 1, Part II, Item 9a ... If Forms 3115 Were Filed in Previous Years *(continued)*

Note that Item 9(c) states, "If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation."

Off-hand, usually the first or most logical previous change within this period that might come to mind would be the change made by a dealership using the LIFO method to combine its two new vehicle LIFO pools under the New Vehicle Alternative LIFO Method (Rev. Proc. 97-36) into a single, combined pool for all new vehicles (i.e., the Vehicle-Pool Method under Rev. Proc. 2008-23). It is quite possible that other changes have been made within this 5-year window. See *"Automatic Changes in Accounting Methods Frequently Encountered in Motor Vehicle Dealerships"* on page 11.

The revised narrative statement proforma includes a reminder to provide this information.

Note: The Instructions do not require a copy of that Form 3115 that was previously filed to be attached.

Page 3, Part IV ... Section 481(a) Adjustment ... In General

Section 481(a) adjustment ... be careful with this. Don't get confused and report the net amount of increase or decrease in taxable income for the current-year tax return as a result of filing Form 3115.

Section 481(a) adjustments. 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.

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. Note that where the valuation of inventories involves the use of the LIFO method, technically, the LIFO layers for the base year and all of the intervening years are subject to potential adjustment ... unless a short-cut approach is permitted to be applied.

In the situations that are currently under discussion here (i.e., where a dealership's changes in methods of accounting under Section 263A are being made to make the safe harbor elections), Section 481(a) requires that the taxable income for the year preceding the year of change [that would be the taxable income for the year 2009, if the change(s) is(are) effective for calendar year 2010] must be determined under the method of accounting that was then used, and income for the year of change [that would be calendar year 2010] and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

In order for the taxable income for the year of change (i.e., 2010) to be determined under the new method, the beginning inventory for the year (i.e., January 1, 2010 / December 31, 2009) must be recomputed.

Note the reference is only to the beginning of the year of change.

Example. Assume the following:

- 2010 is the year of change, and at the beginning of the year, the dealership had capitalized costs in the amount of $15,000.
- The amount of Sec. 263A capitalized cost in the beginning inventory for 2010 as a result of making the change to the safe harbors, etc., is only $2,000.
- As a result of the change in method, the amount of the Section 263A costs to be capitalized at the end of 2010 (i.e., the end of the year of change) is $6,000.

Page 3, Part IV ... Section 481(a) Adjustment ... In General *(continued)*

Given these assumptions, the Section 481(a) adjustment is a negative $13,000 (i.e., the difference between $15,000 and $2,000). This is the effect on the inventory at the beginning of the year (Dec. 31, 2009/Jan. 1, 2010).

The net increase in Section 263A costs for the year of change is $4,000 (i.e., $6,000 - $2,000).

For 2010, the year of change, the net decrease in income (via the deduction for the cost of goods sold) in the income tax return is $9,000. This is the $13,000 negative adjustment to correct the beginning-of-the-year capitalized cost, which is offset by the $4,000 adjustment to increase capitalized Section 263A costs to the correct amount at the end of the year.

Page 3, Part IV ... Section 481(a) Adjustment ... Spread Periods

Note the carryover to Page 4 of Form 3115 of questions relating to the Section 481(a) adjustment. Generally...

- For a net positive Sec. 481(a) adjustment, the spread period is 4 years.
- For a net negative Sec. 481(a) adjustment, the spread period is 1 year (i.e., if the Section 481(a) adjustment is a negative amount, the entire amount must be deducted in the year of change).
- ***De minimis rule.*** If the net positive Sec. 481(a) adjustment for the change in method is less than $25,000, a taxpayer may elect to use a one-year Sec. 481(a) adjustment period, in lieu of the 4-year spread period. In other words, if the 481(a) adjustment is an increase in income of less than $25,000, the dealership may elect to take the entire amount of the adjustment into account in the year of change (by checking the "Yes" box).
- ***Short period as a separate taxable year.*** If the year of change or any other taxable year during the Sec. 481(a) adjustment period is a short taxable year, the Sec. 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year.

Form 3115, Page 3, Part II, Question 14

The question reads: "Will the proposed method of accounting be used for the applicant's books and records and financial statements? If 'No,' attach explanation."

The answer to this question will depend on whether the Section 263A adjustments for capitalized costs are reflected in the dealership's tax returns as adjustments on Schedule M-1 or M-3. Alternatively, in some cases, although infrequently for dealerships, the Section 263A costs are actually recorded in the books and records and on the dealership's (year-end) financial statements.

If there are costs to be capitalized and these are run through Schedule M-1 or M-3, the response can simply be... "Adjustments are recorded through Schedule M-1 or M-3."

You may want to incorporate your response to Question 14 on Page 3 into your narrative statement.

Form 3115, Pages 6, 7 & 8 ... Schedule D

Instead of attempting to respond to all of the interrogatories in Part II and Part III on pages 6, 7 and 8, many practitioners have made no entries in any of these Sections.

At the bottom of each of the 3 pages, they have inserted the following statement ... ***"See statement attached. All changes are pursuant to Rev. Proc. 2010-44 and Section 11 of the Appendix to Rev. Proc. 2011-14."***

If applicable, the following sentence may be added ... "The dealership has no costs to be capitalized pursuant to Section 263A."

Narrative Statement Attachment (Revised) & Addendum

The Form 3115 narrative proforma statement incorporates much of the information required to be submitted in response to various questions on Form 3115. The Year-End 2010 Edition of the *DTW* included a previous version of this proforma on pages 40-41. This narrative proforma has been expanded from 2 to 3 pages to incorporate more potential responses or for clarification purposes.

Addendum. This revision also includes a 2-page addendum of additional disclosures to be considered when the dealership's history or operations indicate the potential for additional technical problems.

Note: If the dealership is not eliminating trade discounts (floorplan assistance payments) from the determination of the actual cost of its vehicles, you may wish to delete that sentence (and the following sentence pertaining to advertising fees and expenses, as well).

Letter of Transmittal for Form 3115 to Be Prepared on Dealership Letterhead & Mailed (Immediately) to the IRS National Office in Washington, D.C.

Internal Revenue Service
Attn: CC:ITA - Automatic Rulings Branch
P. O. Box 7604
Benjamin Franklin Station
Washington, DC 20044

Date _____

Re: *Name* _____

EI No. _____

Form 3115: ***Changes in Section 263A Inventory Cost Capitalization Accounting Methods under the Automatic Change Procedures in Rev. Proc. 2011-14 For the [Calendar][Fiscal] Year Ending*** _____

Dear Sir or Madam:

Enclosed is a copy of Form 3115 for the dealership identified above reflecting its request for permission to change its Section 263A inventory cost capitalization accounting methods in connection with its election/adoption of the safe harbor methods for motor vehicle dealerships provided in Revenue Procedure 2010-44 and other related changes in its methods and procedures for inventories under the Section 263A Regulations.

This change is to be effective for the ***[calendar][fiscal]*** year ending _____.

