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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. <u>2011 ... THE YEAR IN REVIEW</u>. It's been another interesting year for those of us who follow IRS developments and guidance on auto dealership tax issues. It seems fair to say that this year there have not been any major pronouncements or guidance issued by the IRS on dealership tax issues.

Sec. 263A ... RIP. The most pressing issue for many years was, of course, the question of how dealerships should apply the Section 263A inventory capitalization rules to their year-end inventories. In late 2010, the IRS issued the "silver bullet" and allowed dealers to benefit from very favorable safe harbor interpretations.

Accordingly, the spring and summer of 2011 occupied many CPAs preparing Forms 3115 by which dealerships elected to protect themselves from further challenge on many issues that would have been very troublesome if the IRS had not allowed them some slack.

I expect that there are still many dealerships that did not file Forms 3115 for 2010 to make these changes. In some cases, this was deliberate because it is their intention to wait to elect the safe harbors effective for calendar year 2011.

When it issued Revenue Procedure 2010-44 last year, the IRS allowed dealerships a "two-year window," meaning that dealerships could make the change for either 2010 or 2011 with relative safety and impunity. However, after the second year (i.e., starting in 2012), it will become difficult for some dealers to make the change under the IRS procedures for automatic changes in methods.

The next headache. There is, however, another major controversial tax issue which - like the 263A issue - has been brewing for years. I'm referring, of course, to the proper tax treatment by dealerships for payments received from the manufacturers under their various and sundry facility improvement and image upgrade programs. And, unfortunately, there is currently no specific "guidance" from the IRS on the tax issues related to this development.

This issue affects almost all dealers in one way or another, or it will affect them sooner or later. As you

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can see, the major content of this Edition of the *Dealer Tax Watch* is devoted to this subject.

Timelines. The 2011 Timeline on page 5 updates the earlier 6-month version and reveals no major activity, and just a few IRS guidance pronouncements.

I've included an updated timeline for 2010 in order to provide (1) additional material with respect to the issuance of Rev. Proc. 2010-44 and (2) an overview of the *Tax Relief Act of 2010*. I've also included 2009 and 2008 timelines just to give you a better frame of reference for how 2011 fits into the overall picture.

#2. *De FILIPPS UNIVERSITY* AUDIO SEMINARS. This year was especially busy because I began a series of 3-hour audio seminars to supplement this publication and various speaking engagements.

Complete information about *De Filipps University* and each audio seminar is available on our web site (www.defilipps.com). If you missed any of our 2011 seminars listed below, On Demand Audio Recordings (which include all of the presentation materials for that seminar) can be purchased at www.krm.com/wjd (on the "Recordings" tab).

Participants find these audio seminars to be practical and cost efficient because there is no limit on the number of individuals who can listen to a presentation at one registration site. In addition, no travel time, expenses or other inconvenience are incurred. Also, some firms use the information and materials from these seminars to develop, enrich and customize their own in-house training programs.

To facilitate CPE credits for participants, we are registered as a sponsor of continuing education with the National Association of State Boards of Accountancy (NASBA).

I plan to continue to offer these seminars throughout the coming year. Please call or e-mail me with any suggestions you might have for seminar topics in 2012.

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De Filipps University
On Demand Audio Seminar Library

Available at www.krm.com/wjd (on the Recordings tab)

	Date Presented
Dealership Track	
Section 263A Cost Cap. & Other Dealership Year-End Tax Planning Issues	1/25/2011
Sec. 263A Cost Cap & Other Dealership Year-End Tax Planning Issues Including an Overview of Recent Revenue Procedure 2010-44	3/9/2011
Sec. 263A ... Part II ... LIFO Considerations and other Problems & Perils For Dealership Activities Not Fully Covered by the Safe Harbor Elections	3/10/2011
Mid-Year 2011 Dealer Tax Update ... Tax Strategies & IRS Activities	7/20/2011
Sec. 263A Cost Cap for Auto Dealers ... Filing Form 3115 for Safe Harbor Elections	7/22/2011
Planning Strategies for Auto Dealerships in Transition, Distress and/or Disaster Areas	9/1/2011
IRS *Audit Technique Guides* for Auto Dealerships ... Special Tax Issues for Dealerships	9/21/2011
LIFO for Auto Dealers ... A Specialized Seminar Emphasizing the Application of the LIFO Method for Automobile Dealers	10/13/2011
2011 Year-End Dealer Tax Update ... Tax Strategies & IRS Activities (Also to be presented Jan. 11 & 25, 2012)	12/7/2011
General Business Applications Track	
Using LIFO for Soon-to-Be Filed 2010 Business Tax Returns ... Opportunities - Strategies - Problem Areas	3/8/2011
Changes in Accounting Methods (CAMs) with Emphasis on Form 3115 Preparation	8/18/2011
The LIFO (Last-In, First-Out) Inventory Method ... An Overview Course Covering All Business Applications	10/12/2011

On Demand Audio Recordings of each 3-hour program (which includes the detailed presentation outline and supplementary reference materials in PDF format) are available for purchase at www.krm.com/wjd.

CPE Certificates of Completion / Attendance Confirmation Certificates are *not* available in connection with the On Demand Audio Recordings of these presentations. These recordings are *not* currently available for purchase by individuals / firms who are residents of Illinois.

#3. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. This year, the AICPA Annual National Auto Dealership Conference was held at the Loews Royal Pacific Resort, Orlando, FL on October 20-21. About 350 attendees listened to speakers on a broad range of subjects.

As usual, Richard Sox provided an excellent update on dealer franchise legal issues. My report on the AICPA Conference begins on page 12.

#4. SECTION 263A ... LIFE AFTER THE SAFE HARBOR ELECTIONS. Over the past few years, we've followed and written about the IRS' interpretations of Section 263A to auto dealerships and the relief it finally has granted to most motor vehicle dealerships in the form of safe harbor protections that can be elected using the automatic change in accounting method procedures.

The materials on pages 22-29 provide a brief status report and two checklists.

Checklist #1 is intended to be useful in reviewing either past filings of Forms 3115s to make changes to elect the safe harbor methods or in connection with filing Forms 3115 if the change is to be made effective for 2011.

Checklist #2 is for evaluating dealership compliance with the Section 263A rules, particularly for dealerships which have operations and activities outside of the safe harbors.

#5. MISSED FORM 3115 FILING DATES REQUIRE EXTENSIONS. CPAs busy with the technical substantive matters involved in filing Forms 3115 to change to the cost capitalization safe harbor elections also must pay attention to several filing formalities.

The signed original of Form 3115 must be filed with the income tax return for the year of change. Also, a duplicate copy of the signed Form 3115 must be filed with the IRS National Office in Washington, DC when the original is filed with the tax return.

If these filing requirements are overlooked, but subsequently discovered, the proper course of action is to promptly request an extension of time to perfect these filings.

"Getting an extension" can be somewhat of an "ordeal" because it involves formally requesting a Letter Ruling from the IRS to grant the taxpayer permission to make the late filing ... usually 60 days from the date the extension letter is issued ... and paying a user fee for obtaining that permission.

If the taxpayer meets certain conditions, these rulings are permitted under Reg. Sec. 301.9100. Three Letter Rulings earlier this year involve taxpayers who found themselves in these circumstances. For a closer look at the Regulation and these Letter Rulings, see page 30.

#6. MANUFACTURER ASSISTANCE PAYMENTS TO DEALERSHIPS FOR FACILITY IMPROVEMENTS. In recent years, many manufacturers have introduced a variety of programs to stimulate or coerce their dealers into expanding or completely rebuilding their existing facilities. Usually, as an integral part of that activity, dealers are required to polish or "upgrade" the look and image of the dealership into something more aligned with the manufacturer's concept of an "ideal" dealership facility for the brand.

The manufacturers' activities and programs in this regard raise a number of legal, tax, accounting and practical issues for dealers and their advisors. The article (beginning on page 32) and the related materials focus primarily on the correct tax treatment of manufacturer payments and "reimbursements" to dealerships for facilities and image upgrades.

Special attention must be given to the General Motors' *EBE (Essential Brand Elements)* Program because of its more widespread application among the dealership universe and because of its unique features.

As indicated earlier (Item #1), I expect that the tax issues raised by these programs will become a new priority item requiring considerably more attention and published guidance by the IRS if there is to be any degree of consistency in the field.

#7. COVENANTS NOT TO COMPETE ARE SUBJECT TO 15-YEAR AMORTIZATION. The Timeline for April 2010 includes the Tax Court decision in *Recovery Group, Inc.* This case relates to franchise costs, dealership goodwill and other intangibles (including covenants not to compete) that are required to be amortized over a 15-year period by Section 197.

Recovery Group, Inc. unsuccessfully tried to distinguish its acquisition of a 23% interest (i.e., a minority interest) in the business via a stock redemption from the facts and holdings in *Frontier Chevrolet, Co.* ... which involved the acquisition of a 75% interest (i.e., a majority interest) in a dealership indirectly by a stock redemption.

The Tax Court held that covenants not to compete were required to be treated as 15-year amortizable property under Section 197. In addition, the Court declined to impose accuracy-related penalties against the company because it had reasonably relied on the CPAs for the company.

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On July 26, the Tax Court's decision in *Recovery Group, Inc.* was upheld by the U.S. Court of Appeals for the First Circuit. This confirms that under Sec. 197, the term "an interest in a trade or business" means ***any*** portion of the trade or business ... regardless of whether the situation involves a ***minority*** interest - or a ***majority*** interest - in the business.

For an analysis of *Recovery Group, Inc.* after it was affirmed by the First Circuit, see the discussion in the "Accounting" section of *Practical Tax Strategies*, Sept. 2011, pages 134-135.

For a more detailed analysis of this case before it was affirmed by the First Circuit, see *"Short-Term Covenant Not to Compete Can Cause Significant 'Book-to-Tax' Adjustments"* by Bruce M. Bird and Kathy Moffeit, in the *Journal of Taxation*, March 2011, pages 146-151. Or, see the "Tax Clinic" discussion in *The Tax Adviser*, April 2011, pages 214-217.

Frontier Chevrolet and several related cases have been discussed in previous Editions of the *Dealer Tax Watch*.

#8. REPORTING UNCERTAIN TAX POSITIONS TO THE IRS. The IRS' reporting initiative requiring ***certain*** corporation tax return filers to disclose *Uncertain Tax Positions* (UTPs) started in 2010. However, Schedule UTP only was required if the corporation had assets that equal or exceed \$100 million. This \$100 million threshold also applies to 2011.

For all other corporations, there is a 5-year phase-in of this reporting requirement based on the corporation's asset size. The reporting threshold is reduced to \$50 million, starting with 2012 tax years, and the threshold moves down to \$10 million, starting with 2014 tax years.

Accordingly, sooner or later, many dealerships will be required to file Schedule UTP. If the size of your dealership clients is close to these thresholds, you'll want to anticipate how these disclosures will be made if and when it becomes necessary to make them.

#9. MANUFACTURER BANKRUPTCIES & DEALERSHIP CLOSINGS ... WHAT REALLY HAPPENED? The saga continues. A little background, and now some further developments ...

2010 ... SIGTARP Report. On July 19, 2010, the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) issued its report entitled *"Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks."* (For more on this, see pages 4-5 of the Year-End 2010 *DTW*.)

The SIGTARP Report contained the findings of the Independent Office created in connection with the TARP (Troubled Asset Relief Program).

The Report concluded that General Motors and Chrysler (1) did not treat all affected dealerships consistently and (2) they did not consistently follow their own stated criteria. The Report also found that "dealership termination decisions were not based on GM's and Chrysler's cost savings estimates."

Page 5 of the Year-End 2010 *DTW* included information taken directly from the SIGTARP Report on the dealership performance measurement criteria that General Motors and Chrysler allegedly used.

About 40% of the General Motors dealers who were candidates for termination because they failed to meet GM's "performance criteria" (i.e., they were legitimate candidates for termination) were ***not*** terminated by GM. This is just one example of the "inequitable application" of these criteria by the manufacturers that Richard Sox reported in his Legal Update presentation at the AICPA Dealership Conference in 2010.

Quoting directly from the SIGTARP Report ...

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

2011 ... Class action "takings" suits by dealers. On February 17 of this year, a group of Chrysler dealers affected by Chrysler's bankruptcy in 2009 filed a class action suit against the United States of America in the U.S. Court of Federal Claims.

A few days later (Feb. 21, 2011), a group of General Motors dealers affected by General Motors' bankruptcy in 2009 filed a class action suit against the United States of America in the U.S. Court of Federal Claims. (In the last Edition of the *DTW,* it was incorrectly reported that these suits had been filed against the manufacturers; as a matter of fact, both suits were filed against the United States of America.)

Currently, these cases have not been decided and are moving slowly through the system.

Now ... "Outraged." Earlier this year, one dealer published her account of the actions taken by manufacturers in these bankruptcy proceedings. Her account is documented in *Outraged: How Detroit and the Wall Street Car Czars Killed the American Dream*, by Tamara Darvish (Vice-President of DARCARS Automotive in Maryland). A brief review of her book is in *Automotive News*, Nov. 14, 2011, on page 30.

DTW 2011 Timeline	*JAN. 1 TO DEC. 31, 2011 ... THE YEAR IN REVIEW*
January 10	• ***Revenue Procedure 2011-14*** revised and updated the procedures, including those for filing Forms 3115, for taxpayers making designated ***automatic*** changes in accounting methods. ◆ This Revenue Procedure included the Section 263A safe harbor elections for motor vehicle dealerships that can be made as automatic changes #150 and #151. ◆ This Revenue Procedure superseded 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 published 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 United States of America 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 United States of America 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 exempt automobile franchises from the application of Section 197(f)(1).
March 18	• In TAM 201111004, the IRS held 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 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 debt limit increase impasse. • Apparently, this is a follow-up to the President's proposal at the beginning of this year - as part of his "Greenbook" proposals - when he had 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.
July 26	• The Tax Court's decision in *Recovery Group, Inc.* (see April 15 - 2010 Timeline ... T.C. Memo 2010-76) was upheld by the U.S. Court of Appeals for the First Circuit (Docket No. 10-1886). • Both Courts held that a covenant not to compete is 15-year amortizable property under Sec. 197 and that "an interest in a trade or business" under Sec. 197 means ***any portion of the trade or business*** rather than its entirety.
**March 15, June 15, September 15 and/or October 15*	• These are due dates or extended due dates (depending on the entity reporting status) for calendar year 2010 dealership income tax returns electing to be covered under the Section 263A inventory cost capitalization safe harbor rules provided by Rev. Proc. 2010-44. • Also, these are the dates for filing the duplicate copies of Forms 3115 making these elections with the IRS National Office in Washington, DC.