The original of this Form 3115 ***[is][will be]*** attached to Taxpayer's timely filed (including extensions) original Federal income tax return for the year of change. This copy of Form 3115 is being filed at this time with the IRS National Office in Washington, D.C.

As of the date of filing this copy of Form 3115 with the National Office, Taxpayer is ***not*** under audit examination, and Taxpayer does not have any Federal income tax return(s) under consideration by any IRS Appeals Officer or by any Federal Court.

No user fee is required in connection with this Form 3115 filing since it is being filed under the published automatic change procedures described in Revenue Procedure 2011-14.

Respectfully submitted,

Taxpayer Name

(Authorized Officer), President

First Year Tax Returns ... Prepare Your Own Statement of Election ... Form 3115 Is Not Required

Initial tax returns. Form 3115 is not required to be part of the initial tax return filed by a dealership because there is no prior method of accounting that can be changed if the dealership was not in existence in the previous year. There is no official IRS form to be used for making elections in initial returns relating to the computation of Section 263A costs. Therefore, it would be a good idea to modify the information included in the narrative statement, and include it as an attachment describing the various elections being made for the dealership's computation of Section 263A costs.

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. 22/23 ...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 2011-14 (previously Rev. Proc. 2008-52, as modified by Section 7 of Revenue Procedure 2010-44).

The change(s) 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 (are) described in Section 11.01 (Resellers and Reseller-producers) and Section 11.02 (Producers and Reseller-producers) of the *Appendix* to Revenue Procedure 2011-14 (previously Rev. Proc. 2008-52, as clarified and modified by Rev. Proc. 2009-39).

In connection with determining storage, handling, and/or purchasing costs to be capitalized after making these changes, Taxpayer ***[elects to][will]*** use the ***special reseller cost allocation rules*** which include ...

- The **90%-10%** ***de minimis*** **rule to allocate a mixed service department's costs to property acquired for resale** (Reg. Sec. 1.263A-1(g)(4)(ii),
- The **1/3 - 2/3 rule to allocate labor costs of personnel to purchasing activities** (Reg. Sec. 1.263A-3(c)(3)(ii)(A), and
- The **90%-10%** ***de minimis*** **rule to allocate a dual-function storage facility's costs to property acquired for resale** (Reg. Sec. 1.263A-3(c)(5)(iii)(C).

Also, Taxpayer has not included in the computation of its Section 481(a) adjustment, any adjustment with respect to (1) internal labor costs that were previously capitalized in connection with capitalizing the cost of parts added to vehicles and (2) internal profit that was or may have been capitalized in previous years with respect to Section 263A. These possible components of Taxpayer's Section 481(a) adjustment, if any, would simply increase the amount of the negative Section 481(a) adjustment, providing Taxpayer with a larger deduction in the year of change. Taxpayer will make no adjustments for these items in the computation of costs to be capitalized under Section 263A in future years because of the impracticality and additional effort required to determine and quantify these computations. Taxpayer waives any benefit that might accrue to it as a result of not making these adjustments.

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.***

Page 2, Part II, Question 9 ... Forms 3115 Filed Within the Past 5 Years

- For New Vehicle inventories on LIFO, change (automatic #112) to the Vehicle-Pool Method per R.P. 2008-23 was made effective for the taxable year beginning ***[Insert dates or calendar year]***.
- Other _____

Page 6, Schedule D, Part II ... Present Method for Valuing Inventories ... No Changes Are Being Made

New Vehicles. Invoices for new vehicles are received from the manufacturer(s) or from other dealers in dealer trades. Each vehicle invoice consists of the aggregate of differing combinations of capitalizable costs including the vehicle base price which is the principal component, and other lesser sub-components such as destination charges, factory-installed options (both individual as well as in package combinations), options and accessories installed by the dealer, and other capitalizable charges.

Cost reduction for trade discounts. For the purpose of determining the amount of new vehicles at actual cost, cost ***[has][has not]*** been reduced by trade discounts (floorplan assistance payments) in accordance with Reg. Sec. 1.471-3(b) and Revenue Ruling 84-41.

Cost reduction for advertising fees & expenses. Also, for the purpose of determining the amount of new vehicles at actual cost, cost ***[has][has not]*** been reduced by advertising fees and expenses.

New vehicle inventories are identified by using actual cost (as determined above) based on specific identification by invoice. The LIFO (Last-In, First-Out) inventory method ***[is][is not]*** used for valuing new vehicle inventories.

Used Vehicles. The dealership acquires used vehicles either (1) by trade-in from retail customers in connection with their purchase of a new (or used) vehicle from the dealership or (2) by purchase at auctions, from other dealers, or from other individuals. Used vehicle inventories are identified by using actual cost based on specific identification by invoice.

Used vehicles are valued at the lower of cost or market, with market considered to be the lower of wholesale, "as is" value, less estimated reconditioning cost, or estimated current wholesale market value ... ***or ... [_____]***.

[Or, if on LIFO ...] The LIFO (Last-In, First-Out) inventory method is used for valuing used vehicle inventories.

Parts & Accessories. Pursuant to accepted industry-wide practice, cost of parts and accessories inventories is determined at year-end by reference to manufacturer current price lists in effect at year-end. As a result, the ending parts and accessories inventory is valued at higher replacement costs instead of at actual cost. This practice results in an overall valuation for parts and accessories inventories that closely approximates, but usually is slightly in excess of, cost.

This method for valuing parts inventories is permitted by Revenue Procedure 2002-17 which allows automobile dealers to approximate the actual cost of parts and accessories inventory items by reference to end-of-the-year prices taken from manufacturers' price lists.

Miscellaneous Other Inventories. Gas, oil, grease, work in process, body shop supplies, sublet and other inventories are valued at cost. In some instances, the cost of labor and/or parts charged to work-in-process exceeds actual cost to the dealership.

Pages 7-8, Schedule D, Part III ... 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 zero ($0)] ... [is estimated to be not more than $_____] ... [is $_____ . (See below)]***

COMPUTATION OF SECTION 481(a) ADJUSTMENT

	Change No. 150	Change No. 151	Change(s) No. 22 & 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

Clarification of Simplified Resale Method to Which Dealership Is Changing

1. Statement to confirm that the Simplified Resale Method being elected is not using one of the permissible variations of the SRM referenced in the Regulations at Reg. Sec. 1.263A-3(d)(3).

2. Statement whether in the computation of the Simplified Resale Method under Reg. Sec. 1.263A-3(d)(3), the determination of the amount of purchases in the ending inventory includes either (1) ***only*** the amount of the LIFO increment as computed for the year or (2) the ***total*** amount of the LIFO inventory at its LIFO valuation.

   If only the amount of the LIFO increment has been included in determining the Section 471 inventory costs, that would significantly reduce the amount of Sec. 263A costs required to be capitalized.