DTW 2010 Timeline	JAN. 1 TO DEC. 31, 2010 ... THE YEAR IN REVIEW Page 1 of 4
Dec. 1, 2009 Released Early 2010	• In Field Attorney Advice (FAA) 20100501F, the IRS held that a Closing Agreement with a taxpayer did not prevent the IRS from challenging the same LIFO methodology for defining inventory "items" when those item definitions were used in later years.
Dec. 16, 2009 Released Early 2010	• ***The deduction for professional fees paid in the acquisition of a dealership was upheld*** by the Tax Court in its Supplemental Memorandum Opinion in *West Covina Motors, Inc. v. Comm.* • This case lays out a step-by-step approach for identifying and allocating such fees. ◆ *West Covina Motors, Inc.* was discussed in detail in the *DTW* last year ... This new development relates to only one of the three major issues in that case.
Jan. 1	• The Federal ***Estate Tax is repealed*** for decedents dying on or after January 1, 2010. ◆ This "hiatus" lasts only throughout calendar year 2010, with the previous Estate Tax exemptions and rates coming back into effect as of Jan. 1, 2011 ... unless Congress enacts some legislation to the contrary. ◆ In lieu of "Estate Tax," survivors receiving property from the decedent are limited to "carryover basis" which is the lower of the (1) decedent's cost basis or (2) fair market value as of the date of death ... subject to certain, limited increases. • All Gift Tax provisions, however, still remain fully applicable during 2010. • But see legislation enacted by PL 111-312 on December 17, 2010.
Jan. 26	• ***Uncertain tax positions*** will have to be disclosed in ***Schedule UTP*** which is to be included in Form 1120 income tax returns ... as a result of the IRS' new reporting initiative. ◆ This (Announcement 2010-9) impacts taxpayers with assets in excess of $10 million if they issue audited financial statements that reflect uncertain tax positions in connection with transactions reported in those financial statements. ◆ This initiative affects all Form 1120 filers, starting with returns filed for calendar year 2010.
March 19	• In *Robinson Knife Manufacturing Company, Inc.*, the U.S. Court of Appeals, 2nd Circuit reversed the Tax Court Memo Decision (TCM 2009-9) which had ruled in favor of the IRS. • The Court of Appeals held that the taxpayer's trademark royalty payments were based on sales and these payments were incurred only upon the sale of the tools manufactured by the taxpayer. Therefore, these royalty payments were immediately deductible and did not have to be capitalized into inventory under Section 263A. • Some of this discussion by the Appeals Court (relating to indirect costs that are properly allocable to property produced) might be pertinent to the current controversy between the IRS and auto dealerships over the application of Section 263A.
March 30	• ***Health Care & Education Reconciliation Act of 2010*** (P.L. 111-152) recognized the importance of the *Economic Substance Doctrine* by putting it into Code Section 7701(o). ◆ This allows the IRS to disregard any transaction a taxpayer enters into for which the taxpayer cannot demonstrate a proper business purpose. • The *Act* also imposes a "strict liability penalty" under Section 6662(b)(6). ◆ This penalty is 40% of the underpayment of tax attributable to a transaction lacking economic substance or failing to satisfy a similar rule of law. ◆ There is no reasonable cause exception or other means to avoid the penalty. ◆ The penalty is reduced to 20% if the relevant facts affecting the tax treatment of the questionable transaction are adequately disclosed on the tax return or on a statement attached to the tax return.
April 15	• *Recovery Group, Inc.* (T.C. Memo 2010-76) relates to the franchise costs, dealership goodwill and other intangibles (including covenants not to compete) that are required to be amortized over a 15-year period by Section 197. • The company unsuccessfully tried to distinguish its acquisition of a 23% interest (i.e., a minority interest) in the business via a stock redemption from the facts and holdings in *Frontier Chevrolet, Co.* which involved the acquisition of a 75% interest (i.e., a majority interest) in a dealership indirectly by a stock redemption. • The Tax Court declined to impose accuracy-related penalties against the company because it had reasonably relied on the CPAs for the company who were found to be "competent, fully-informed professionals" who were able to prepare its tax returns.

JAN. 1 TO DEC. 31, 2010 ... THE YEAR IN REVIEW

April 19	• ***Schedule UTP, Uncertain Tax Positions***, and lengthy, detailed Instructions for completing the Schedule were released in Draft form by the IRS. (Announcement 2010-30) • See Sept. 2010 ... IRS releases final version of Schedule UTP.
April 20	• ***A Massachusetts dealership successfully sued its former CPA firm for bad tax planning advice.*** ◆ The CPA firm did not face up to the necessity of advising the dealer/dealership that it had became liable for a fairly large built-in gains tax, *and then the CPA firm did not reflect that tax liability on the Form 7004 that it prepared for the dealership to file with the IRS.* • The case of *Haddad Motor Group, Inc. v. Karp, Ackerman, Skabowski & Hogan, PC* was tried in both the District Court and the U.S. Court of Appeals for the 1st Circuit.
May 10	• ***The IRS revised Form 3115 and Instructions for Form 3115.*** (Announcement 2010-32) • New revision date for both Form 3115 and Instructions is December 2009.
May 28	• Another suspension of the enforcement of the "Red Flags" Rule was announced by the Federal Trade Commission. This delay in enforcement will end on December 31, 2010. ◆ "Red Flags" require creditors and financial institutions to have identity theft prevention programs in place.
June	• Auto dealers were excluded from the sweeping legislation to overhaul the U.S. financial system by enacting new customer protection rules.
June 30	• ***IRS Business Plan Year ends*** ... with no action by the IRS on Section 263A inventory cost capitalization guidance, either in the form of a Revenue Ruling or a Revenue Procedure to assist dealerships in evaluating whether they should file Forms 3115 before December 31, 2010 to adopt the IRS positions in TAM 200736026.
July 19	• ***SIGTARP Report.*** The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) issued its report entitled *"Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks."* • Report findings state that the manufacturers did not treat all affected dealerships consistently and "dealership termination decisions were not based on GM's and Chrysler's cost savings estimates."
Summer	• Arbitration proceedings (mandated by Dec. 2009 legislation for terminated GM and Chrysler dealers) are commenced and finalized, with a few dealers having their franchises reinstated.
August 4	• As of Oct. 1, the Large and Mid-Size Business (LMSB) Division of the IRS becomes the Large Business and International Division (LB&I). • This change reflects the expansion, centralization and coordination of more IRS agents and activities involving compliance with international tax issues into this new unit. • The LB&I will continue to focus on corporations, S-corporations and partnerships with assets of more than $10 million and certain high-wealth individuals.
August 9	• ***Extension of IRS moratorium on raising Section 263A issues for automobile dealerships.*** • In *Tier III - Field Directive on the Planning and Examination of IRC Section 263A Issues in the Auto Dealership Industry #2*, dated August 9, 2010, the IRS extended the existing audit suspension period (i.e., the moratorium) until the date the IRS publishes guidance (on these Section 263A issues) in the *Internal Revenue Bulletin.* • The *Field Directive* explains the reason for the extension as follows... "The IRS Office of Chief Counsel is currently considering additional published guidance related to dealership IRC Section 263A issues. It is expected that the guidance will address many of the issues outlined in TAM 200736026 and will apply to various retail motor vehicle dealerships."
Sept. 2	• ***Form 8300 filings, penalties & recovery of costs.*** In *Bale Chevrolet Co.*, the Eighth Circuit Court of Appeals denied the dealership's request for reimbursement of litigation costs under Section 7430. ◆ The IRS had assessed a $100,000 *intentional disregard* penalty for failure to file Forms 8300 against the dealership. The dealership subsequently paid the penalties and then successfully challenged the assessment in District Court. In addition, the dealership sought to recover (from the IRS) its costs and attorneys' fees under Section 7430. ◆ Citing *Tysinger Motor Co.* (and other cases), the Eighth Circuit denied the recovery under Sec. 7430.

DTW 2010 Timeline	*JAN. 1 TO DEC. 31, 2010 ... THE YEAR IN REVIEW* **Page 3 of 4**
Sept. 15	• ***Registration of paid tax return preparers ... New PTIN registration requirements & restrictions*** • Initial on-line registration began on or about September 15, 2010. • Anyone who prepares all or substantially all of a return (or claim for refund) will be required to have a PTIN, regardless of whether they are required to sign the return. • Failure to provide a valid PTIN may result in penalties under Section 6695(c). • Eventually, all registrants for a PTIN will undergo an automatic suitability and compliance check.
September	• ***Schedule UTP, Uncertain Tax Positions.*** Final version of Schedule UTP with revised Instructions ... and liberalized provisions ... is released by IRS (IRS Announcement 2010-75). • A corporation must file Schedule UTP for 2010 if it has assets that equal or exceed $100 million. • For all others, there is a 5-year phase-in of the reporting requirement based on the corporation's asset size. • No reporting of the Minimum Tax Adjustment (MTA) is required. • In lieu of MTA computations, taxpayers are required to show the "Ranking of Tax Position." • A corporation is required to rank all of the reported tax positions based on the U.S. Federal income tax reserve (including interest and penalties) recorded for the position taken in the return.
Sept. 27	• ***Small Business Jobs Act of 2010*** (P.L. 111-240) includes several provisions that may benefit dealerships. Four key provisions are below. • For tax years beginning in 2010 and 2011 ... ◆ Section 179 expense limitation increases to $500,000, with a $2 million phase-out threshold. ◆ Qualified real property expensing limitation increases to $250,000. ◆ 50% bonus depreciation provisions are increased. • For 2011, the built-in gains holding period for an S-corporation is temporarily reduced from 7 years down to 5 years.
October	• Ford network changes ... Lincoln and Mercury... • ***Number of Lincoln dealerships downsized.*** Ford Motor Co. announces plans to eliminate at least 175 dealers from its Lincoln brand over the next two years. Reductions apparently will be focused in major metropolitan markets. ◆ Ford will meet with Lincoln dealers over the next 100 days to offer voluntary buy-outs. ◆ Many Lincoln dealerships that remain will be expected to upgrade their facilities. • ***All Mercury dealerships are to be completely eliminated by the end of 2010.***
Oct. 22	• De Filipps presentation at AICPA National Auto Dealership Conference in Phoenix, AZ. • *"The Practitioner's Nightmare - Uncertainty & Dealership Tax Issues: Opportunities & Pitfalls Lurking in Current Critical Tax Issues."*
Summer - Fall	• Form 8939, *Allocation of Increase in Basis for Property Received from a Decedent*, is required to be filed by executors to show allocation of carryover basis adjustments. • IRS issues *Draft* Form 8939 (3 pages), then realizes there are even more changes that might have to be reported on it, and subsequently withdraws the *Draft* Form 8939. • But see legislation enacted by PL 111-312 on December 17, 2010 which gives executors an election opportunity to avoid having to deal with carryover basis provisions.
November	• IRS publishes *Audit Technique Guide* dealing with the C2R ... Capitalization vs. Repairs ... Section 263(a) issues. • In January 2010, the IRS had released two IDD Directives regarding the importance of C2R issues.

JAN. 1 TO DEC. 31, 2010 ... THE YEAR IN REVIEW

Nov. 9	• *Section 263A issues.* Long-awaited guidance from IRS is published in Rev. Proc. 2010-44. • Motor vehicle dealerships will be allowed to use either or both of the safe harbor methods of accounting in order to elect or change their Sec. 263A accounting methods to ... ◆ Treat certain sales facilities as retail sales facilities for purposes of Section 263A, and/or ◆ Be treated as resellers without production activities for purposes of Section 263A. • Other Section 263A changes in accounting method to be considered w/r/t 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.
December 17	• ***The Tax Relief, Unemployment Reinsurance Reauthorization and Job Creation Act of 2010*** (PL 111-312) enacted. • ***Income tax provisions*** ◆ This legislation extends the "Bush-era" tax cuts and includes other significant income tax provisions affecting dealerships. ◆ Income tax rates extended for two years ... 2011 and 2012. ◆ Retains maximum 15% rate for long-term capital gains and qualified dividend income ◆ Alternative Minimum Tax (AMT) patch for 2010 and 2011 ◆ Social security payroll tax rates on individual (not the employer) reduced from 6.2% to 4.2%. ◆ Self-employment tax rate reduced from 12.4% to 10.4% for 2011 • ***Estate tax provisions*** ◆ This legislation also addresses (temporarily) the estate tax repeal affecting estates created by death during the year 2010. ◆ For estates created by death during 2011 and 2012, all three death-related taxes (gift tax, generation-skipping transfer tax and estate tax) have been unified. ◆ Exclusion amount is $5 million. ◆ Any of the $5 million estate and gift tax exclusion that is not applied against the asset value of the first spouse to die can be carried over and added to the $5 million exclusion of the surviving spouse ... i.e., the $5 million exclusion is *"portable."* ◆ Maximum estate tax rate for 2011 and 2012 is 35%. ◆ After 2012, the exclusions decrease back down to the previous legislation (*EGTRRA*) rates. • For estates created by death during 2010 (the year in which the estate tax was repealed), executors may elect to ... ◆ Pay no estate tax but subject all property in the decedent's estate to the carryover basis rules and provisions for inherited assets with more than $1.3 million appreciation (plus an additional $3 million for assets passed to the surviving spouse), ***or*** ... ◆ File Form 706 (as required under the "old estate tax regime") and pay an estate tax at the rate of 35% on the excess of the value of the decedent's assets over $5 million.

DTW 2009 Timeline	JAN. 1 TO DEC. 31, 2009 ... THE YEAR IN REVIEW Page 1 of 2
February 17	• ***American Recovery & Reinvestment Act of 2009 (ARRA)*** enacted. Includes significant provisions to reduce taxable income and expand ability of businesses to carryback net operating losses. Two major provisions affecting (some) dealerships... ◆ Net operating losses occurring in tax years beginning or ending in 2008 can be carried back for three, four or five years (instead of only two years) by election of the taxpayer. ▪ However, this applies only to businesses with average gross receipts of less than $15 million. ▪ Unfortunately, this beneficial provision excludes many, many dealerships, since they are "too big to be small," and are thus, ineligible. ◆ Section 179 expense/depreciation limits expanded and extended through 2009. ▪ Increase in Sec. 179 expense amount to $250,000 limit. ▪ Increase in phase-out threshold to $800,000.
April 30	• ***Chrysler bankruptcy.*** Chrysler files for protection under Chapter 11 of the U.S. Bankruptcy Code in the Southern District of New York. ◆ On May 14 ... 789 Chrysler dealers received letters telling them their franchises will be terminated. ◆ This impacts Chrysler, Jeep, Dodge and Dodge Truck dealers ◆ Initial filings indicate that Chrysler's bankruptcy proceedings are going to take the form of a sale of Chrysler's major assets under Section 363 of the Bankruptcy Code and a liquidation of a remainder of the Company. • See NADA web site (www.nada.org) for comprehensive information and a detailed timeline.
June 1	• ***General Motors bankruptcy.*** General Motors files for protection under Chapter 11 of the U.S. Bankruptcy Code in U.S. Bankruptcy Court in Manhattan (New York). • GM notifies 1,124 dealers that their franchises will not be renewed when they expire in Oct. 2010. ◆ GM intends to eliminate all Pontiac, Saab, Saturn and Hummer dealers. ◆ In addition, GM intends to eliminate more than 1,000 Chevrolet, Cadillac, Buick and GMC dealers. These dealers have received what are called "Wind-Down Agreements." • Those Chevrolet, Cadillac, Buick and GMC dealers that General Motors has determined it will allow to continue in operation will receive what are labeled "Participation Agreements." • See NADA web site (www.nada.org) for comprehensive information and a detailed timeline.
July 24	• ***Employee tool & equipment plans.*** Letter Ruling 200930029 holds that an employer's expense reimbursement arrangement satisfies the accountable plan requirements of Sec 62(c). ◆ The employer in this Ruling is not an automobile dealership. ◆ The plan involved is basically a dollar-for-dollar reimbursement arrangement.
August 17	• ***LIFO terminations ... IRS guidance on spread period for dealership recapture of LIFO reserve when election is terminated due to loss of franchise.*** IRS issues guidance on Section 481(a) adjustments and spread periods when dealers who lose their franchises terminate their LIFO elections. • In ILM 200935024 (dated August 17, 2009), the agent was questioning whether the usual 4-year spread period for the Section 481(a) adjustment resulting from the termination of the LIFO election should be accelerated because the dealership no longer had new vehicle inventory specific to the franchise that was terminated. Three situations were addressed. ◆ In the first two fact situations in the ILM, the dealership involved was not using the Alternative LIFO Method for new vehicles. Instead, this dealership was using a separate LIFO pool for the new vehicles for each ***franchise*** ... the dealership had 5 different franchises, and it had 5 separate LIFO pools. ◆ The third fact situation seems to provide a "blueprint" that might be beneficial to certain dealerships that have lost their franchises. The IRS guidance in this case may help them to stay on LIFO for some of their new vehicle inventories, while losing only the benefit of the LIFO reserve attributable to the lost franchise.
August 27	• ***More accounting method changes become automatic.*** Revenue Procedure 2009-39 updates the official list of automatic accounting method changes in the Appendix to Rev. Proc. 2008-52. • It also includes a few Sec. 263A definition clarifications.

DTW 2009 Timeline	***JAN. 1 TO DEC. 31, 2009 ... THE YEAR IN REVIEW*** Page 2 of 2
September 15	• ***IRS declares 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 IDD (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.
November 6	• ***Worker, Homeownership and Business Assistance Act of 2009 (WHBA)*** amended Code Section 172(b)(1) to allow dealerships a greater opportunity to benefit from current net operating losses. • *Net operating loss carryback relief expanded to include all dealerships.* All businesses, including dealerships, may carryback losses incurred in 2008 or in 2009 for up to 5 years preceding the year of the net operating loss. ◆ Under the *ARRA* legislation (Feb. 17), most dealerships would not have qualified for relief. • ***Limitation:*** Any loss carried back under *WHBA* to the 5^{th} preceding year cannot offset more than 50% of the income in that 5^{th} preceding year. ◆ However, the excess of the amount of loss over 50% of the taxable income for the carryback taxable year can be carried to the other later taxable years. • Revenue Procedure 2009-52 provides all of the details for making these elections, timely filing requirements and forms required to be filed.

DTW 2008 Timeline	***JAN. 1 TO DEC. 31, 2008 ... THE YEAR IN REVIEW***
Feb. 25	• Cost Segregation (depreciable asset lives) for dealerships is addressed comprehensively in a new chapter added to IRS *Audit Technique Guide.*
March 4	• U.S. Court of Appeals for the 6^{th} Circuit affirmed Tax Court decision in *Huffman, et al.*, allowing IRS to change accountant's errors in LIFO calculations by making a Section 481(a) adjustment to the dealership's earliest open year.
March 8	• ***Revenue Procedure 2008-23.*** IRS permits dealerships to use a single, combined LIFO pool for all new vehicles ... and/or for all used vehicles (Rev. Proc. 2008-23). ◆ Alternatively, IRS clarifies how new and/or used crossover vehicles should be treated by dealerships if they do not elect to use the single, combined LIFO pool method.
April 2	• In *Irwin Muskat v. U.S.A.*, IRS prevails in District Court, and taxpayers who sold their business are not able to prove that $1 million of the proceeds received under a non-compete agreement were really allocable to goodwill that they sold in connection with their business.
April 16	• In *Solomon v. Comm.*, IRS prevails in Tax Court, and the individual sellers of a portion of their business are not successful in claiming that a portion of the proceeds received were received for the sale of customer lists (which should have been taxed as long-term capital gain). ◆ Instead, amounts received were attributable to the sellers' covenants not to compete, and therefore, they were taxable as ordinary income.
May 7	• IRS Chief Counsel's Office issues Memo No. 200825044 ... Guidance on Combining Pools Under Rev. Proc. 2008-23 Vehicle-Pool Method ... potential problems with IRS approach
July 2	• ***Employee tool & equipment plans*** ... IRS issues Coordinated Issue Paper for the Motor Vehicle Industry (based upon Chief Counsel Advice issued in late 2007) ... LMSB-04-0608-037
August	• ***Revenue Procedure 2008-52.*** IRS revises and updates procedures for taxpayers to secure designated automatic changes in accounting methods (Rev. Proc. 2008-52). ◆ The Rev. Proc. includes an updated list of all changes eligible for "automatic change" treatment. Effective for Forms 3115 (*Change in Accounting Method*) filed after Aug. 18, 2008. ◆ Note: Rev. Proc. 2011-14 (Jan. 10, 2011) revised and updated Rev. Procs. 2008-52 and 2009-39.

2011 AICPA NATIONAL AUTO DEALERSHIP CONFERENCE REPORT

This year, the AICPA Annual National Auto Dealership Conference was held at the Loews Royal Pacific Resort, Orlando, FL on October 20-21. About 350 attendees listened to speakers on a broad range of subjects.

Unfortunately, again this year, the AICPA did not tape any of the Conference presentations. In the past, we've had the benefit of being able to go back and listen to the presentations to reinforce our initial hearing of the material. Not anymore.

UPDATE FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

This just didn't happen.

This year, the usual and much anticipated presentation by Terri Harris did not take place because she was unable to attend.

Many attendees told me that they were eagerly looking forward to hearing what Ms. Harris would have to say concerning the IRS position on proper tax treatment by dealerships for payments received from the manufacturers under their various and sundry facility improvement and image upgrade programs.

Not to worry ... At this time, there is no IRS guidance specific to this issue for auto dealerships.

About two weeks before the Conference, I was asked to fill in the time spot that had been allotted for the IRS Update. Since a separate tax panel discussion was also on the agenda, to avoid duplication of topics, my presentation was entitled *Tax Update, LIFO Issues & Tax Treatment of Manufacturer Payments to Dealerships for Facility Improvements & Upgrades.*

I'll skip a discussion here of my comments on manufacturer assistance payments because my presentation was condensed to fit into about 30 minutes, and it basically was a "short form" version of a portion of the materials in this Edition of the *DTW.*

LIFO UPDATE ... EMPHASIS ON COMPLIANCE WITH THE FACTORY FINANCIAL STATEMENT CONFORMITY REQUIREMENTS

In the LIFO Update portion of my presentation at the Conference, I discussed the importance of carefully following through on all aspects of the financial statement conformity requirements relating to year-end statements sent to the manufacturers. These requirements apply to the 12th month statement and, if issued, also to the 13th statement sent by the dealership to the manufacturer and/or to the credit/financing corporation.

Over the years, some dealership controllers and/or their CPAs may have become lax in complying with the requirement that, in all year-end statements to the manufacturer, the actual change in the LIFO reserve should be reflected as a reduction (or an increase) in net income.

This means that the change in the LIFO reserve ... or the adjustment of a year-end projected amount →

Conference Report — ***2011 AICPA National Auto Dealership Conference***

to the actual amount of the LIFO reserve change for the year ... should ***not*** be charged directly against retained earnings. Furthermore, and specifically, this adjustment (from the projected change amount to the actual change amount) should ***not*** be included as an adjustment in the monthly statement for January or for February of the following year.

"At a Glance" Flowchart. As a visual reminder to emphasize this, I included the ***financial statement conformity flowcharts*** that I developed many years ago.

These flowcharts were originally developed in 1995 (i.e., before the IRS issued Revenue Ruling 97-42). This was at the height of the controversy with the IRS over conformity violations in statements sent by dealers to the manufacturers and to the credit corporations.

In 1995, the IRS issued Private Letter Rulings which required the termination of auto dealers' LIFO elections because the dealerships failed to satisfy the financial statement conformity requirements in the year-end reports they were required to send to their manufacturers. Although these letter rulings were non-precedential, there was no doubt that the IRS was taking a hard line against any dealer who was not properly reflecting LIFO adjustments in its Factory statements.

Two years later, in Revenue Ruling 97-42, the IRS held that LIFO users must reflect the projected and/or actual change in the LIFO reserve for the year as a charge against (or as a credit to) income ***in the income statement***.

If the projected change in the LIFO reserve for the year is reflected on the 12th statement, the net amount to adjust from the projected change to the actual change for the year must be reported on the 13th statement ***as a charge against (or as a credit to) income***.

Rev. Rul. 97-42 indicates that the LIFO change may be reflected as an adjustment to either the *Cost of Goods Sold* account or to *Other Income* or *Other Deductions* accounts. An adjustment to any of these accounts flows directly to the net income line in the Income Statement.

Interpreting the Flowcharts. In the flowchart for calendar-year dealerships, there are three boxes (and in the flowchart for fiscal-year dealerships, there are four boxes) where references are made to reflecting the amount of a LIFO adjustment ... "In the *CGS* (*Cost of Goods Sold*) section of the Income Statement."

As a result of the IRS' more liberal holdings in Rev. Rul. 97-42, the LIFO change adjustment(s) to reflect the actual or projected amount of change in the LIFO reserve for the year can be made in the *Other Income* and/or in the *Other Deductions* accounts (instead of being made in the *Cost of Goods Sold* section).

Accordingly, when interpreting these flowcharts now, all references in the flowcharts to the *CGS* account would be expanded to read ... "In the *CGS* section ***or*** in the *Other Income **or** Other Deductions* accounts." This is stated in the very small print in the rectangular box near the center of each flowchart.

These flowcharts, updated with notation to reflect Rev. Rul. 97-42, appear on pages 14-15.

In my Conference presentation, I also briefly discussed other LIFO topics including: (1) How Does (Might) a Dealer's Loss of a Franchise Affect the Dealership's LIFO Calculations? (2) How Much Longer Will LIFO Be Around? (3) Formation of LLCs Creates Traps for Dealerships with LIFO Elections and (4) Section 263A Cost Capitalization Safe Harbor (Rev. Proc. 2010-44) Election Issues.

TAX PANEL Q & A SESSION

The Tax Panel this year consisted of Steve Bedell (Crowe Horwath), Robert Kouza (Plante & Moran), Matt Solomon (Moss Adams LLP) and Sid Tobiason (Moss Adams LLP). I was also asked to participate in the Panel on Friday because there were a number of questions from my presentation on Thursday which my limited time did not allow me to answer.

Each member of the Panel had significant discussion materials on a wide range of topics including (1) Section 263A UNICAP and Rev. Proc. 2010-44, (2) the provisions of the 2010 Tax Relief/Job Creation Act, (3) tax planning for dealership facility expenditures, (4) franchise terminations and worthless goodwill, (5) proposed IRS Regulations on offshore insurance captives and (6) IRS audit activity, exams and notices.

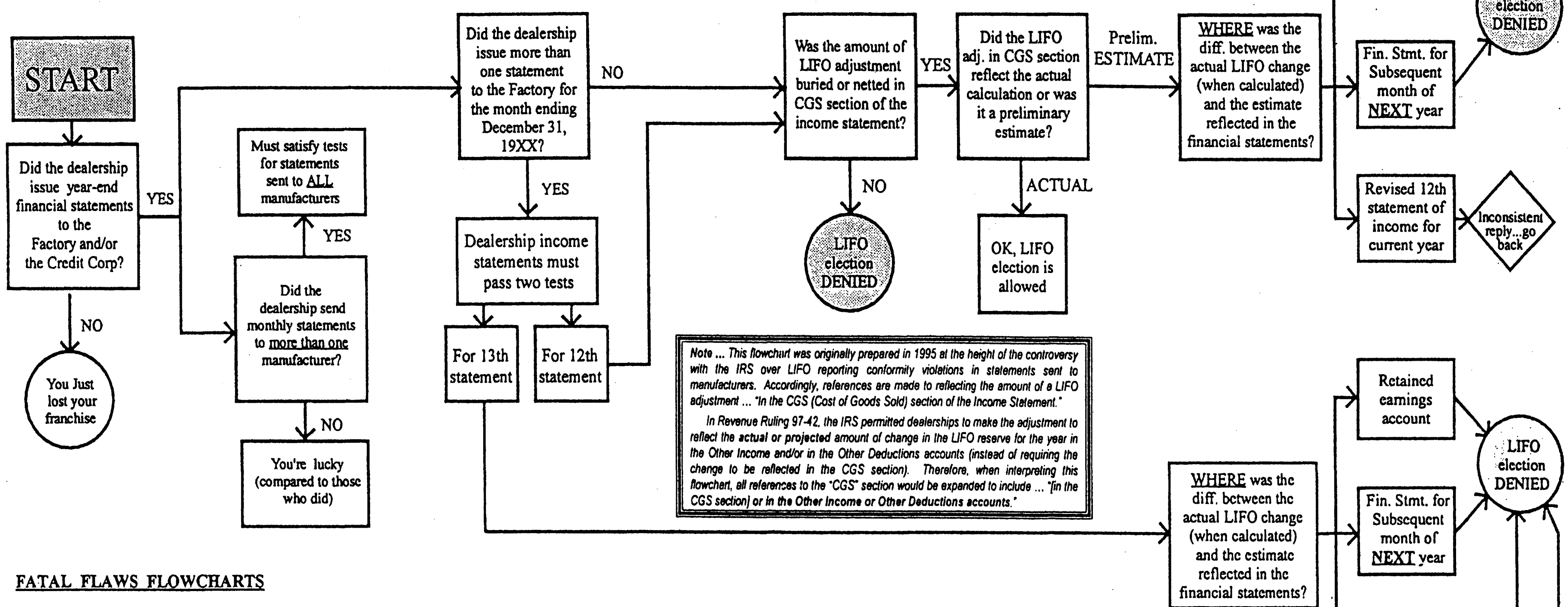
The section on tax planning for dealership facility expenditures included (1) cost segregation studies and related planning, (2) the energy efficient commercial building deduction, (3) capitalization vs. repairs expense for facility expenditures, (4) qualified leasehold and qualified retail improvements and (5) the selection of the appropriate entity for funding dealership construction and improvement projects.