3. In other words, the examples in the Regulations at Reg. Sec. 1.263A-3(d)(3)(iv) do not address the factual situation where ***some*** of a taxpayer's inventories are valued using LIFO and ***some*** of that taxpayer's inventories are valued using a method other than LIFO, in computing the amount of the *"Section 471 costs remaining on hand at year-end"* (by which the amount of the combined absorption ratio is to be multiplied), the taxpayer has ...
   - multiplied the combined absorption ratio by the total valuation of all inventories (i.e., as shown in Schedule L), or
   - multiplied the ratio by the sum of the valuation of all inventories not on LIFO ***plus*** only the amount of current-year increment computed as part of the current-year LIFO calculations

Dollar-Value LIFO Beginning Inventories ... Section 481(a) Adjustment ... Revaluation Matters

4. If the LIFO method has been used to value any of the dealership's inventories, state whether or not the inventories have been revalued under Reg. Sec. 1.263A-7. This will depend on which Simplified Resale Method has been previously been used.

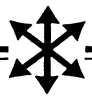
   Note that Reg. Sec. 1.263A-7(a)(5) provides that ***A change from the Modified Resale Method*** set forth in Notice 89-67 (1989-1 C.B. 723) ... to the Simplified Resale Method set forth in Reg. Sec. 1.263A-3(d) ***is not a change*** in method of accounting within the meaning of Reg. Sec. 1.446-1(e)(2)(ii). Therefore, ***this change is <u>not</u> subject to the provisions (i.e., the revaluation requirements) of this Section.***

   However, this Regulation provides that ***a change from the Simplified Resale Method*** set forth in former Reg. Sec. 1.263A-1T(d)(4) to the Simplified Resale Method set forth in Reg. Sec. 1.263A-3(d) ***is a change*** in method of accounting within the meaning of Reg. Sec. 1.446-1(e)(2)(ii).

5. If the dealership has used LIFO and simply reflected Section 263A costs as Schedule M-1 adjustments, should it be disclosed that the additional Section 263A costs were not embedded in the layer valuations in the appropriate years?

Trade or Business Aspects

6. Whether the Regulations have been applied to the dealership's departments as separate trades or businesses (under Section 446) or whether - for purposes of Section 263A - all of the dealership's operations and activities have been treated as a single trade or business.
   - Reg. Sec. 1.263A-1(j)(3) states that "Notwithstanding the references generally to the dealership throughout this Section and Reg. Secs. 1.263A-2 and 1.263A-3, the methods of accounting provided under Section 263A are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of Section 446(d) and the Regulations thereunder."



Positions Taken (in Determining Capitalizable Costs) that Are Contrary to TAM 200736026 Holdings

7. If a portion of the dealership's activities and operations are not covered under the retail sales facility safe harbor method (i.e., CAM change No. 150), whether any of the IRS holdings/conclusions in TAM 200736026 have not been followed or applied in making the on-site sales versus off-site sales determinations.

   In other words, in making the on-site sales versus off-site sales determinations, Issue #7 of TAM 200736026 held that lease sales, wholesale sales and Internet sales were considered as off-site sales.

   Lease sales activity. If a dealership has a heavy concentration of its new vehicle sales as lease sales, the IRS position expressed in TAM 200736026 that lease sales are not considered to be on-site retail sales could be problematic.

   Wholesale sales activity. If a dealership has a heavy concentration of vehicles sold at wholesale, the IRS position expressed in TAM 200736026 that wholesale sales are not considered to be on-site retail sales could be problematic.

   Internet sales activity. If a dealership has a heavy concentration of vehicles sold over the Internet, the IRS positions expressed in TAM 200736026 regarding lease and wholesale sales might also be extrapolated to cause dealership Internet sales Internet to be considered as off-site sales.

   In determining on-site versus off-site sales for this dealership, if the dealership takes the position that these sales are "on-site" sales, that would be a position contrary to that taken by the IRS in the TAM.

   If significant or material, should these positions be disclosed in the narrative statement attachment?

8. If there are any other (significant) departures from the TAM holdings in determining capitalizable costs, should these be disclosed in some fashion as "aggressive" positions?

Ability (or Inability) to Document the Dealership's Previous Election(s) re: the Use of a Simplified Resale Method

9. The dealership should be able to locate documentation to show or prove which Simplified Resale Method it has been using (prior to the filing of this Form 3115).

   If dealership was in existence in 1994 and was subject to Section 263A (i.e., it had average annual gross receipts in the three preceding years in excess of $10 million) ...

   - Was a "Section 263A checklist" filed as part of the Form 3115 filed when the Sec. 263A Regs were finalized? If so, how is it completed, what elections were made?
   - If the checklist was not filed, should that fact be disclosed to the IRS in the narrative statement?

   If the dealership is ***unable to locate*** documentation to show or prove which Simplified Resale Method it has been using (prior to the filing of this Form 3115), should disclosure of this fact be made, and if so, consider something along the following lines.

Statement re: Original Election of the Simplified Resale Method Used by the Dealership

☐ A copy of the original Statement electing to use the Simplified Resale Method is attached.

☐ A copy of the original Statement electing to use the Simplified Resale Method is not attached.

I certify that to the best of my knowledge and belief, _____ ***[dealership name]*** properly elected the use the Simplified Resale Method by filing Form 3115 and/or making such statement with its return for the tax year _____ ***[year]*** and otherwise complied with the provisions of Section 263A and the Regulations thereunder.

/S/ _____

ADDITIONAL DISCLOSURES TO BE CONSIDERED FOR THE FORM 3115 NARRATIVE STATEMENT

Summary of Section 11 of the Appendix to Rev. Proc. 2011-14

- 11.01 *Certain uniform capitalization (UNICAP) methods used by resellers and reseller-producers*
- 11.02 *Certain uniform capitalization (UNICAP) methods used by producers and reseller-producers*
- 11.03 - 11.06 Text Omitted ... These CAMs are not dealership-related.
- 11.07 *Safe harbor methods under Section 263A for certain dealerships of motor vehicles*

Sec. 11.01 ... Certain Uniform Capitalization (UNICAP) Methods Used by Resellers and Reseller-Producers

(1) ***Description of change.***

(a) ***Applicability.*** This change applies to:

(i) A small reseller of personal property that wants to change from a permissible UNICAP method to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies as a small reseller;

(ii) A formerly small reseller that wants to change from a permissible non-UNICAP inventory capitalization method to a permissible UNICAP method in the first taxable year that it does not qualify as a small reseller;

(iii) A reseller-producer that wants to change from a permissible UNICAP method for both its production and resale activities to a permissible simplified resale method described in Reg. Sec. 1.263A-3(d)(3) in any taxable year that it qualifies to use a simplified resale method for both its production and resale activities under Reg. Sec. 1.263A-3(a)(4) (resellers with ***de minimis*** production activities);

(iv) A reseller-producer that wants to change from a permissible simplified resale method described in Reg. Sec. 1.263A-3(d)(3) for both its production and resale activities to a permissible UNICAP method for both its production and resale activities in the first taxable year that it does not qualify to use a simplified resale method for both its production and resale activities under Reg. Sec. 1.263A-3(a)(4);

(v) A reseller that wants to change its permissible UNICAP method to include a special reseller cost allocation rule;

(vi) A reseller or reseller-producer that wants to change to a UNICAP method (or methods) specifically described in the Regulations and includes any necessary changes in the identification of costs subject to Section 263A that will be accounted for using the new method in any taxable year, other than the first taxable year, that it does not qualify as a small reseller. However, this 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

(vii) A reseller or reseller-producer that wants to change from not capitalizing a cost subject to Section 263A to capitalizing that cost, if the reseller or reseller-producer is otherwise already using a UNICAP method (or methods) specifically described in the Regulations.

(b) ***Inapplicability.***

(i) ***Self-constructed assets.*** This change does not apply to a taxpayer that wants to use either the simplified service cost method or the simplified production method for self-constructed assets under Reg. Secs. 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D).

(ii) ***Historic absorption ratio.*** This change does not apply to a taxpayer that wants to make an historic absorption ratio election under Reg. Sec. 1.263A-2(b)(4) or 1.263A-3(d)(4), or to a taxpayer that wants to revoke an election to use the historic absorption ratio with the simplified resale method (see Reg. Sec. 1.263A-3(d)(4)(iii)(B)), including a taxpayer using the simplified resale method with an historic absorption ratio that wants to change to a UNICAP method specifically described in the Regulations that does not include the historic absorption ratio. However, this change applies to a small reseller that wants to change from the historic absorption ratio with the simplified resale method to a permissible non-UNICAP inventory capitalization method under Section 11.01(1)(a)(i) of this *Appendix*.

(c) ***Scope limitations inapplicable.*** The scope limitation of Section 4.02(7) of this Revenue Procedure does not apply to the changes described in Reg. Sec. 11.01(1)(a)(i) and (ii) of the *Appendix* of this Revenue Procedure.

Sec. 11.01 ... Certain Uniform Capitalization (UNICAP) Methods Used by Resellers and Reseller-Producers

(2) ***Definitions.***

(a) "Reseller" means a taxpayer that acquires real or personal property described in Section 1221(a)(1) for resale.

(b) "Small reseller" means a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence for the three preceding taxable years) do not exceed $10,000,000. See Section 263A(b)(2)(B).

(c) "Formerly small reseller" means a reseller that no longer qualifies as a small reseller.

(d) "Producer" means a taxpayer that produces real or tangible personal property.

(e) "Reseller-producer" means a taxpayer that is both a producer and a reseller.

(f) "Permissible UNICAP method" means a method of capitalizing costs that is permissible under Sec. 263A.

(g) "A UNICAP method specifically described in the Regulations" includes the 90-10 ***de minimis*** rule to allocate a mixed service department's costs to resale activities (Reg. Sec. 1.263A-1(g)(4)(ii)), the 1/3-2/3 rule to allocate labor costs of personnel to purchasing activities (Reg. Sec. 1.263A-3(c)(3)(ii)(A)), the 90-10 ***de minimis*** rule to allocate a dual-function storage facility's costs to property acquired for resale (Reg. Sec. 1.263A-3(c)(5)(iii)(C)), the specific identification method (Reg. Sec. 1.263A-1(f)(2)), the burden rate method (Reg. Sec. 1.263A-1(f)(3)), the standard cost method (Reg. Sec. 1.263A-1(f)(3)), the direct reallocation method (Reg. Sec. 1.263A-1(g)(4)(iii)(A)), the step-allocation method (Reg. Sec. 1.263A-1(g)(4)(iii)(B)), the simplified service cost method (Reg. Sec. 1.263A-1(h)) (with a labor-based allocation ratio), and the simplified resale method without the historic absorption ratio election (Reg. Sec. 1.263A-3(d)), but does not include any other reasonable allocation method within the meaning of Reg. Sec. 1.263A-1(f)(4).

(h) "Special reseller cost allocation rule" means the 90-10 ***de minimis*** rule to allocate a mixed service department's costs to property acquired for resale (Reg. Sec. 1.263A-1(g)(4)(ii)), the 1/3 - 2/3 rule to allocate labor costs of personnel to purchasing activities (Reg. Sec. 1.263A-3(c)(3)(ii)(A)), and the 90-10 ***de minimis*** rule to allocate a dual-function storage facility's costs to property acquired for resale (Reg. Sec. 1.263A-3(c)(5)(iii)(C)).

(i) "Permissible non-UNICAP inventory capitalization method" means a method of capitalizing inventory costs that is permissible under Section 471.

(3) ***Section 481(a) adjustment period.*** Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to Sections 11.01(1)(a)(i), 11.01(1)(a)(iii), or 11.01(1)(a)(iv) of this *Appendix* generally must take any applicable net positive Section 481(a) adjustment for such change into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. A taxpayer changing its method of accounting for costs pursuant to Sections 11.01(1)(a)(ii), 11.01(1)(a)(v) or 11.01(1)(a)(vi) of this *Appendix* generally must take any applicable net positive Section 481(a) adjustment for such change into account ratably over four taxable years. See Section 5.04(3) of this Revenue Procedure for exceptions to this general rule.

(4) ***Multiple changes.*** A taxpayer that wants to make both this change and another change in method of accounting for the same year of change must comply with the ordering rules of Reg. Sec. 1.263A-7(b)(2).

(5) ***Designated automatic accounting method change number.*** The designated automatic accounting method change number for a change under Section 11.1 of this *Appendix* is "22."

(6) ***Example.*** The following example illustrates the principles of Section 11.01 of this *Appendix* for small resellers and formerly small resellers. *[**Text of Example omitted** ... Example relates to changes in status when average gross receipts are below $10 million and in subsequent years, the average increases to more than $10 million, thus changing the status of the taxpayer from being a small reseller (exempt from Sec. 263A).]*

(7) ***Contact information.*** For further information regarding a change under this Section, contact Alexander R. Roche or Kari Fisher, at 202-622-4970 (not a toll-free call).

Sec. 11.02 ... Certain Uniform Capitalization (UNICAP) Methods Used by Producers and Reseller-Producers

(1) ***Description of change.***

(a) ***Applicability.*** This change applies to a producer (as defined in Section 11.01(2)(d) of this *Appendix*) or a reseller-producer (as defined in Section 11.01(2)(e) of this *Appendix*) that wants to change to a UNICAP method (or methods) specifically described in the Regulations, including any necessary changes in the identification of costs subject to Section 263A that will be accounted for using the new method. This change also includes a change from not capitalizing a cost subject to Section 263A to capitalizing that cost for a producer or a reseller-producer that is otherwise already using a UNICAP method (or methods) specifically described in the Regulations. However, this change does not include a change for purposes of recharacterizing "Section 471 costs" as "additional Section 263A costs" (or ***vice versa***) under the simplified production method.