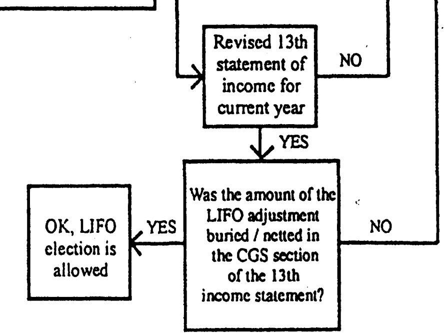
Considerations in selecting the appropriate entity to fund construction projects will depend on several factors. These factors include (1) terms or other conditions in existing legal contracts and (2) in cases where there are options, tax deductions and their deductibility or potential limitations on their deductibility because of the passive *activity* and/or passive *loss* rules (Sections 465 and 469, respectively).

see **AICPA CONFERENCE REPORT**, page 16

CALENDAR YEAR DEALERSHIPS

LIFO CONFORMITY REQUIREMENTS FOR YEAR-END FACTORY STATEMENTS



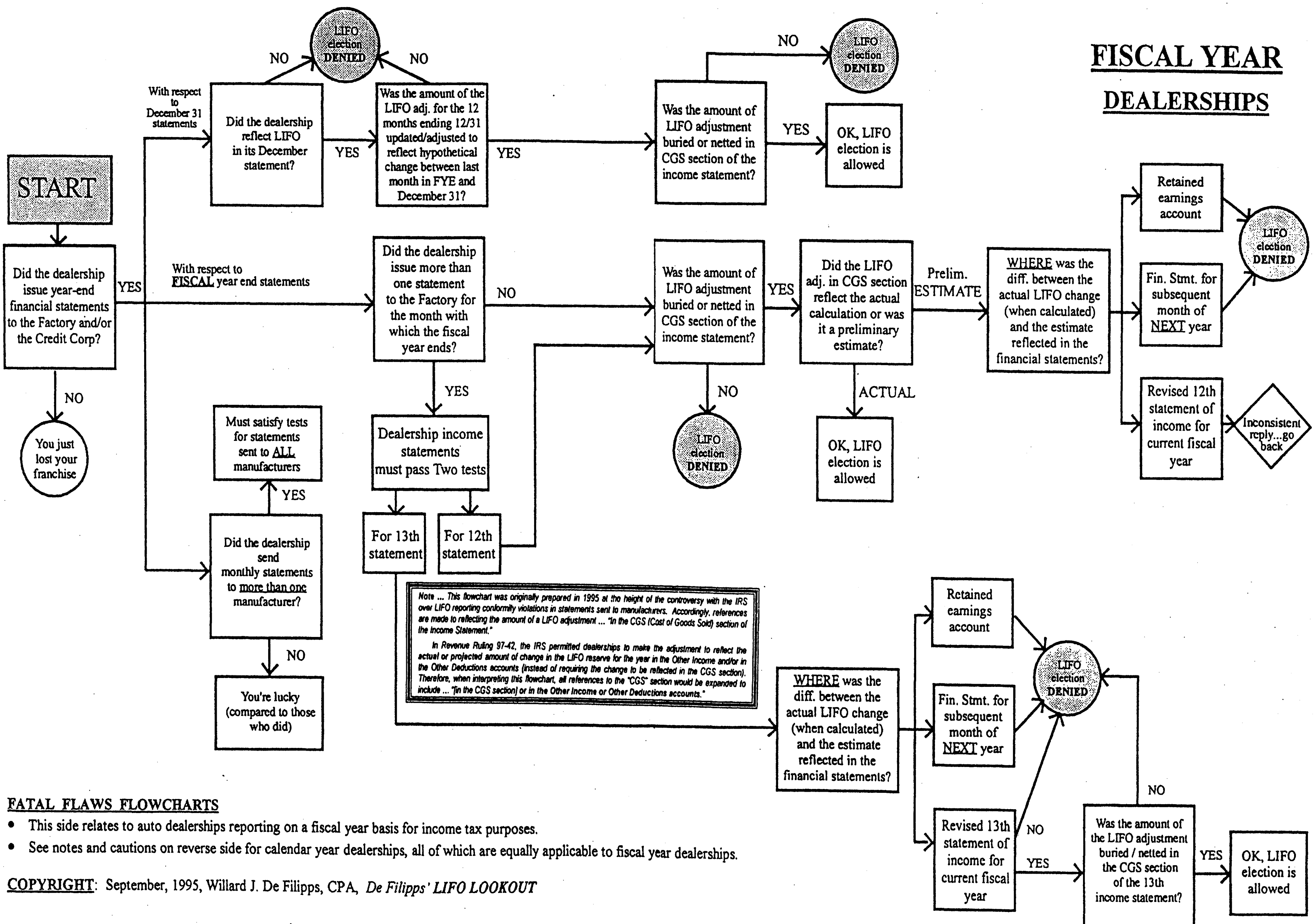


FATAL FLAWS FLOWCHARTS

- **This side relates to calendar year auto dealerships.** See reverse side for fiscal year dealerships.
- **Multi-Franchise Dealers:** LIFO adjustments must be reflected in the year-end income statements submitted to each different manufacturer.
- **New, Used and/or Parts on LIFO:** LIFO adjustments must be computed (or estimated) and properly reflected in the dealership's year-end income statements **for each different class of goods subject to a LIFO election.**
- **Preliminary** or **Estimated** calculations should be based on reasonable assumptions, documented and saved for review.
- CAUTION: These flowcharts summarize the LIFO conformity requirements as the IRS appears to interpret them (as of September, 1995) with respect to the financial statements prepared by auto dealerships on Factory-prescribed formats and sent to the manufacturer and/or to the manufacturer's credit corporation affiliates. **IRS interpretations may change without notice at any time.**

  Although these flowcharts are intended to be helpful in determining the consequences of various LIFO reporting conformity situations, they may not be appropriate in all cases. You must have a thorough understanding of the LIFO conformity regulations and of the IRS official and unofficial interpretations of them, and of the dealership's specific reporting practices to the Factory, in order to determine whether the reporting situation is within the scope of either flowchart summary.

FISCAL YEAR
DEALERSHIPS



FATAL FLAWS FLOWCHARTS

- This side relates to auto dealerships reporting on a fiscal year basis for income tax purposes.
- See notes and cautions on reverse side for calendar year dealerships, all of which are equally applicable to fiscal year dealerships.

(Continued from page 13)

DEALERS DROWNING IN FEDERAL REGULATIONS

Paul Metrey is the Chief Regulatory Counsel - Financial Services, Privacy, and Tax for the National Automobile Dealers Association (NADA). His presentation *"Keeping Pace with the Regulatory Onslaught,"* covered just the tip of the iceberg of new Regulations and requirements that affect dealerships starting in 2011.

Among other topics, Mr. Metrey discussed the *Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010* which has many provisions that became effective during 2011.

Provisions taking effect on July 21, 2011 include those affecting (1) small business credit applications (Section 1071) and (2) new disclosures applying to Adverse Action Notices and Risk-Based Pricing Notices (Section 1100F). On June 23, 2011, the Federal Reserve Board proposed temporarily exempting motor vehicle dealers subject to its jurisdiction from the Section 1071 requirements.

Mr. Metrey also described NADA's active involvement with the Federal Trade Commission's Motor Vehicle Roundtables. The formal name for these sounds a warning ... *"Public Roundtables: Protecting Consumers in the Sale and Leasing of Motor Vehicles"* ... Project No. P104811.

The new Customer Financial Protection Bureau, under the *2010 Dodd-Frank Financial Reform Law*, has the authority to regulate auto lenders, but in practice, it may not have much authority over franchised dealers.

Under the law, the FTC has increased rule-making authority over auto dealers, and the stated purpose of the Roundtables is to gather information and viewpoints from the public that will assist the FTC in making determinations concerning what additional action, if any, may be needed to regulate the sale and financing of motor vehicles at dealerships.

NADA's letter to the FTC re: "Roundtables." In a comprehensive 10-page letter dated April 11, 2011, NADA provided comments on a number of matters which are the subject of the Roundtable discussions. On the very first page, NADA expressed the perspective from which its comments were being made.

After stating that NADA welcomes the opportunity to work with the FTC and members of the public, its letter continues ... "However, NADA objects to the ***unbalanced and hostile view*** that the notice exhibits towards dealer-assisted financing and to the extent to which it seeks to examine issues that are not germane to the underlying basis for the Notice, which is the authority the Commission will soon assume 'to prescribe rules ... with respect to unfair or deceptive acts or practices by motor vehicle dealers'."

In a footnote to this, NADA states ... "The fifteen sets of questions contained in the Notice consist largely of a series of leading questions that adopt pejorative terminology and suggest the answers they are seeking."

NADA's letter of comment was reproduced as a supplement to Mr. Metrey's presentation. An outline of the letter appears on the facing page. If you are interested, you can obtain a copy of Mr. Metrey's presentation by directly requesting this material from him (pmetrey@nada.org).

AUTO DEALER FRANCHISE LEGAL UPDATE

In my opinion, the highlight of the Conference continues to be the discussion of dealer legal/franchise issues by Richard N. Sox, Esq. His presentation again this year was excellent.

Mr. Sox again emphasized ... as the single most important point in his presentation ... the importance of having a written record of response to each and every communication the dealer receives from the manufacturer. He said every manufacturer maintains a file and keeps a record of every communication that it has sent to the dealer. He warned that dealers should not trust or rely on any oral assurances they receive from their manufacturer's representatives that the dealer will be treated fairly and/or that the dealer should not (or does not need to) "worry about" any particular details.

Therefore, Mr. Sox advised that for each and every communication the dealer receives from the manufacturer, the dealer should prepare and promptly reply with an appropriate written, factually-documented response from the dealer back to the manufacturer. Dealers should seek the assistance of experienced dealer counsel in preparing these replies.

Dealers should continue to "paper the file."

Mr. Sox's material superbly reflects the extensive litigation and representation services that his firm (Bass Sox Mercer, previously Myers & Fuller) provides for dealers and dealer associations.

A summary of his Conference presentation this year (including his PowerPoint slides which are reproduced with his permission) begins on page 20. His comments regarding manufacturer facility programs are on page 38.

see **AICPA CONFERENCE REPORT**, page 18

More Dealer Regulation?

MOTOR VEHICLE ROUNDTABLE ISSUES

NADA LETTER TO THE FEDERAL TRADE COMMISSION ... APRIL 11, 2011

In a comprehensive 10-page letter, NADA recently submitted comments to the FTC concerning its increased rule-making authority over auto dealers. This increased authority results from the 2010 Dodd-Frank Financial Reform Law.

NADA's comments on these Roundtable topics are intended to assist the FTC in making determinations concerning additional actions that may be needed to regulate the car buying and financing process.

Topics Discussed in NADA Letter

I. Appropriate Basis For Exercising Unfair or Deceptive Acts or Practices (UDAP) Rulemaking Authority

   a. Issues Relevant to the Exercise of the UDAP Rulemaking Function
   b. Record Upon Which UDAP Rulemaking Should be Based

II. Overview of Dealer-Assisted Financing

   a. Respective Functions of Dealers and Their Finance Sources
   b. Explanation of the Components of the Rate Offered to the Consumer ... see below *
   c. Payment of Dealer Participation
   d. Conditional Sales Agreements
   e. Disclosure of Credit Terms

III. Industry Efforts to Educate Consumers About Vehicle Financing

IV. The Benefits of Dealer-Assisted Financing

** Components of the Retail Rate Offered to the Consumer (NADA Letter pg. 5 of 10)*

The retail rate that is offered to the consumer in dealer-assisted financing transactions (also known as the 'annual percentage rate' or 'APR') reflects the separate functions performed by the finance source, in its capacity as the credit underwriter, source of the funds, and servicer of the finance contract, and the dealer, in its capacity as the retail distributor of the finance product.

It (i.e., the ***retail rate***) consists of a ***wholesale rate*** (known as the ***'buy rate'***) that is established by the finance source and a ***retail margin*** (known as ***'dealer participation'***) that is established by the dealer.

The buy rate includes the risk premium, along with the finance source's costs of funds, loan production and servicing costs, and a return on investment on its costs.

The dealer participation consists of the dealer's loan distribution costs and a return on investment on its costs.

The wholesale and retail elements of the retail rate outlined above exist in every automobile finance contract, whether they are divided between two parties (as in the case of dealer-assisted financing) or they are handled by a single party (as in the case of a direct loan from a bank or credit union).

The amount charged by the dealer cannot be avoided by seeking financing directly from the dealer's finance sources as, in the absence of the function performed by the dealer, the finance source would be required to erect a retail distribution network for its products that would prevent it from being able to offer, on a sustained basis, financing to consumers at the wholesale buy rate that it provides to the dealer. Nor can the amount charged by dealers be avoided by seeking financing directly from a bank or credit union as each must build its retail distribution costs into its pricing structure.

Consequently, it should come as no surprise that dealer-assisted financing, which must compete with these alternative finance sources in an intensely competitive market, is chosen by millions of consumers each year.

(Continued from page 16)

EXPENSE CONTROL FOR DEALERSHIPS ... SERVICES MERITING YOUR FURTHER INVESTIGATION

At the Conference, I had the opportunity to talk at length with representatives from the K.C. Automarine Group, Messrs. K.C. Burke, Ryan Kleinjan and Brendan Reardon. I was impressed with the two services they provide for auto dealerships.

One of their services involves purchasing expense management and control. This service is offered through Performance Management Group (PMG) which offers *Spend Management Support* to the Automotive and Heavy Truck Dealership industry. PMG's reports analyze all of a dealership's spend categories from A to XYZ (Advertising to Window Washing). From this analysis, PMG determines a dealership's "average spend," "average suppliers," "benchmark savings percentages" and "saving opportunities." This provides the template from which PMG and the dealership's personnel can work together to reduce purchasing costs and to increase efficiencies in the dealership's purchasing processes.

PMG has historically helped its clients realize an average of 23% cost savings while freeing their internal staff to focus on the dealership's guests and top-line focused activities. PMG has served over 700 dealerships in various analytical capacities, and it currently is working with 400 dealerships as their strategic Spend Management partner.

More information describing PMG's expense management and control surveys and dealership savings reports can be obtained by contacting Ryan Kleinjan, Manager New Business Development, 10812 Nesbitt Avenue South, Bloomington, MN 55437, office: 952-746-8034, cell: 651-338-1260, e-mail: rkleinjan@pmgpurchasing.com, www.pmgpurchasing.com.

The other service involves providing cost savings to dealerships by reviewing and strategically reducing their energy consumption.

"Utility Utilizers" conducts surveys and ultimately provides significant solutions for dealerships to reduce energy and utility costs. Dealership savings result from "utilizing existing infrastructure with affordable energy products to maximize utility efficiency."

Benefits include (1) reduced energy consumption, (2) increased electrical system efficiency, (3) time reductions in maintenance and down time and (4) longer equipment life.

More information describing *"Utility Utilizers"* and sample surveys and dealership savings reports can be obtained by contacting Brendan Reardon, 613 Main Street, Delafield, WI, 53018, phone: 612-221-8772, e-mail: brendan@utilityutilizers.com, www.utilityutilizers.com.

NEW INCOME TAX RETURN DISCLOSURES FOR CERTAIN DEALERS TO REPORT FOREIGN FINANCIAL ASSETS

Greg Petrowski, an attendee who was not a speaker at the Conference, has considerable experience in the area of advising dealers with regard to their offshore reinsurance companies. During our conversation, he called my attention to the new disclosure requirements for U.S. shareholders of foreign corporations and how this will affect the preparation of the 2011 income tax returns for some auto dealers.

Greg has summarized these requirements in the article on the facing page. This emphasizes the need for dealers who are subject to these reporting requirements to file Form 8938 with their 2011 income tax returns.

Form 8938

STATEMENT OF SPECIFIED FOREIGN FINANCIAL ASSETS
(DRAFT AS OF JUNE 21, 2011 ... 2 PAGES)

- Identification of entity or individual filing Form 8938.
- *Part I - Foreign Deposit and Custodial Accounts* ... Identification of type of account, dates regarding accounting opening/closing, maximum value, foreign currency, financial institution where account is maintained, etc.
- *Part II - Other Foreign Assets* ... Description of asset, dates acquired and/or disposed of, maximum value, applicable foreign currency exchange rates, identification of foreign entity if "other foreign asset" is an investment in a foreign entity, etc.
- *Part III - Summary of Tax Items Attributable to Specified Foreign Financial Assets* ... For (1) foreign deposit and custodial accounts and for (2) other foreign assets ... the type of tax item, the amount reported on the form or schedule, and the tax form or tax schedule (with line item) where amount is reported.
- *Part IV - Excepted Specified Foreign Financial Assets* ... Identification of other specified foreign financial assets reported on other forms (3520, 3520-A, 5471, 8621 and/or 8865) in which case, information on those assets is not required to be reported on Form 8938.

Form 1040 Filing Alert

NEW DISCLOSURE REQUIREMENTS FOR US SHAREHOLDERS OF FOREIGN CORPORATIONS

By Greg Petrowski, CPA

In 2010, the *Hiring Incentives to Restore Employment Act* (*HIRE Act*) created Section 6038D of the Internal Revenue Code: *Information with Respect to Foreign Financial Assets.* This Section requires US persons to file disclosures annually with their personal tax returns if they own "specified foreign financial assets" and the value of those assets exceeds the threshold for their filing status.