(b) ***Inapplicability.*** This change does not apply to a producer or reseller-producer that wants to revoke an election to use the historic absorption ratio with the simplified production method (***see*** Reg. Sec. 1.263A-2(b)(4)(iii)(B)), including a taxpayer using the simplified production method with an historic absorption ratio changing to a UNICAP method specifically described in the Regulations that does not include the historic absorption ratio. This change also does not apply to a taxpayer that wants to use either the simplified service cost method or the simplified production method for self-constructed assets under Reg. Sec. 1.263A-1(h)(2)(i)(D) and 1.263A-2(b)(2)(i)(D). Also, this change does not apply to a producer or reseller-producer that wants to change its method of accounting for interest capitalization.

(2) ***Definition.*** A "UNICAP method specifically described in the Regulations" includes

- The 90-10 ***de minimis*** rule to allocate a mixed service department's costs to production or resale activities (Reg. Sec. 1.263A-1(g)(4)(ii)),
- The 1/3 - 2/3 rule to allocate labor costs of personnel to purchasing activities (Reg. Sec. 1.263A-3(c)(3)(ii)(A)),
- The 90-10 ***de minimis*** rule to allocate a dual-function storage facility's costs to property acquired for resale (Reg. Sec. 1.263A-3(c)(5)(iii)(C)),
- The specific identification method (Reg. Sec. 1.263A-1(f)(2)),
- The burden rate method (Reg. Sec. 1.263A-1(f)(3)),
- The standard cost method (Reg. Sec. 1.263A-1(f)(3)),
- The direct reallocation method (Reg. Sec. 1.263A-1(g)(4)(iii)(A)),
- The step-allocation method (Reg. Sec. 1.263A-1(g)(4)(iii)(B)),
- The simplified service cost method (Reg. Sec. 1.263-1(h)) (with either a labor-based allocation ratio or a production cost allocation ratio), and
- The simplified production method without the historic absorption ratio election (Reg. Sec. 1.263A-2(b)),
- However, a "UNICAP method specifically described in the Regulations" ***does not include any other reasonable allocation method within the meaning of Reg. Sec. 1.263A-1(f)(4).***

(3) ***Multiple changes.*** A taxpayer that wants to make both this change and another change in method of accounting in the same year of change must comply with the ordering rules of Reg. Sec. 1.263A-7(b)(2).

(4) ***Designated automatic accounting method change number.*** The designated automatic accounting method change number for a change under Section 11.2 of this *Appendix* is "23."

(5) ***Contact information.*** For further information regarding a change under this Section, contact Alexander R. Roche or Kari Fisher, at 202-622-4970 (not a toll-free call).

Sec. 11.03 - 11.06 Text Omitted ... These CAMs Are Not Dealership-Related

- 11.03 Change to no longer capitalize research and experimental expenditures under Section 263A
- 11.04 Impact fees
- 11.05 Change to capitalizing environmental remediation costs under Section 263A
- 11.06 Change in allocating environmental remediation costs under Section 263A

Sec. 11.07 ... 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.

Note: The wording of Section 11.07 of the Appendix to Rev. Proc. 2011-14 is identical to the wording in Section 11.07 that was added to the Appendix of Rev. Proc. 2008-52 by Section 7 of Rev. Proc. 2010-44

IRS

REVENUE PROCEDURE 2010-44 PROVIDES UNICAP RELIEF FOR MOTOR VEHICLE DEALERSHIPS

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Introduction

On November 9, 2010, the IRS issued formal UNICAP (Internal Revenue Code 263A) guidance to auto dealers and several other types of motor vehicle dealerships. Revenue Procedure (Rev. Proc.) 2010-44 provides two safe harbor methods of accounting that, if properly elected and applied, should simplify a dealership's UNICAP computations. Dealers properly changing to one or both of the safe harbor methods receive audit protection (as defined in section 7 of Rev. Proc. 2008-52) for years prior to the year of change.

Generally, taxpayers subject to UNICAP are required to capitalize rather than deduct certain direct and indirect costs allocable to property produced and/or acquired for resale. Indirect costs most often incurred by a reseller include purchasing, storage, and handling costs. However, a reseller is not required to capitalize handling and storage costs incurred at a retail sales facility.

Although the UNICAP provisions were originally enacted in 1986, the industry's focus on the issue increased in 2007 with the issuance of Technical Advice Memorandum (TAM) 200736026. The complex TAM addressed many auto dealership UNICAP issues and concluded that the dealership at issue had not properly applied the UNICAP rules. The TAM analyzed one specific dealership and cannot be used or cited as precedent. Nevertheless, the TAM provided insight as to how the Service would interpret similar facts for similarly situated taxpayers.

Many in the automobile industry expressed concern that complying with the legal authority outlined in the TAM would cause undue burden on both the industry and the IRS. The new safe harbors may provide motor vehicle dealerships an opportunity to alleviate that burden and change their method of accounting for UNICAP costs.

What are the Safe Harbors?

Effective November 9, 2010, Rev. Proc. 2010-44 provides that qualifying motor vehicle dealerships may elect either or both of the following safe harbor methods of accounting:

Retail sales facility safe harbor method – A qualifying dealer using this method may teat its entire sales facility as a retail sales facility. The dealer is not required to capitalize and may currently deduct handling and storage costs incurred at its facility provided that certain criteria are met.

The facility must be routinely visited by retail customers and the dealership must normally and routinely conduct on-site retail sales from the facility. A retail sales facility includes a vehicle lot that is a part of the sales facility and is routinely visited by customers.

Facts and circumstances and common understanding govern the definition of a retail sales facility for purposes of the retail sales facility safe harbor. Some dealerships operate their sales facility under one roof. Others have more than one building located on one piece of real estate. Still others have nearly all of their operations on one piece of real estate with a portion, such as a service shop or body shop, located elsewhere. A key component of any analysis is whether or not the locations are routinely visited by retail customers. For example, if the service or body shop located apart from the main dealership location is not visited by the retail customers, it is unlikely to be part of the retail sales facility, and UNICAP costs must be capitalized.

Reseller without production activities safe harbor method – A qualifying dealer electing this safe harbor method may treat itself as a reseller without production activities. The benefits of electing this method include classifying activities conducted by dealership employees and contractors working at the dealership location as handling costs rather than production costs. Handling costs incurred at a retail sales facility may be currently deducted rather than capitalized. Costs associated with outside contractor work performed away from the dealership still must be capitalized rather than deducted. The cost of parts must be capitalized on dealership-owned vehicles as an acquisition cost of the vehicle.

Most dealerships add the cost of both parts and labor, often including a profit margin, to the cost basis of the dealership owned vehicle. However, for tax purposes, the labor costs and internal profit are not required to be capitalized and may be currently deducted. A word of caution: dealers that currently include labor and internal profit in inventory for tax purposes may not stop including those costs without changing their method of accounting for those costs. The new revenue procedure provides that a dealer may make a corresponding change in method of accounting to remove those costs at the same time they elect the new safe harbors. (See below for more information on accounting method changes.)

Who Qualifies for the Safe Harbors?