Specified foreign financial assets include: accounts maintained at foreign financial institutions, stock or security issued by a foreign corporation, any financial instrument held for investment, etc. ***From an automobile dealer perspective, this may include stock ownership in an offshore reinsurance company.***

The married filing jointly value threshold is if the aggregate value of all specified foreign financial assets exceeds \$100,000 at December 31st or \$200,000 at any point during the tax year (\$50,000 or \$100,000 respectively for single filers).

Value is generally the fair market value of the asset. The draft instructions for Form 8938 give several examples of sources of value such as periodic account statements, reported stock process for publically traded securities, and based on distributions received from foreign trusts.

The disclosure requirements vary by the type of assets. For all assets the maximum value of the asset during the year must be disclosed. Generally the information necessary to identify the instrument and the names and addresses of the issuers, counterparties, or financial institution must be disclosed.

The IRS has created Form 8938 to facilitate these disclosures. Draft copies of the Form 8938 and related instructions are available at http://www.irs.gov/businesses/corporations/article/0,,id=236667,00.html.

These disclosures are not required for shareholders of offshore reinsurance companies with valid IRC Section 953(d) elections. This election effectively changes the status of the offshore company to domestic for Federal income tax purposes. Most dealer-owned offshore reinsurance companies make this election and file annual Federal income tax returns.

Failure to comply with these new requirements can result in an extension of the statute of limitations and fines starting at \$10,000, with additional penalties related to underpayment of taxes on income related to specified foreign financial assets.

Section 6038D is effective for the 2011 tax year. Therefore, the Form 8938 would need to be filed with the dealer's personal 2011 tax return due in April, 2012.

Every dealer who owns stock in an offshore reinsurance company should consult his or her tax advisor regarding the possible application of the new reporting requirements to his or her specific facts and circumstances.

For further information, Mr. Petrowski can be reached at GPW and Associates, Inc., 2700 N. 3rd Street, Suite 3050, Phoenix, AZ 85004. Phone (602) 200-6924, E-mail: gpetrowski@gpwa.com. Web: www.gpwa.com

Dealer-Manufacturer Issues	**AUTOMOBILE DEALER FRANCHISE LEGAL UPDATE** ***2011 AICPA Conference Presentation by Richard N. Sox, Esq.*** Page 1 of 2
Add Point Activity	• Volkswagen, Kia and Hyundai are aggressively adding dealerships ◆ Based on the expectation of continuing market share growth ◆ What about latest economic predictions? • Dealers must exercise right of protest to protect franchise investment ◆ Dealers will benefit from stay of the addition of new point ◆ Dealers should ***not*** get lulled into promises by Manufacturer Representative that existing dealer will be taken care of or threat that protesting dealer will be punished • Settlement will be a benefit to protesting dealer(s) ◆ Withdrawal of proposal for new dealership, cash, additional vehicle allocation, LOI, etc. • Reasons add point may not be justified ◆ Increase in market share was result of Japanese disaster creating a temporary imbalance from which Toyota and Honda will recover ◆ Continuing stagnation in the economy ◆ Recent major capital expenditures by existing dealers ◆ Increase in expected sales does ***not*** correlate into need for additional dealerships (see GM and Chrysler bankruptcy examples - too many dealers weakens dealers' profitability)
Sales Performance Warnings	• Volkswagen and Honda sending out warnings and Notices of Default • GM required dealers to be at 85% of Retail Sales Effectiveness (RSE) by December 2011 ◆ Not likely to enforce due to severe lack of dealership inventory and recent changes in dealer's areas of responsibility • Dealers must respond aggressively ◆ Describe ***unique*** market conditions ◆ Lack of vehicle allocation ◆ Flaws in performance calculation ◆ List recent major capital expenditures and the need for time to allow dealer to realize a return on that new additional investment ◆ Indicate the dealer's unwillingness to sell at prices below acceptable margins ◆ Indicate dealer's awareness of his or her franchise protections and intention to use them • Dealer response should describe specific plans for increasing sales ◆ Increase in advertising expense, media exposure, etc. ◆ Change in pay plan ◆ Changes in management personnel, team, etc. ◆ Follow through with plan • Don't miss deadlines for filing written protests in response to manufacturers' ◆ Notices of Default, Notices of Threatened Termination under franchise laws, etc. ◆ Do ***not*** accept manufacturer representative statements that dealer won't really be terminated
Facility Programs	• This information is included with the article *Manufacturer Assistance Payments to Dealerships for Facility Improvements*
Lincoln	• Pressing stand-alone Lincoln dealers to sell-out • Starving stand-alone Lincoln dealers of vehicles • Instituted allocation program favoring urban dealers ◆ Franchise laws protect dealers from discriminatory allocation ◆ Dealers must document need for inventory and lose customer sales ◆ Make formal demand for additional product
Mercury	• Litigating unilateral termination of Mercury franchise • Profitable dealers have viable claim for damages from loss of franchise (but not many Mercury dealers were profitable)
Retail Reimbursement for Warranty Work	• 25 states have passed laws requiring reimbursement for parts and labor used in warranty work to be paid at the equivalent of the dealer's <u>retail rates</u> • Most states provide a specific formula for calculation of retail (excludes discounted items) • Results in <u>significant</u> increase in monthly <u>profit</u> • Mfgs are begrudgingly complying...Nissan and GM threatening invoice surcharge to recover costs • Mfgs sued Florida arguing that requirement to pay retail and "no surcharge" provisions are unconstitutional

AUTOMOBILE DEALER FRANCHISE LEGAL UPDATE

2011 AICPA Conference Presentation by Richard N. Sox, Esq.

Recent Franchise Law Changes

Termination Protections	• Traditionally required good cause to termination • Recent changes: ◆ Clarify that a linemake termination is not considered a termination for "good cause" ◆ Require that a successor distributor or manufacturer offer franchise to existing dealers ◆ Require payment of fair market value of franchise in the case of a termination without cause (FMV calculation done as of 12 months prior to termination) ◆ Require that a dealer who is terminated as the result of manufacturer bankruptcy has the first right of refusal to reopen franchise ◆ Provide dealer with cure period to correct performance (i.e., 180 days) ◆ Require that sales performance calculation take into account dealer's market circumstances
Warranty Claims & Sales Incentive Audit/ Chargebacks	• Traditionally placed limit on lock-back period for warranty audits with exception for "fraud" • Recent changes: ◆ Add limitation on time frame for sales incentive audit ◆ Limit look-back period for accusations of fraud ◆ Allow for a protest and stay of the chargeback ◆ Require manufacturer show that basis for chargeback is reasonable (not merely a failure to comply with manufacturer rules and procedures) ◆ Require proof that dealer knew or should have known that a vehicle would be exported ◆ Provide a rebuttable presumption that if vehicle was registered in the U.S. that dealer had no knowledge of intention of customer to export
Dealership Data Protections	• Traditionally no protections provided • Recent changes: ◆ Prohibit manufacturers or their agents from requiring dealers provide access to customer lists, customer information, transaction data and service files ◆ Exceptions provided for reasonable audits and necessary manufacturer product programs ◆ Dealer may provide data without manufacturer having direct access to dealership electronic systems ◆ Manufacturer must indemnify dealers if damage occurs as a result of receiving data
Other New Franchise Laws	• Prohibition against unreasonable changes in dealer's area of responsibility • Prohibition against manufacturer requiring dealer sell manufacturer-related extended service contracts • Enhancement to allocation provisions requiring fair allocation and requiring allocation formula to be published upon request. Mfgs. can't show favoritism - they must treat all dealers fairly. • Prohibition against requiring dealer to purchase construction materials from sole-source if the dealer can identify substantially identical (functionally equivalent) product available from another source for a lower cost
Manufacturer Response	• Chrysler litigation against states requiring first right of refusal to reopen franchise in same market • Alliance litigation against Flörida arguing franchise laws are unconstitutional interference with contract • Manufacturers arguing that dealer laws not intended to apply to ***existing*** dealer agreement (i.e., dealers must wait until renewal before enjoying protections of franchise laws) • Manufacturer surcharges against invoice price of new vehicles to recover additional warranty reimbursements costs
Most Important of all … "Paper the File"	• Again this year, Mr. Sox emphasized the importance of having a written record of response to each and every communication to the dealer from the manufacturer cannot be stressed enough. Every manufacturer maintains a file and keeps a record of every communication that it sends to the dealer. Accordingly, for each and every such communication to the dealer, there should be a written, documented, appropriate response from the dealer back to the manufacturer.

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

- *"Emerging Manufacturer Initiatives Impacting Automobile Dealerships"* (*DTW*, Dec. 2006, pgs. 24-40)
- *"Dealer-Franchise Issues Update … Manufacturer-by-Manufacturer"* (*DTW*, Dec. 2007, pg. 12-23)
- *"Latest Manufacturer Initiatives Threatening Dealership Viability"* (*DTW*, Year-End Edition, 2008, pg. 13)
- *"Auto Dealer Franchises vs. Manufacturers … Legal Update"* (*DTW*, Year-End Edition, 2010, pgs. 15-16)
- *"Dealers Under Duress … Pressure from Manufacturers"* (*DTW*, Mid-Year Edition, 2011, pg. 4)

SECTION 263A ... CHOPPY WATERS BEYOND THE SAFE HARBOR LIMITS

Sec. 263A R.I.P. ?

For many dealers and their CPAs, Revenue Procedure 2010-44 and the subsequent filing of Forms 3115 to elect the protection of the generous safe harbor methods marks the happy ending of a long chapter of unease and uncertainty over how the rules of Section 263A should be applied to auto dealerships.

The IRS will allow dealerships to use the automatic consent procedures and file a single Form 3115 to implement the changes to elect to use the safe harbor methods and to make the other related changes.

STEERING INTO THE SAFE HARBORS

Let's briefly summarize where things now stand. The IRS allows motor vehicle dealerships to elect to use one or both of two safe harbor methods of accounting that would greatly alleviate (some of) their problems in complying with the Sec. 263A Inventory Cost Capitalization Rules.

Under Rev. Proc. 2010-44 (Nov. 9, 2010), a dealership may elect to change its Section 263A accounting methods in order to treat its entire sales facility from which it ***normally and routinely*** conducts ***on-site sales*** to ***retail*** customers, including any vehicle lot that is an integral part of its sales facility and ***that is routinely visited by retail customers***, as a retail sales facility (under Reg. Sec. 1.263A-3(c)(5)(ii)(B)). This election can be made as automatic change in accounting method #150.

In addition, a dealership may also elect to change its Section 263A accounting methods in order to be treated as a reseller without production activities for purposes of Section 263A. This election can be made as automatic change in accounting method #151.

[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 Rev. Proc. 2011-14 (formerly 2008-52), as modified by Section 7 of Revenue Procedure 2010-44.]

For many reasons, I have advocated that several other Section 263A changes in accounting method should be considered with respect to the Forms 3115 being filed to make these two elections. These additional changes are ...

(1) Election to use/change to 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 elections can be made as automatic change in accounting methods #22 and/or #23.

(2) Inclusion (or exclusion) of labor costs and/or internal (gross) profit on parts capitalized in previous years with respect to Section 263A in the computation of the Section 481(a) adjustment.

(3) Clarification that in determining storage, handling and purchasing costs to be capitalized after making these changes, the "1/3 - 2/3 rule for allocating purchasing labor costs" and the other 90%-10% *de minimis* rules contained in the Regulations will be used.

"Simplified Resale Method" concerns. Did the dealership properly elect to use the simplified resale method as it is described in the current Regulations? How can you be sure?

As explained in previous *DTW* articles, the development of the so-called "simplified resale method" is somewhat tortured. Proposed Regulations under Section 263A were issued in March, 1987 and clarified in August, 1987. These described the first simplified resale method.

Subsequently, IRS Notice 88-86 authorized the use of an *Alternative Simplified Resale Method.* Then, a second alternative simplified resale method, referred to as the *Modified Resale Method*, was 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, resulted in three different potential "***simplified resale methods.***"

In 1994, the final Regulations under Section 263A were issued. In the final Regulations, the previous *Modified Resale Method* (permitted under *TAMRA*) became the "new" ***Simplified Resale Method*** ... as set forth in Reg. Sec. 1.263A-3(d)(3).

As a result of this potential confusion over which simplified resale method computation might have been elected, my suggestions has been that dealerships filing Forms 3115 making these safe harbor elections should also make changes under the automatic change in accounting methods #22 and/or #23 for all other inventories that may not be subject to the safe harbor elections.

[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 Sections 11.01 and 11.02 of the *Appendix* to Rev. Proc. 2011-14 (formerly 2008-52.]

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SECTION 481(a) ADJUSTMENT IS REQUIRED

In connection with making these changes, dealerships are required to make a Section 481(a) adjustment. 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 year.

In other words, 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.

In general, the Section 481(a) adjustment for most dealerships is a ***negative*** adjustment which can be deducted 100% in the year of change.

On the other hand, if the Section 481(a) adjustment is a ***positive*** adjustment, the amount of the adjustment is spread over 4 years. However, if it is under $25,000, an election can be made to take the entire amount of the positive adjustment into income in the year of change.

Over the years, many dealerships followed the practice of taking the amounts required to be capitalized under Section 263A (as determined by their calculations) into taxable income as net adjustments in Schedule M-1 or M-3 in their income tax returns each year. This practical approach made it easy to reconcile their off-the-books Sec. 263A calculations (i.e., their calculations on spreadsheets) with adjustments to taxable income in their returns.

For these dealerships, it would appear that their Section 481(a) adjustment (required at this time in electing to be covered by 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.

Although it would appear that these dealerships would not have to deal with the revaluation provisions in Reg. Sec. 1.263A-7, the IRS has not provided any specific guidance as to whether this simple, practical approach would be acceptable.

For dealerships using the LIFO method to value their inventories, the Section 481(a) adjustments (for Sec. 263A changes in methods) may be a bit more complicated. This is because some dealerships embedded the Section 263A costs into their LIFO layers ... while other dealerships on LIFO did not.

A detailed discussion of these LIFO considerations appears in the Year-End 2011 Edition of the *LIFO Lookout*.

PURCHASING COSTS MAY HAVE TO BE CAPITALIZED

Revenue Procedure 2010-44 mentions nothing about purchasing costs - it only addresses handling and storage costs. Therefore, the Section 263A rules relating to purchasing costs continue to apply, notwithstanding an election by the dealership to be covered under the safe harbors for its other activities.

Therefore, a dealership may be required to capitalize, if necessary, purchasing costs and allocable general and administrative expenses related thereto. Allocable general administrative expenses are referred to as "mixed service costs" and are defined in the Regulations.

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

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

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

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

This determination is to be made on an employee-by-employee or individual-by-individual basis, and it is based on time (hours or days?) performing purchasing activities. It is not to be made on an overall departmental basis.

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

Under this 1/3 - 2/3 Rule, many dealerships may find that they have insignificant amounts to capitalize or that they have no costs at all required to be

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

capitalized because the purchasing activities do not exceed the 1/3 threshold for any individual employee.

CHOPPY WATERS OUTSIDE THE SAFE HARBORS

For dealerships that have activities and operations that are not covered by the safe harbor elections, there are several (potentially very troublesome) Section 263A issues and questions that remain unresolved or unanswered.

How might dealerships expect the IRS to audit their compliance with Section 263A? IRS Agents in the field probably will end up relying upon the "guidance" found in the "Audit Tool Kit" that was attached to the IRS Directive in which the first moratorium on raising Section 263A issues was published. This "Audit Tool Kit" basically incorporates all of the IRS' holdings in TAM 200736026. Accordingly, if IRS agents were to follow the "Tool Kit," that would raise other questions, including whether or not the Regulations take precedence over the IRS interpretations in TAM 200736026.