The revenue procedure defines a qualifying motor vehicle dealership broadly as a dealership that primarily purchases and resells to retail customers one or more of the following categories of new or used vehicles:

- Automobiles,
- Light, medium, or heavy duty trucks
- Recreational vehicles
- Motorcycles
- Boats
- Farm or construction machinery and equipment

The new safe harbors do not require that a dealer analyze dealership transactions and categorize them as a retail sale or non-retail sale as the TAM required. To determine whether it qualifies for the safe harbors, the dealership should consider its typical operations and determine whether its primary activity is the acquisition and resale of vehicles to retail customers that visit the dealership facilities. A retail customer is defined as the final purchaser of the vehicle or equipment.

Determination of whether a dealership primarily purchases and resells to retail customers requires a fact and circumstances analysis. But it is anticipated that a typical dealership would be categorized as a qualifying motor vehicle dealership for purposes of this revenue procedure.

How Do I Adopt the New Safe Harbors?

A qualifying dealership that wants to take advantage of either or both of the new safe harbors must follow specific rules to change their method of accounting for UNICAP. In nearly all cases, the dealership does not need to secure advance permission from the IRS to make the accounting method change but rather may make the change by completing a Form 3115 (Application for Change in Method of Accounting). The completed form must be attached to their timely filed return for the year in which they make the change. A copy of the form must also be sent to the IRS National Office.

In most cases, a dealership can adopt the new safe harbors for its first or second year ending after November 9, 2010 without considering most of the restrictions sometimes imposed on automatic method changes. If a dealer chooses to adopt the method during a later period, they should refer to the scope limitations provided in the automatic change in method of accounting revenue procedure.

Some dealers may also decide that it is appropriate or necessary to change other UNICAP methods of accounting in conjunction with the change to the safe harbor(s). A dealer that files a Form 3115 to change to one or both of the safe harbors may also make other concurrent automatic changes, such as removing internal profit or labor, on the same form using the same method change designation number as the safe harbors.

Does the Revenue Procedure Include Audit Protection?

In most cases, a dealer that properly changes its method of accounting to a method consistent with the safe harbor methods will receive audit protection for prior year returns. In other words, the IRS will not require the dealer to change its method of accounting for the same item in a year prior to the year of change. That doesn't mean that the IRS cannot audit other issues at a dealership that changes to one or both of the new safe harbor methods. The examiner may also ask to review the Form 3115 and any computations made to change to one or both of the safe harbors to ensure that the change was properly made.

The audit protection attaches when the copy of the Form 3115 is filed with the National Office. But if the National Office copy is filed prior to year end, the dealership may be required to perfect the Form 3115 when the return is filed.

Does This Mean That Auto Dealerships are Not Subject to UNICAP?

No. Dealerships are still subject to IRC 263A (UNICAP). The revenue procedure is merely a set of safe harbors that may be elected. Dealers remain subject to UNICAP and should consider how all of the UNICAP rules could affect the dealership. For example, dealers must still consider whether they have off site storage requiring cost capitalization and purchasing activity for which they need to capitalize costs.

Additional Information

This Alert is intended to be a brief overview of the new safe harbor provisions and changes in method of accounting. To determine how these provisions apply to your dealership, please review Internal Revenue Code §263A and the accompanying regulations, Revenue Procedure 2010-44 and Revenue Procedure 2011-14.

Practice Guide	***CHECKLIST FOR EVALUATING DEALERSHIP COMPLIANCE WITH THE SECTION 263A INVENTORY COST CAPITALIZATION RULES***	
		Yes / No / Comments
Determine Which SRM the Dealership Has Elected to Use	• Determine which Simplified Resale Method (SRM) the dealership has elected to use ◆ If dealership entity was in existence before 1994 … there are three possibilities. Which of the three SRMs was the dealership using? ▪ Did the dealership change to the current SRM method as it is set forth in Reg. Sec. 1.263A-3(d)? ▪ Did the dealership file a Form 3115 in 1994 to make that change? • Has the dealership filed any Forms 3115 in previous years to change any Section 263A cost capitalization methods? ◆ If so, what changes were made? • ***Dealerships in existence in 1993.*** If the dealership entity began after 1993, did the dealership elect to use the current SRM method (Reg. Sec. 1.263A-3(d))? ◆ What proof does the dealership have that it made this election? • ***Dealerships in existence in 1988.*** Was the Section "263A Checklist" provided in IRS Notice 88-92 attached to the Form 3115 which was required to be included in the income tax return filed by the dealership for 1988?	
Analyze Dealership Operations	• Are all of the dealership operations covered by the retail sales facility safe harbor? • Are there any operations that might potentially be outside the safe harbor? ◆ If so, describe and estimate amounts of Sec. 263A costs to be capitalized in connection with… ▪ Any off-site storage facilities. ▪ Any dual-function storage facilities.	
Rev. Proc. 2010-44 ***Safe Harbor Elections*** ***2010 vs. 2011***	• ***Should 2010 or 2011 be the year of change?*** Has consideration been given to whether the dealership should file Form 3115 to make the changes effective for calendar year 2011 instead of 2010? • Has the dealership filed Form 3115 to make any changes under Revenue Procedure 2010-44? ◆ If so, what year was the year of change, and what changes/elections were made? • ***Possible safe harbor elections*** ◆ No. 150 … Change to treat certain sales facilities as retail sales facilities (Sec. 5.01 of Rev. Proc. 2010-44) ◆ No. 151 … Change to be treated as reseller without production activities (Sec. 5.02 of Rev. Proc. 2010-44) ◆ No. 22/23 … 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 • ***Other possible changes, disclosures, statements to include with Form 3115*** ◆ The 1/3 - 2/3 rule to allocate labor costs of personnel to purchasing activities (Reg. Sec. 1.263A-3(c)(3)(ii)(A), ◆ The 90%-10% de minimis rule to allocate a mixed service department's costs to property acquired for resale (Reg. Sec. 1.263A-1(g)(4)(ii), and ◆ The 90%-10% de minimis rule to allocate a dual-function storage facility's costs to property acquired for resale (Reg. Sec. 1.263A-3(c)(5)(iii)(C). ◆ Whether or not any adjustments - in connection with the capitalization of the cost of parts or accessories that the dealership has added to vehicles - will be made to remove (1) internal labor costs that were previously capitalized and/or (2) internal gross profit that was included with the actual cost of parts. • If any of these safe harbor elections or other disclosures were not made, explain why… _____ • How thorough is the narrative statement attached to Form 3115?	
National Tax Office Filing	• ***Timely filing of duplicate copy of Form 3115.*** Was a duplicate copy of Form 3115 filed with the National Office of the IRS in Washington, D.C.? … Yes or No? • If Yes, on what date was that copy filed/mailed? _____	