If a dealership has to capitalize costs in connection with operations outside the safe harbors, it will have to contend with the troublesome conclusions in the TAM regarding "on-site" vs. "off-site" sales. In the TAM determinations, the IRS held that the following were to be classified as "off-site" sales ...

(1) ***Most vehicles sold at wholesale***, because they are not sold to the final purchaser of the merchandise.

(2) ***Vehicles sold to other dealerships*** (i.e., "dealer trades") because they are not sold to the final purchaser of the merchandise.

(3) ***Leased vehicles*** because they are sold to Credit [unrelated party purchasing the lease contracts], and accordingly, they are not on-site sales because Credit (i.e., the entity that purchases the lease paper) does not purchase the vehicles at one of the Taxpayer's sales locations and it is not the ultimate consumer/customer.

If a dealership does not agree with the IRS' holdings in the TAM, then it must consider what positions to take if it adopts other computational approaches.

Several ramifications include whether the dealership's positions are aggressive and whether disclosure of some kind is necessary in the income tax returns being filed.

It should be noted that the dealership in the TAM had a very unusual fact pattern, and a TAM is not considered to be "precedential." However, TAMs and Private Letter Rulings (issued after October 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))

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

Should a dealership consider taking a "separate trade or business" approach for each department? The Regulations contain ***different rules*** for applying Section 263A absorption ratios to inventories that are not on LIFO and for inventories that are on LIFO. Therefore, in some cases, significantly smaller amounts of Section 263A costs will be capitalized if the dealership treats its separate departments (i.e., new vehicles, used vehicles, parts and service) as separate trades or businesses.

Currently, in some situations, the IRS considers all these activities as a single, integrated trade or business; in others, it appears that it does not.

Under the Section 446 Regulations ...

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

(2) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business.

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

Reg. Sec. 1.263A-1(j)(3) states that ***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. Consistent with this, in the context of the application of the *simplified service cost method*, Reg. Sec. 1.263A-1(h)(7) provides that to the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of paragraph (f)(4) of this Section.

In some instances, the IRS seems to have taken inconsistent positions on the separate trade or business issue. For example, in the TAM, the dealership was considered as a single trade or business for Section 263A purposes.

However, another dealership in a different situation was considered as operating several trades or businesses for purposes of guidance on Section 481(a) adjustment acceleration of LIFO reserve when the dealership loses a franchise. (Chief Counsel Advice / CCA 200935024).

In connection with dealerships losing their franchises and/or terminating their LIFO elections because of significantly reduced inventories, the "trade or business" concept was very significant. The question seems to be "Will the dealership stay in business just selling used vehicles and/or maintaining an active service department?"

If it did, there would be no acceleration of a Section 481(a) adjustment if the dealership continued to operate these remaining activities as portions of its overall trade or business ... See discussion of Situation 1 in IRS Legal Memorandum (ILM) 200935024.

Other reasonable allocation methods. For automobile dealerships, the IRS has issued no guidance on what might constitute an "other reasonable allocation method." Might the separate trade or business approach fit in to this category?

PRACTICE GUIDES

Included as supplementary materials are two checklists and a proforma statement for the initial income tax return being filed for a dealership. This statement describes the Section 263A methods of accounting that it intends to employ. Form 3115 is not required to be filed with an ***initial*** return because the taxpayer has no previous method from which a change is being made.

Checklist #1 (on page 27) is intended to be useful in reviewing either past filings of Forms 3115s to make changes to elect the safe harbor methods or in connection with filing Forms 3115 if the change is to be made effective for 2011.

Checklist #2 (on pages 28-29) is intended to assist in evaluating dealership compliance with the Section 263A rules, particularly for dealerships which have operations and activities outside of the safe harbors.

These checklist items were previously combined in one overall Section 263A checklist that was included on pages 41-43 of the Mid-Year 2011 Edition of the *Dealer Tax Watch*.

Practice Guide

INITIAL INCOME TAX RETURN STATEMENT OF ELECTIONS RE: SECTION 263A INVENTORY COST CAPITALIZATION METHODS OF ACCOUNTING

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

Initial tax returns. A dealership's initial income tax return should not include Form 3115 (*Application for Change in Accounting Method*). The reason no Form 3115 is required is because, since the dealership was not in existence in the previous year, it has no previous Section 263A methods that require changing.

However, the dealership should include a statement of elections regarding Section 263A inventory cost capitalization methods in its initial return.

The IRS has not developed an official form to be used for making elections in initial returns relating to the computation of Section 263A costs.

The sample language below may be helpful, with appropriate modifications.

XYZ Dealership
Initial Income Tax Return Statement of Elections
re: Section 263A Inventory Cost Capitalization Methods of Accounting
For the Initial Year _____

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 Sec. 4 of Revenue Procedure 2010-44, and in connection with its methods of accounting for capitalizing inventory costs in accordance with Section 263A, Taxpayer elects to...

- Treat certain sales facilities as retail sales facilities (as described in Section 5.01 of Rev. Proc. 2010-44),
- Be treated as a reseller without production activities (as described in Section 5.02 of Rev. Proc. 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.

In connection with determining storage, handling, and/or purchasing costs to be capitalized, Taxpayer will use the special reseller cost allocation rules which include ...

- 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).

Also, Taxpayer ***[will][will not]*** include as inventoriable costs (under Section 471) to which Section 263A may apply (1) internal labor costs that are included in the capitalization of the cost of parts added to vehicles and (2) internal profit that also is or may be capitalized in accordance with its usual accounting procedures and methods.

Taxpayer will make no adjustments to remove these cost elements from the costs to be capitalized because of the impracticality and the additional accounting effort required to determine and quantify the appropriate amounts.

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Form 3115 Checklist #1

AUTOMATIC CHANGES TO THE SECTION 263A SAFE HARBOR METHODS ... CHECKLIST FOR EVALUATING FORM 3115 FILED BY THE DEALERSHIP

		Yes / No / Comments
Analyze Dealership Operations	• Are all of the dealership operations covered by the retail sales facility safe harbor? • Are any operations or activities (potentially) not covered by the safe harbors? ◆ 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.	
Changes to Elect the Safe Harbor Methods	• For 2010, did the dealership file Form 3115 to elect to make any changes under Revenue Procedure 2010-44 to the Sec. 263A safe harbor methods? ◆ If so, what changes/elections were made? • If the dealership did not file Form 3115 to make these changes, has consideration been given to making these changes effective for calendar year 2011? ◆ If not, why not? ________________________________	
Possible Safe Harbor Elections under Rev. Proc. 2010-44 *Safe Harbor Elections*	• No. 150 ... Change to treat certain sales facilities as retail sales facilities. • No. 151 ... Change to be treated as reseller without production activities. • No. 22/23 ... 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. • ***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 ... ◆ Which ones were not made? Explain why. ____________________ • How thorough is the narrative statement attached to Form 3115?	
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?	
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
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.	
Purchasing Activities & Costs	• Is the dealership required to capitalize any costs with respect to purchasing activities? ◆ ***"1/3-2/3" Rule.*** 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 … If other, identify method of allocation.	
Determine Which SRM the Dealership Has Elected to Use	• ***Did the dealership's Form 3115 (filed effective for either 2010 or 2011) include an election under automatic CAM Nos. 22/23 to change to use the Simplified Resale Method (under Reg. Sec. 1.263A-3(d)) for all activities and operations not subject to the safe harbor elections under automatic CAM Nos. 150 and 151?*** • ***If not,*** 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?	
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?	

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

		Yes / No / Comments
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...	
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 not have any 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."	
First Year Tax Returns	• In an initial return, there is no change in method ... Form 3115 is not required. • Include a statement in the initial income tax return to notify the IRS of the Sec. 263A methods the dealership will be using. This statement could be patterned after the Narrative Statement for Forms 3115 electing to make automatic changes.	

Tsk... Tsk...

MISSED FORM 3115 FILING DATES REQUIRE EXTENSIONS

Form 3115 filing procedures for automatic changes. A taxpayer making a change in accounting method under the automatic consent procedures is required to complete and file an application (Form 3115) in duplicate. The original Form 3115 must be attached to the taxpayer's timely filed (including extensions) Federal income tax return for the year of change. A duplicate copy (with signature) of the Form 3115 must be filed with the IRS National Office no earlier than the first day of the year of change and no later than when the original is filed with the Federal income tax return for the year of change.

Letter Ruling 201126014 ... Extension of Time to File Original Form 3115

Failure to attach signed original of Form 3115 to the timely electronically filed income tax return. Letter Ruling 201126014, involves a taxpayer who did not attach the signed original Form 3115 to its timely ***electronically*** filed income tax return. Upon discovery of this oversight, the taxpayer requested the IRS to grant it an extension of time to file the signed original of Form 3115.

When a taxpayer changes an accounting method, if a Section 481(a) adjustment is required, the amount of that adjustment must be disclosed on Page 3, Part IV. In this case, the taxpayer was changing a method of accounting for repair and maintenance costs pursuant to the automatic consent procedures and it apparently decided to file the Form 3115 before the end of the year of change.

Here's what happened... At the time the duplicate copy of Form 3115 was filed with the IRS National Office, the information needed to compute the Section 481(a) adjustment was not available. Thus, the first copy of Form 3115 filed with the IRS National Office contained a statement that the Section 481(a) adjustment was to be determined. The taxpayer subsequently computed the amount of the Section 481(a) adjustment and on a later date (still before the end of the year of change), it timely filed an update (i.e., second) duplicate copy of the Form 3115 that included the required Section 481(a) adjustment with the IRS National Office in Washington, DC.

The taxpayer was under audit and filed an appropriate copy of Form 3115 with the examining agent. In addition, the taxpayer also filed a copy of the Form 3115 with the IRS' Ogden, Utah office, as required under a further special filing requirement relating to a change in method of accounting for repair and maintenance costs.

Finally, after all this, the taxpayer timely filed its Federal income tax return for the taxable year of change ***via electronic filing***. The tax return filed reflected the taxpayer's change in method of accounting for repair and maintenance costs.

The taxpayer relied on one of its employed tax professionals to attach the original Form 3115 to the timely filed Federal tax return. However, the taxpayer later discovered that the signed original of Form 3115 had not been attached to the timely electronically filed Federal income tax return. When this oversight was discovered, the taxpayer promptly submitted a request to the IRS for relief (i.e., an extension of time to file) under Reg. Sec. 301.9100 to file the duplicate copy.

After analyzing the requirements and conditions set forth in Reg. Sec. 301.9100, the IRS held that the taxpayer qualified for an extension of time and the taxpayer was granted 60 calendar days from the date of the letter to file the original of the Form 3115, ***with signature***.

Letter Ruling 201128002 ... A Clear Case of Miscommunication

In Letter Rulings (LTRs) 201128002 and 201138030, the taxpayers did not timely file the duplicate copy. Upon discovering this oversight, each taxpayer took prompt action.

Here's what happened in LTR 201128002... A firm (a CPA firm?) assisted the taxpayer in the preparation of the Form 3115, and the firm had advised the taxpayer to attach the original Form 3115 to the taxpayer's timely filed Federal income tax return for the year of change. The firm also advised the taxpayer either (1) to send a duplicate copy of the Form 3115 back to the firm so that the firm could hand deliver the duplicate copy to the IRS National Office before the date on which the tax return would be filed ***or*** (2) to mail the duplicate copy of the Form 3115 directly to the IRS National Office at the address provided in the Revenue Procedure via certified mail, postmarked no later than the filing date.

Unfortunately, the taxpayer mailed the duplicate copy of the Form 3115 back to the firm with the understanding that the firm would file the duplicate copy with the IRS National Office. The firm received the duplicate copy of Form 3115 on a later date that precluded it from filing the duplicate copy with the IRS National Office on or before the date of the taxpayer's timely filed income tax return. When this miscommunication was discovered, the taxpayer promptly submitted a request to the IRS for relief (i.e., an extension of time to file) under Reg. Sec. 301.9100 to file the duplicate copy.

After analyzing the requirements and conditions set forth in Reg. Sec. 301.9100, the IRS held that the taxpayer qualified for an extension of time and the taxpayer was granted 60 calendar days from the date of the letter to file the required duplicate copy of the Form 3115, ***with signature***, with the IRS National Office. The taxpayer was also directed to attach a copy of the Letter Ruling to the duplicate copy.

Form 3115 Late Filing Relief	***Requesting Permission From the IRS for an Extension of Time to File After the Regular Filing Due Date Has Been Missed*** ***Reasonable Extensions of Time for Late Filings***
IRS Can Permit Late Filing	• Under Reg. Sec. 301.9100-1(c), the Commissioner has the discretion to grant a reasonable extension of time to make a ***regulatory election*** … provided that … ◆ The taxpayer has acted reasonably and in good faith, and ◆ Provided that granting relief will not prejudice the interests of the Government. • A ***regulatory election*** is defined to include a request to adopt, change or retain an accounting method. • The rules governing automatic extensions for regulatory elections are in Section 301.9100-2. • If the provisions of Reg. Sec. 301.9100-2 do not apply, then Reg. Sec. 301.9100-3 may apply instead.
"Standards" for Relief	• These standards are set forth in Reg. Sec. 301.9100-3. • These standards apply to determine whether the Commissioner will grant an extension of time to make a *regulatory election.* • These standards also detail the information and representations that must be furnished by the taxpayer in order to enable the IRS to determine whether the taxpayer has satisfied these standards. • The standards also are applied to determine whether ◆ The taxpayer acted reasonably and in good faith and ◆ Whether granting relief would prejudice the interests of the Government.
"Good Faith"	• A taxpayer applying for relief for failure to make an election ***before the failure is discovered by the Service*** ordinarily will be deemed to have acted reasonably and in good faith. • Reg. Sec. 301.9100-3(b)(1)(i)
Three Indicators of "Bad Faith"	• A taxpayer will not be considered to have acted reasonably and in good faith … if the taxpayer … ◆ Seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under Section 6662 at the time the taxpayer requests relief and the new position requires or permits a regulatory election for which relief is requested. ◆ Was informed in all material respects of the required election and related tax consequences but chose not to file the election. ◆ Uses hindsight in requesting relief. • Reg. Sec. 301.9100-3(b)(3)
Interests of the Government Are Prejudiced	• The interests of the Government are prejudiced … if granting relief to the taxpayer … ◆ Would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the regulatory election than the taxpayer would have had if the election had been timely made (taking into account the time value of money). ◆ Would result in a tax liability that is lower, in the aggregate, for a group of taxpayers (as a result of extending the time for making the election) than the (collective) tax liability of the group would have been if the election had been timely made. ◆ Reg. Sec. 301.9100-3(c)(1)(i) • The interests of the Government are ***ordinarily*** prejudiced if the tax year in which the *regulatory election* should have been made … or any tax years that would have been affected by the election had it been timely made … are closed by the period of limitations on assessment under Section 6501(a) before the taxpayer's receipt of a Ruling granting relief under Reg. Sec. 301.9100-3. ◆ Reg. Sec. 301.9100-3(c)(1)(ii)

TAXABILITY OF MANUFACTURER ASSISTANCE PAYMENTS TO AUTOMOBILE DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

INTRODUCTION

In recent years, more and more manufacturers have introduced a variety of programs to stimulate or coerce their dealers into expanding or completely rebuilding their existing facilities, and as an integral part of that activity, polishing or "upgrading" the look and image into something more akin to the "ideal" dealership facility - if such a structure exists.