CHECKLIST FOR EVALUATING DEALERSHIP COMPLIANCE WITH THE SECTION 263A INVENTORY COST CAPITALIZATION RULES

		Yes / No / Comments
Section 481(a) Adjustment ... In General	• What is the amount of the Section 481(a) adjustment? ◆ Is the Section 481(a) adjustment a positive or negative adjustment? • Is there a detailed calculation of the Section 481(a) adjustment included with the narrative statement attached to Form 3115? • Is the Simplified Resale Method from which the dealership is changing considered to be a change in accounting method under Section 263A that requires the revaluation of the beginning inventory? See Reg. Sec. 1.263A-7(a)(5)	
Section 481(a) Adjustment ... Dealerships Using the LIFO Method	• Is the dealership using the LIFO method to value any inventories? ◆ If so, which inventories are valued using LIFO? ◆ If so, how has the use of LIFO been taken into consideration in determining the Sec. 481(a) adjustment? • Have the additional Sec. 263A costs been embedded in the LIFO valuation layers? ◆ If ***yes***, have the LIFO layers at the beginning of the year-of-change been revalued? ▪ Which revaluation method has been used under Reg. Sec. 1.263A-7? ◆ If ***no*** (i.e., worksheet computations of Sec. 263A amounts have been simply reflected as Schedule M-1 or M-3 adjustments on a year-to-year basis in the income tax returns), have you revalued the LIFO layers? ▪ If the LIFO layers have not been revalued, has the fact that they have not been revalued been disclosed in the narrative statement attached to Form 3115?	
Purchasing Activities & Costs	• Is the dealership required to capitalize any costs with respect to purchasing activities? ◆ Did any employee spend more than 1/3 of his or her time involved in purchasing activities? ◆ What written documentation reflects the percent of activity by each employee involved in purchasing activities? ▪ Is this documentation signed and dated by the dealership employee and/or verified his/her supervisor? (Or, was it just "phoned in?") • How has the amount of mixed service costs allocable to purchasing been determined? ◆ Simplified Service Cost Method (labor-based) ◆ Some other method	
For Dealership Operations & Activities Outside the Safe Harbors ... On-Site Off-Site Sales/Facilities Definitions	• ***Determination of "on-site" vs. "off-site" sales.*** TAM 200736026 takes the position that the following types of sales are "off-site" sales (i.e., they are not "on-site" sales)... ◆ Vehicles taken in trade or purchased at auction and then re-sold at wholesale ◆ Vehicles sold to another dealership at cost (i.e., "dealer trades) ◆ Vehicle lease sales ◆ Wholesale sales of parts to purchasers who are not the end users where the parts are picked up at the dealership's parts department by the purchaser or delivered to the purchaser by a driver from the dealership's parts department • Determine the percentage of sales that are on-site sales and that are off-site sales. ◆ Applying the (restrictive) holdings in Issue #7 in TAM 200736026. ◆ Not applying some or all of the (restrictive) holdings in Issue #7 in the TAM. • Has the dealership taken any positions in its Sec. 263A computations that are contrary to the holdings in TAM 200736026? If so, describe... _____ ◆ TAMs (issued after Oct. 31, 1976) are considered to be "substantial authority" for the tax treatment of an item in a tax return. (Reg. Sec. 1.6662-4(d)(3)(iii)) ◆ What, if any, disclosure of these positions has been made in the tax returns?	
Other Costs (Storage & Handling Required to Be Capitalized)	• For dealership operations not falling under the safe harbor elections ... ◆ How have the amounts of capitalizable ***storage costs*** been determined? ◆ How have the amounts of capitalizable ***handling costs*** been determined? • Have ***mixed service costs*** been applied to increase the storage and handling costs? • How have the amounts of allocable mixed service costs been determined? ◆ Simplified Service Cost Method (labor-based) ◆ Some other method ... Describe...	

		Yes / No / Comments
Calculation of Additional Sec. 263A Cost to Be Capitalized ... Dealerships Using the LIFO Method	• For dealerships required to capitalize (1) purchasing costs and/or (2) storage and handling costs associated with activities not covered by the safe harbor elections... • Have you considered the IRS' "Tool Kit" 12-Step Audit Program which was included as an exhibit in its first moratorium announcement in September 2009? ◆ If so, describe ... • In determining the amount of the *"Section 471 costs remaining on hand at year-end,"* there are at least three possibilities. Has the Sec. 263A combined absorption ratio for the year been multiplied by ... ◆ The total valuation of all inventories (i.e., the amount shown in Schedule L)? ▪ If the dealership uses LIFO, this approach would overstate the amount of additional Section 263A costs to be capitalized; however it is one of the permitted variations of the SRM. ◆ Only the amount of LIFO increment computed for the current year ... and not by the total valuation of the LIFO inventory (i.e., as shown in Reg. Sec. 1.263A-3(d)(3)(iv), Example 2 for LIFO inventories)? ▪ In years when a LIFO decrement was computed, were previously capitalized Sec. 263A costs properly eliminated/reduced? ◆ The sum of the valuation of all inventories not on LIFO ***plus*** only the amount of current-year increment computed as part of the current-year LIFO calculations? ▪ ***Note:*** The examples in the Regulations at Reg. Sec. 1.263A-3(d)(3)(iv) do not address the factual situation where ***some*** of a taxpayer's inventories are valued using LIFO and ***some*** of that taxpayer's inventories are valued using a method other than LIFO. ◆ Have you disclosed which approach you have used in determining the Section 481(a) adjustment? • Note: This encompasses the SRM and the two permissible variations of the Simplified Resale Method at Reg. Sec. 1.263A-3(d)(3)(iii).	
Documentation of Computations & Discussions	• Are all Section 263A computations adequately documented? • Have all discussions of major Section 263A implications been discussed with the dealer? Is there documentation of these discussions? • If Form 3115 is going to be filed, has a signed engagement letter been obtained? If not, why not? _____	
If the Dealership Has No Costs to Capitalize...	• In response to the questions in Schedule A (Cost of Goods Sold), has the box asking if the dealership is subject to Section 263A been answered ... "Yes"? ◆ The dealership is subject to Section 263A; it may simply have no Sec. 263A costs that are required to be capitalized. • Consider including a statement in the tax return to the effect that ... "The dealership is subject to Section 263A; however, it has no costs in the current year that are required to be capitalized (because all activities are covered by the safe harbors in Rev. Proc. 2010-44 and no employee spends more than 1/3 of his or her time engaged in purchasing activities."	
If This Is a First Year Tax Return for the Dealership...	• Form 3115 is not required ... In an initial return, there is no change in method. • Consider including in the initial income tax return a statement (patterned after the Form 3115 Narrative Statement) to notify the IRS that the dealership elects to ... ◆ Treat certain sales facilities as retail sales facilities (Sec. 5.01 of R.P. 2010-44) ◆ Be treated as reseller without production activities (Sec. 5.02 of R.P. 2010-44) ◆ 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 ◆ Apply the 1/3-2/3 rule to allocate labor costs of personnel to purchasing activities (Reg. Sec. 1.263A-3(c)(3)(ii)(A)	

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IRS FINDS ANOTHER NON-COMPLIANT EMPLOYEE TOOL PLAN

Many articles have appeared in the *Dealer Tax Watch* documenting the IRS' relentless attack against dealership employee tool reimbursement plans.

In essence, a reimbursement or other expense allowance arrangement satisfies the requirements of Section 62(c) only if it meets all three of these requirements ...

1. Business connection
2. Substantiation, and
3. Returning amounts (received) in excess of actual expenses (to the employer, so that only actual expenses have been reimbursed tax-free).

In recent guidance (ILM 201120021, dated March 18, 2011), the IRS held that a reimbursement plan failed to meet the business connection requirement (i.e., the first test of the three-pronged test above).

Since the plan failed to satisfy the first test, there was no need for the IRS to consider the other two tests.

This guidance adds one more example (to a long list of others) of a tool plan reviewed by the IRS that fails to meet the accountable plan requirements of Section 62(c). See *"IRS Approves a 'Tool Reimbursement Plan' in LTR 200930029,"* (Year-End 2009 *DTW*), *"IRS Revised Coordinated Issue Paper Hammers Employee Tool Plans,"* (Mid-Year 2008 *DTW*), *"ILM 200745018 ... Tool Reimbursement Plan is a Non-Accountable Plan,"* (Dec. 2007 *DTW*), *"Rev. Rul. 2005-52 Emphasizes Strict Compliance ... Obviously Flawed Plans Take a Hit,"* (Sept. 2005 *DTW*) and *"A Comprehensive Report on Technicians' Tool Reimbursement Plans Under Section 62(c),"* (June 2005 *DTW*).

Issue

Whether a reimbursement or other expense allowance arrangement meets the ***business connection requirement*** of an accountable plan where an employer pays an amount to its employee regardless of whether an expense is paid or incurred or reasonably expected to be paid or incurred by the employee in the performance of services for the employer.

Facts

An employer (whose kind of business is not identified in the ILM) participates in a tool plan administered by a third party. The tool plan is intended to reimburse the employer's employees for the use of their tools and equipment.

Under the tool plan, tool payments are made to employees as purported nontaxable reimbursement for the cost of the tools they are required to provide as a condition of employment. However, neither the employer nor the plan administrator verifies that the tools being claimed by the employees are actually required in the performance of services for the employer.

Prior to enrolling in the tool plan, an employer compensates its employees on an hourly wage basis, with no specific amount attributed to the provision of tools or equipment.

Once an employer and its employees enroll in the tool plan, the employees' hourly wages are split into two components: a reduced hourly wage and a tool plan payment, which is calculated as a set percentage of the employee's hourly wage.

Under the tool plan, an employer issues its employees one check for the reduced hourly wage amount; the employer also issues a second check for the tool plan payment which is treated as not subject to employment taxes.

The employer's ***employees continue to receive essentially the same amount per hour under the tool plan as they did before implementation of the tool plan***, but under the tool plan the amount is split into two portions, one treated as wages and the other treated as nontaxable reimbursement for tool expenses and the tool plan's administrative fee.

Facts *(continued)*

Once an employee has received an amount equal to the total amount to be "reimbursed" under the tool plan (i.e., the value or estimated cost of the employee's tool and equipment inventory), the employee stops receiving tool plan payments and returns to his or her regular pay at the hourly wage rate earned prior to implementation of the tool plan.

The amount to be "reimbursed" is determined by taking an inventory of each employee's tools and equipment. The tool plan administrator asks each employee for a list of their tools and equipment and for any available receipts.

The inventory includes tools or equipment the employee acquired prior to being employed with his or her current employer. If an employee does not have receipts to establish cost, the initial inventory of tools is valued using estimates, valuation publications, or current price lists.

Note: We note that tool plans may vary in how they determine the value of an employee's tool and equipment inventory. For example, tool plans may use vendor catalogs or valuation publications to determine current replacement value, or base estimated cost on factors such as the type of tool or equipment, its useful life and geographic location of the worker.

The tool plan did not obtain information regarding any previous depreciation taken by the employee for the tools in inventory or prior reimbursements, which is necessary to determine the expenses actually incurred by the employee in performing services for the employer.

Purchases made after implementation of the tool plan are generally determined at actual cost and require receipts.

The Problem with This Plan ... Wage Recharacterization

Where a plan serves to recharacterize amounts as a reimbursement allowance that would otherwise be paid if there were no expenses reasonably expected to be incurred for the employer, amounts paid under the plan will not be treated as paid under an accountable plan.

Further, although an employer may prospectively alter its compensation structure to include reimbursement of substantiated expenses under an accountable plan, an employer may not structure its compensation arrangement so as to avoid the payment of employment taxes by substituting reimbursements and expense allowances for amounts that would otherwise be paid as wages, as illustrated by a temporary reduction in an hourly wage amount only for as long as the tool rate amount is paid.

Such recharacterization violates the business connection requirement of Reg. Sec. 1.62-2(c) because the employee receives the same amount regardless of whether expenses were incurred or reasonably expected to be incurred.

Conclusion

A reimbursement or other expense allowance arrangement that pays an amount regardless of whether an expense is paid or incurred or reasonably expected to be paid or incurred by the employee in performing services for the employer violates the business connection requirement of an accountable plan. Specifically, such an arrangement violates the business connection's reimbursement requirement under Reg. Sec. 1.62-2(d)(3)(i).

Accordingly, payments made under the arrangement are treated as made under a nonaccountable plan.

Amounts treated as paid under a nonaccountable plan must be included in the employee's gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee's Form W-2.

(Continued from page 15)

ized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed."

C corporations and certain partnerships are not entitled to defer gain under Section 1033 if the replacement property is acquired from a related party.

Other special rules that might come into play could allow a taxpayer (1) to obtain an extension of time for making an election to defer the gain under certain circumstances and/or (2) to acquire the replacement property indirectly by purchasing at least 80% of the stock of a corporation which owns such property.

BOOKS & RECORDS

As a general proactive and protective strategy, dealerships should maintain a back-up set of records that is stored electronically and off-site so that if a disaster should occur, it will have access to these records.

In addition, it would be desirable to store copies of important records off-site. Some of these records would include: incorporation papers, corporate minutes, prior year tax returns, franchise agreements, succession planning documents, etc.

ELECTRONIC RECORDKEEPING REQUIREMENTS

Under Revenue Procedure 98-25, if a business incurs an event that disrupts its electronic recordkeeping system, there are formal procedures that taxpayers are required to follow. These include notifying appropriate IRS personnel of a plan to reconstruct records, etc. In this respect, see Section 8 of the Rev. Proc. ... especially Section 8.04.

To date, it appears that the IRS has not made any formal announcement that would waive, or lessen, these requirements or otherwise provide an official dispensation to the countless businesses whose records were destroyed by Katrina, Wilma, Rita or any of the more recent Federally-declared disasters.

MORE INFORMATION ON DISASTER AREAS

Unfortunately, many Federally-declared disasters have occurred recently all over the country. The fact that TAM 201111004 relates to the Katrina disaster several years ago does not lessen its potential application today to businesses that are located in the many different currently-designated Federal disaster areas.

For a list of more recent (2011) disaster areas, see the www.irs.gov/newsroom article "Tax Relief in Disaster Situations" (last updated on May 25, 2011). Also, see www.fema.gov for other information on Federally-declared disasters.

Perhaps this TAM may provide distressed businesses with some help from an unexpected source.

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