The manufacturers' activities in this regard raise a number of legal, tax, accounting and practical issues for dealers and their advisors. This article and the related materials focus primarily on the taxability of manufacturer payments and "reimbursements" to dealerships for facilities and image upgrades (i.e., manufacturer assistance payments). Particular emphasis is placed on the General Motors' *EBE (Essential Brand Elements)* Program.

TAXABILITY OF MANUFACTURER ASSISTANCE PAYMENTS

The relevant Code Section that has drawn the attention of many CPAs in considering the taxability of manufacturer assistance payments is Code Section 118. This Section deals with contributions to the capital of a corporation.

The Law. Code Section 118 provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. In other words, contributions to the capital of a corporation may be excluded from gross income. This is a deceptive simplification because not all funds received by a corporation are classified (for tax purposes) as "contributions of capital." Under Section 118, only certain contributions of capital to a corporation may be excluded from income.

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Facilities & Image Upgrades

MANUFACTURER ASSISTANCE PAYMENTS TO DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

Executive Summary

MANUFACTURER ASSISTANCE PAYMENTS TO AUTOMOBILE DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

- The many different programs that manufacturers have introduced to encourage their dealers to expand or completely rebuild their facilities have raised many legal, tax, accounting and practical issues for dealers and their advisors.
- In interacting with their dealership constituencies, the manufacturers have never done anything without expecting an equal, if not greater, benefit in return. Accordingly, it is reasonable to conclude that dealers are providing services to the manufacturers in return for their receipt of assistance payments under these programs.
- There is an extensive body of case law dealing with taxpayers' attempts to treat various payments as non-taxable contributions to capital. There is also extensive IRS guidance - some precedential and some not precedential - on this issue. This case law ... and related IRS guidance ... extend far back to many years before Section 118 came into the law in 1954.
- The *John B. White, Inc.* case (decided in 1971 by the Tax Court and upheld on appeal) and the *Detroit Edison* case present the most formidable barriers against dealerships successfully sustaining the position that payments they receive from manufacturers for facility improvements and upgrades can be excluded from taxable income.

  It is difficult to imagine circumstances - or manufacturer plan specifics - that could possibly support any treatment to the contrary. Has any manufacturer ... Chrysler, General Motors, or any other ... ever done anything that was not in its own best business interests ... or without exacting (at a minimum) a *quid pro quo*?
- The General Motors' *EBE (Essential Brand Elements)* Program requires special attention because of its unique features and because there are so many GM dealers in the country.

  The *EBE* Program consists of four components or elements. In order to be eligible to receive ***any*** payment under the *EBE* Program, the dealership must be fully compliant on a cumulative basis with all of the requirements of all four of these Program components or elements. This 100% compliance requirement inextricably links all four of the components; and it should cause any payments received by the dealership under the Program to be treated as ordinary income taxable upon receipt (rather than as basis reductions charged against fixed asset, goodwill or other accounts).

  This conclusion is consistent with case law in other areas, notwithstanding the fact that GM's summary of the Program suggests that there may be severability by the statement ... "*On average, 90% of the costs associated with the Brand Elements is dedicated toward the Facility Image Program.*"
- Some Programs, to a lesser or a greater degree, contain forfeiture provisions that would require the dealership to repay funds provided by the manufacturer either in full or according to a sliding scale over time if the dealership fails to satisfy some or all of the conditions of the Program. Some CPAs contend that amounts received under these Programs may be characterized or treated as non-taxable loans (rather than as taxable income immediately upon receipt). This contention, more likely than not, would not be successful.
- The position of the IRS is that Section 118 applies ***only to corporations***. This would exclude from Section 118 many dealerships that conduct operations in non-corporate form (i.e., as disregarded entities electing to be taxed as partnerships or LLCs). The IRS is actively monitoring and challenging partnerships that are trying to secure the non-taxable treatment benefits of Section 118, and it describes these non-corporate entities as being ***abusive***.
- In filing income tax returns for years in which manufacturer assistance payments have been offset against basis (in reliance on the position that these payments are Section 118 contributions to capital or on some other theory), consideration should be given to adequate disclosure and potential accuracy-related penalties, taxpayer penalties and tax return preparer penalties. This involves Schedule M-1, M-3 and/or Schedule UTP disclosure matters and/or whether Form 8275 should be filed with the tax return. There are also statute of limitation considerations because different depreciation deductions will result from Section 118 treatment.
- At this time, there is no specific "guidance" from the IRS on the proper tax treatment by dealerships for payments received from the manufacturers under their various and sundry facility improvement and image upgrade programs. These programs and the difficult tax issues they raise should become a new priority item requiring published guidance if the IRS hopes to enforce any degree of consistent treatment by dealerships.

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Section 118(a), enacted in 1954, does not expressly define the term "contribution to capital." However, the legislative history of Section 118 explicitly states that the statute was meant to "place" in the Code the Court decisions on this subject.

The Regulations. The Regulations were published in 1956. One part of the Regulations addresses the treatment of contributions received directly from corporate shareholders. This portion of the Regulations provides that ...

"If a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation.

"In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company."

The second portion of the Regulations applies to contributions to capital made by persons other than shareholders. This portion provides, by way of example, that ...

"...[T]he exclusion [from taxable income of the corporation] applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities."

Finally, and most significantly, the Regulation provides that "...[T]he exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production."

The Legislative History. The legislative history of Section 118 includes the following ...

"Your committee's bill provides that in the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject.

"It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce or other association of individuals having no proprietary interest in the corporation.

"In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as ***a payment for future services***." (Note: the emphasis is in the *House Report*.)

The above appears in the *House Report* (H.R. Rep. No. 1337, at 17 (1954)).

The wording that was included in the *House Report*, with the same emphasis on the words "a payment for future services," is repeated in the *Senate Report* (S. Rep. No. 1622, at 18-19 (1954)).

COURT DECISIONS

Detroit Edison & Brown Shoe. The "court decisions on this subject" that were intended to be "placed in the Code" include two very old cases: *Detroit Edison Co. v. Commissioner* (319 U.S. 98 (1943)) and *Brown Shoe Co., Inc. v. Commissioner* (339 U.S. 583 (1950)).

The distinction between the *Detroit Edison* case and the *Brown Shoe* case rested upon (1) the nature of the benefit to the transferor, rather than to the transferee, and (2) upon whether that benefit was direct or indirect, specific or general, certain or speculative.

Where the transfers were made with the purpose of receiving direct service or recompense, as in *Detroit Edison*, the transfers were not treated as a contribution to the capital of the corporation.

In contrast, where the transfers were made with the purpose of obtaining advantage for the general community, as in *Brown Shoe*, the transfers were treated as a contribution to the capital of the corporation.

CB&Q. In 1973, the Supreme Court held that other characteristics of a contribution to capital are implicit in the *Brown Shoe* and *Detroit Edison* cases that do focus upon the use to which the assets transferred were applied or upon the economic and business consequences for the transferee corporation. (*United States v. Chicago, Burlington & Quincy Railroad Co.,* 412 U.S. 401 (1973)).

These other characteristics of a nonshareholder contribution to capital are ...

- It certainly must become a permanent part of the transferee's working capital structure,
- It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee,
- It must be bargained for,
- The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value, and

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- The asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Although the tax character of a transfer was ultimately determined by the transferor's intent, for a court to hold that a transfer was a capital contribution, each of the first four, and ordinarily the fifth, characteristics must also be satisfied.

AT&T. In January 2011, in *AT&T, Inc. v. U.S.*, the following statement appears as a commentary on the *Brown Shoe* case ... "to be compensation for services, a transfer does not need to be directly or immediately used for the provision of services; nor does it need to benefit all transferors commensurately with their individual contributions. Instead, consistent with the Court's statements that a transferor's intent ultimately determines the tax character of the transfer, whether a payment is compensation for services turns on whether it is given in expectation of a specific service to the transferor or whether it is given simply to pay for or generate a service to others."

This statement should be interpreted in its context which involved transfers to the corporation which resulted from the philanthropic efforts "by certain community groups as an inducement to the location or expansion of a business' factory operations in the community."

Accordingly, these transfers were capital contributions because the philanthropic groups "neither sought or could have anticipated any direct service or recompense whatever; their only expectation being that such contributions might prove to be advantageous to the community at large." (Note: more than one transferor was involved ... i.e., there were several transferors.)

For an excellent discussion of the case law (through 1997) and the interplay of the five characteristics of a non-shareholder contribution to capital, see *"Achieving Capital Contribution Treatment for Location Inducements,"* by John C. Taylor in the *Journal of Taxation*, August, 1997, (pp 112-117).

DETERMINATION OF THE BASIS OF PROPERTY WHICH IS CONTRIBUTED TO A CORPORATION

Code Section 362(c) provides that the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders is to be reduced by the amount of the contribution that was excludable from gross income.

In general, if ***property other than money*** is received by a corporation as a contribution to capital, ***and*** is not contributed by a shareholder as such, then the basis of such property shall be zero. (Section 362(c)(1) ... applicable to transfers on or after June 22, 1954.)

In general, if ***money*** is received by a corporation as a contribution to capital, ***and*** is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. (Section 362(c)(2) ... applicable to transfers on or after June 22, 1954.)

If the amount of money contributed to the corporation exceeds the amount of the reduction of basis of the property under the preceding sentence, that excess amount shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any ***other*** property held by the taxpayer. The particular properties to which the reductions shall be allocated shall be determined under the Regulations.

IRS' NARROW INTERPRETATION OF SEC. 118

Current challenges by the IRS to Section 118 (nontaxable contribution to capital) treatment by corporations and by other entities (partnerships) is evidenced by the IRS treating this as a Tier 1 issue and the publication of IRS Abuse Directives emphasizing (mis)interpretation of Section 118 by taxpayers.

There can be no doubt that The IRS is actively monitoring and challenging partnerships that are trying to secure the benefits of Section 118.

The position of the IRS is that Section 118 applies only to corporations, and many dealerships conduct operations in non-corporate form (i.e., disregarded entities electing to be taxed as partnerships or LLCs).

Two of the IRS Directives issued in 2006 and 2007 are summarized in the supplementary materials. There are many other *IRS Directives* on this issue; most of these, however, relate to payments received under specific Federal, State or municipal programs.

Although these IDD directives place emphasis on the IRS concern over the misapplication of reliance on Section 118 by partnerships, it seems reasonable to expect that the increasing prevalence of manufacturer incentive programs for auto dealerships will result in (more) special attention directed to how dealerships are handling the receipt of incentive payments for tax purposes.

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One might generalize that the position of the IRS appears to be that the exclusion for non-shareholder contributions under Section 118 is available to a corporation only when the party providing the incentive will enjoy the benefits as a member of the general community in which the recipient business is operating. The receipt of incentive payments would constitute current taxable income if the party making the payment(s) desires to obtain benefits which have a reasonable connection (i.e., nexus) to the business.

JOHN B. WHITE, INC.

John B. White, Inc. is one of the important cases to consider in evaluating the potential application of Section 118 to payments that a dealer receives from a manufacturer for facility improvements.

This case was decided in 1971 by the Tax Court. It involved a Ford dealer who received a payment from Ford Motor Company to induce the corporation to move to another location in order to increase the sales of Ford products and enhance the Ford image.

Ford Motor Company anticipated that the move to a "better" neighborhood would increase the sales of Ford Motor Company products and enhance the Ford image. In other words, Ford expected to derive a direct benefit from its payment.

The benefit anticipated by Ford (i.e., the increased sales of Ford products ***and*** the enhancement of the Ford image) had a reasonable nexus with the business that the recipient dealership corporation customarily provided (i.e., the sale of Ford products).

The IRS and the Tax Court both held that the payment received by the dealership was taxable as ordinary income upon receipt and that Section 118 was inapplicable to the transaction.

In 1972, the decision of the Tax Court was upheld by the United States Court of Appeals for the Third Circuit.

The *John B. White, Inc.* case is summarized in the supplementary materials.

It is instructive to note that the Tax Court reviewed the dealership's franchise agreement and all of the correspondence the dealer had received from the manufacturer (and the dealer's responses) as part of its determination of the factual basis supporting its conclusion. Practitioners should be sure to read and study all similar documentation in order to support their conclusions regarding whether payments received by the dealer from the manufacturer for facility improvements are taxable or nontaxable (i.e., deferred as a result of applying those payments against the basis of the improvements).

JAMES BROWN, ET AL. V. COMM.

Some accountants have suggested that the case of *James Brown, et al. v. Comm.* can be cited as authority for the potential application of Section 118 to exclude from income payments that a dealer receives from a manufacturer for facility improvements.

These accountants would believe that this Board of Tax Appeals decision in *James Brown* supports the position that facility and image upgrade payments received from manufacturers (under current plans) may be treated by dealerships as reductions of cost basis.

The *James Brown* case was decided in 1928 by the Board of Tax Appeals (BTA). Of the six issues in this old case, the relevant issue relates to the proper treatment of the amount paid by the majority stockholder in a company to Mr. Brown in order to induce Mr. Brown to purchase the stock which comprised the minority interest in that company. Mr. Brown was paid $100,000 (by the majority stockholder) to purchase the minority interest from an estate.

The BTA held that the $100,000 that Mr. Brown received as an inducement to purchase the stock was a reduction of the cost of the stock to Mr. Brown. Therefore, the $100,000 payment to Mr. Brown (by the majority stockholder) was not taxable income to him upon receipt.

It should be noted that the applicability of Section 118 was not an issue in *James Brown* because Section 118 was not enacted until many years later ...1954 to be exact.

The *James Brown, et al. v. Comm.* case is summarized in the supplementary materials. The caution expressed above regarding studying all of the appropriate documentation applies equally if reliance is to be placed on this case for the position that payments received for facility improvements are nontaxable.

OTHER CASES

Freedom Newspapers, Inc. v. Comm., a 1977 case, involves the question of whether amounts received from a third party to reimburse a purchaser (of stock interests) constituted taxable income when received or a reduction of the company's basis in certain property.

Some current commentators believe that this case also supports the position that payments from manufacturers may be treated as reductions of cost basis by dealerships currently receiving manufacturer incentive payments.

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As indicated previously, *AT&T, Inc. v. U.S.* (2011) contains a very good summary of the five characteristics of nonshareholder contributions to capital.

Elder-Beerman Stores Corp. (1997) ... Involves payments to induce tenant relocation and/or improvements. The fact pattern in this case is clearly distinguishable from fact patterns involving auto manufacturers' payments to dealerships to induce facility improvements.

Finally, as mentioned previously, for an excellent discussion of the case law (through 1997) and the interplay of the five characteristics of a non-shareholder contribution to capital, see *Achieving Capital Contribution Treatment for Location Inducements* by John C. Taylor in the *Journal of Taxation*, August, 1997, (pp. 112-117).

SELECTED IRS RULINGS AND OTHER RELATED GUIDANCE

There is no shortage for other IRS rulings and related guidance involving the (potential) application of Section 118 to payments received in various situations. These rulings and guidance include...

- LTR 9308001
- LTR 9452003
- IRS Retail Industry Paper (Oct. 7, 1996)
- ISP Settlement Guidelines Paper (Sept. 23, 1998)
- Revenue Ruling 76-96
- General Counsel Memo (GCM) 38994
- General Counsel Memo (GCM) 39228

None of these, in my opinion, alter the conclusion that the *John B. White, Inc.* case presents the most formidable barrier for claiming that payments received by dealerships from manufacturers for facility upgrades can be excluded from taxable income.

FACILITY PROGRAMS - IN GENERAL

Many manufacturers have instituted programs the effect of which is to require dealerships to invest substantial amounts in order to improve their facilities and/or the branding/image of the manufacturer.

Some programs involve allocation considerations, per car bonuses and/or direct financial assistance payments to the dealership as the *quid pro quo* for the dealership's cooperation in additional investment.

see **MANUFACTURER ASSISTANCE PAYMENTS**, page 39

Common Features

COMMON CHARACTERISTICS AND/OR ELEMENTS IN MANUFACTURERS' FACILITY IMPROVEMENT PROGRAMS

- *The manufacturer sets the facility appearance and construction standards for the upgrade.*
- *The manufacturer requires completion of upgrade by a specified date or percentage of completion over specified intervals.*
- *Payments are made based on meeting standards, benchmarks and/or milestones set out as program requirements.*
- *The manufacturer makes cash payments directly to the dealership or provides credit against other liabilities or as offsets against other account balances.*
- *Payments are based upon the number of new vehicles purchased or new vehicles sold by the dealership.*
- *Participation in the program is not mandatory ... but dealers are always concerned about the negative repercussions or adverse consequences if they don't participate.*
- *Manufacturer payments may be made on the basis of cumulative performance (rather than performance based on one period of measurement alone).*
- **Forfeiture repayments.** *In some instances, a portion or all of the payments may have to be returned to the manufacturer if certain (long-term) conditions are not satisfied.*
- **Exclusivity.** *Exclusivity component in all programs ...* ***This is a major, serious concern.***

Manufacturer Facility Programs	***Automobile Dealer Franchise Legal Update*** ***2011 AICPA Conference Presentation by Richard N. Sox, Esq.***

New Programs	*Continuing Programs*
• GM Essential Brand Elements ◆ Per car bonus ◆ Deadline for compliance is a moving target ◆ Rumors that GM issuing extensions for first phase dealers (2 year extension?) • Hyundai new image program ◆ No program materials issued • Kia gallery program ◆ Pays up to 25% of construction costs ◆ Construction must begin by April, 2012	• Infiniti IREDI ◆ Financial assistance payment • Mercedes Benz Autohaus ◆ Per car bonus • Nissan NREDI ◆ Financial assistance payment • Toyota Image II ◆ Additional allocation

Comments & Concerns	• Exclusivity component in all programs ... this is a major serious concern ◆ Franchise law implications ... vary state-by-state, depending on the degree of dealer protection afforded by the statute • Per car bonus may put non-compliant dealers at competitive disadvantage • More and more franchise laws addressing incentive programs ◆ Must be ***practically*** available to add dealers ◆ Can dealer practically comply with facility program? • Facility program requirements placed in franchise renewal agreement ◆ ***Never*** sign unless intend to construct new facility ◆ "Expired" dealer agreement continues to apply • Recently, some state dealer protection statutes have included a prohibition against the manufacturer requiring the dealer to purchase construction materials from sole-source if the dealer can identify substantially identical (functionally equivalent) product available from another source for a lower cost
Push-back By Dealers	• Dealers must be responsive to requests by the manufacturers for facility upgrades, when these requests are received from the manufacturers • Working with the assistance of counsel experienced in handling dealership matters, dealers could file written objections, which might include the following facts and/or strategies to counteract requests for upgrades ◆ Discuss the dealership's practical inability to comply with such requests, if applicable ◆ Describe prohibitive costs ◆ Lack of available land ◆ Lack of financing ◆ Offer a ***compromise*** in the scope of the (requested) upgrade ◆ Adequacy of existing facilities ◆ Cite to sufficient sales performance (where is upside?) ▪ Also, note that manufacturers' programs that involve per car bonuses may place dealers who are non-compliant with the program at a competitive disadvantage ◆ Question the manufacturer's basis for increases in (1) planning volume and (2) projected Units in Operation (UIOs) ◆ Where applicable, cite to dealer protections available under State franchise laws ▪ The franchise laws in many states now address incentive programs requiring that they must be practically available to all dealers ▪ Check with the dealer's specific state law to see if applicable • Don't miss deadlines for filing written protests ◆ Do ***not*** accept any manufacturer representative oral statements w/r/t program details
NADA Study	• NADA has funded a study to determine the practical benefit to dealers and manufacturers of larger and fully-imaged facilities • The results of this study will be presented at the NADA Convention in February 2012
Source	• Richard N. Sox, Esq. ... *Auto Dealer Franchise Legal Update* ... AICPA National Auto Dealer Conference, October 2011, Orlando, FL ... Bass Sox Mercer ... (850) 878-6404

At the 2011 AICPA National Auto Dealership Conference, Richard Sox, Esq. included in his "Auto Dealer Franchise Legal Issues" presentation a discussion of these programs, and a number of concerns - legal and otherwise - they are creating for dealers. His remarks are summarized on page 38.

Some of the more common characteristics and/ or elements in many manufacturers' facility improvement programs are listed below.

Discussion of the GM *EBE Program* should be differentiated from a discussion of other manufacturers' programs because most of the other manufacturers' programs are more specifically targeted or limited to (providing incentives for the) upgrading of dealership facilities and/or other image enhancement considerations.

GENERAL MOTORS *EBE (ESSENTIAL BRAND ELEMENTS)* PROGRAM

In the GM *EBE Program*, the facilities upgrade component is just one of four components, and all four components are inextricably combined with each other and with the opportunity for the dealership to receive cumulative payments over a fairly rigid time frame.

Component #1 - Facility exclusivity and/or image upgrades. This component of the *EBE Program* may be summarized as the alignment of the GM dealership facility with GM's image standards. It consists of GM's desired facility changes.

- Exclusive showrooms by Oct. 31, 2010 if the facility is a non-GM dual facility.
- Exclusive entire facilities by Sept. 30, 2011 if the facility is a non-GM dual facility.
- Other facility renovations and/or upgrades, regardless of whether or not a dual facility is involved.

Components #2-3-4. The other three components of the GM *EBE Program* involve...

- Participation in a coordinated and integrated customer sales and service retention program,
- Adoption of a common digital strategy, and
- Establishment and maintenance of a highly-trained and professional sales and service organization.

Payments to GM dealerships under the *EBE Program* are based upon the cumulative satisfaction of all four components.

The *EBE Program Guidelines* summary states, "A dealer that maintains 'Green' status in all four program Elements at the end of a quarter will earn that quarter's payout and receive payment by the end of the following quarter through the BARS open account system. ***There are no partial payouts with the EBE Program; the dealership must be compliant in all four Elements.***"

Opinion ... It would appear that because a dealership must be compliant with the requirements of all four components or elements of the EBE Program in order to receive a payment, all four of the components are inextricably linked and therefore, any payments to the dealership under the Program should be treated as ordinary income (rather than as basis reductions charged against either fixed asset and/or goodwill or other accounts).

John B. White, Inc. seems to be a strong argument in favor of this conclusion.

In *Springfield St. Ry. Co. v. United States,* 577 F.2d 700 (Ct. Cl. 1978), the Court of Claims held that grants by the Commonwealth of Massachusetts to a taxpayer were not conditioned on the taxpayer's use of such funds for the acquisition of capital assets. As a result, such funds were not considered to be contributions to capital and were included in the taxpayer's gross income.

Under the GM *EBE Program*, monies received by a dealership are not necessarily "conditioned on the taxpayer's use of such funds for the acquisition of capital assets." Some of the funds may be used to defray the costs of other programming and training.

In the *Program* description, it is stated that "GM dealers ***earn*** a ... quarterly payout, provided they maintain their eligibility in each of the four *EBE* critical brand strategies. (Emphasis added)

The *EBE Program Guidelines* summary states, "The majority of the *EBE* payout is designed to assist dealers who choose to remodel or build their facilities to be in compliance with the GM Facility Image Program. ***On average, 90% of the costs associated with the Brand Elements is dedicated toward the Facility Image Program.***"

It has been anecdotally reported that some dealerships have been advised that they can treat 80% of the payment amounts received as offsets against the facility upgrade costs required to be capitalized, and 20% of the payment amounts received as taxable income when earned. Some may even stretch these ratios to 90% (nontaxable) - 10% (taxable) ... based on the statement in the *EBE Program Guidelines.*

see MANUFACTURER ASSISTANCE PAYMENTS, page 40

 (Continued from page 39)

2011 developments... Deadline for compliance seems to be a "moving target." Rumors are circulating that GM is issuing extensions for first phase dealers. Also, according to the article by Richard N. Sox, Esq. in *Dealer Magazine* (November 2011, page 12), General Motors "is issuing two-year extensions to the deadline for dealers to complete their *Essential Brand Elements* facility upgrades."

Payments to dealerships under GM's *EBE Program* may be further affected by GM's announcement in January of 2011 that all dealers' Areas of Primary Responsibility (APR) are going to change due to the alterations that GM has made to its dealer network over the past 12 months. Dealers will be assigned a new APR for each linemake.

Accordingly, a dealer's APR for one brand/franchise may be significantly different for its APR for another GM brand/franchise.

OTHER CONSIDERATIONS & OBSERVATIONS

Over the past several years, I have discussed the treatment of manufacturer payments related to facility improvements/upgrades with many CPAs and controllers.

Most of them seem to be of the "opinion" that the receipt of these payments from the manufacturer can be treated as currently non-taxable; and that they can be offset against the adjusted tax basis of fixed assets (or other unamortized intangible capitalized assets such as goodwill), resulting in these payments being treated as excludable from income under Section 118 or some "theory" or precedent that yields the same non-taxable result.

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

Some CPAs have taken the position that where a dealership receives program payments that are subject to forfeiture provisions (that would require the dealer to repay some or all of the payments to the manufacturer), the amounts received may be characterized or treated as loans, rather than as taxable income upon receipt.

Tax return disclosure, risk of penalties? In the filing of income tax returns where manufacturer incentive payments are being offset against basis (relying on the position that these payments are contributions to capital or some other theory), dealerships and/or CPAs preparing dealership tax returns in which such payments are offset against basis should consider whether they should file Form 8275 or make some other disclosure(s) in light of the recently-tightened taxpayer penalties, tax return preparer penalties and Schedule UTP disclosure considerations.

Schedule M-3 contains a specific line (Line 36 on Page 3) with respect to exclusion of payments from income under Section 118 and requires that an explanation be attached describing these payments.

CONCLUSION

The burning question with respect to manufacturer assistance payments received by dealerships for facility upgrades is whether or not they are taxable to the dealership upon receipt.

In my opinion, the *John B. White, Inc.* case, the *Detroit Edison* case (and more recently the *AT&T* case in 2011) present the most formidable barriers against dealerships successfully sustaining the position that payments they receive from manufacturers for facility improvements and upgrades can be excluded from taxable income.

It is difficult to imagine circumstances - or manufacturer plan specifics - that could possibly support any treatment to the contrary.

Has a manufacturer ... Chrysler, General Motors, or any other ... ever done anything that was not in its own best interests?

Repayment Contingencies

FORFEITURE EVENTS REQUIRING REPAYMENT IN EVENT OF DEFAULT

- Dealer fails, for any reason, to maintain at all times exclusive ***[the manufacturer]*** signage, sales, parts and service operations at the dealership site as required by this Letter of Agreement or the Dealer Agreement; or
- Dealer relocates any part of the ***[the manufacturer]*** dealership's operations or dealer's business without ***[the manufacturer]*** prior written consent; or
- Dealer fails to maintain part of ***[the manufacturer]*** dealership facilities open for business as required under the Dealer Agreement; or
- Dealer voluntarily terminates its Dealer Agreement with ***[the manufacturer]*** for any reason except a sale of all or substantially all of the assets of ***[the manufacturer]*** dealership which sale ***[the manufacturer]*** has approved in advance and in writing; or
- Dealer's Dealer Agreement is terminated by ***[the manufacturer]*** under the terms of the Dealer Agreement and applicable law; or
- Dealer should cease operations, declare bankruptcy, become insolvent, become subject to a receiver or trustee, abandon the dealership site or otherwise perform any act reasonably and materially in breach of or inconsistent with an intent to perform its obligations under this Letter of Agreement or the Dealer Agreement; or
- Dealer should default on any loan secured by the sites occupied by ***[the manufacturer]*** dealership or any secured lender should initiate foreclosure proceedings against the dealership site.

IRS INDUSTRY DIRECTORS DIRECTIVES #1 & #3

Directive #1 ... IRS LMSB Memorandum for Industry Directors ... Dec. 28, 2006	
Background / Strategic Importance	• "Taxpayers operating in corporate and partnership form are using Section 118 to exclude certain payments from gross income. The field should ***disregard Section 118 arguments by a taxpayer operating in partnership form. Section 118 is only applicable to corporations.*** • Section 118(a) provides that '[i]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.' Thus, taxpayers operating in partnership form cannot benefit from the use of Section 118."
Planning & Exam Risk Analysis	• "The field should challenge all arguments by taxpayers operating in partnership form that Section 118 allows them to exclude payments from gross income."
Audit Techniques	• "A generic Information Document Request should be issued asking the taxpayer for a list of all I.R.C. Section 118 exclusions from income."

Directive #3 ... IRS LMSB Memorandum for Industry Directors ... October 5, 2007

This Memo alerts IRS Field Directors to the improper application of the provisions of Section 118 in connection with non-shareholder contributions of capital, noting that partnerships and other non-corporate entities may attempt to exclude contributions to capital from gross income.

Subject Line	• "Tier I Issue: IRC Section 118 ***Abuse*** Directive #3." • Note: Heightened IRS displeasure over misuse is indicated by inserting ***"Abuse"*** above.
Overview	• "This Memorandum is intended to provide the field with direction on a Tier I issue relating to Section 118 abuse. IDD#1 (issued on December 28, 2006) instructs the field that Section 118 by its terms has no application to partnerships. • ***"Some taxpayers, however, continue to contend that a common law "contribution to capital" doctrine exists, independent of Code Section 118,*** and that this alleged common law doctrine permits them to exclude from a partnership or other non-corporate entity (e.g., a limited liability company) income amounts allegedly "contributed to the capital" of the non-corporate entity. • The intent of this IDD is to provide additional guidance to the field."
Background / Strategic Importance	• "Taxpayers operating in both corporate and non-corporate forms have taken the position that amounts are excludable from income as "contributions to capital" under Code Section 118 and/or under an alleged common law contribution to capital doctrine. • "Non-corporate entities have made this argument with respect to Universal Service Fund (USF) payments, with respect to federal, state and local subsidies, grants, payments etc., as well as with respect to other miscellaneous Section 118 issues."
LMSB Position	• "The Service's position is that no common law doctrine for non-corporate taxpayers exists, under the case law preceding the enactment of Code Section 118 in 1954, nor under the Code or case law since enactment of Code Section 118. • "Neither Code Section 118 nor any alleged common law "contribution to capital" doctrine permits the exclusion from income of amounts transferred to a non-corporate entity by a non-owner. The legislative history to Code Section 118 is clear that the provision codified the preexisting case law, all of which case law addressed the issue of whether amounts transferred to a corporation by a non-shareholder were excludable from income. Thus, neither the preexisting case law nor the Code supports the argument that amounts transferred to a non-corporate entity by a non-owner are excludable from income. • "See, for additional discussion, GCM 38944."
Planning & Examination Risk Analysis	• "If this Tier I compliance issue is present during an examination, it is subject to a documented risk analysis. • "The field should challenge all arguments raised by taxpayers operating in a non-corporate form who take the position that Code Section 118 ***or any other theory*** permits the taxpayer to exclude an amount from income as a 'contribution to capital'."
Audit Techniques	• "A generic Information Document Request should be issued asking the taxpayer for a list of all I.R.C. Section 118 exclusions from income. See attachment for list of information to request."
Resources	• See *Section 118 - IRS Audits - Information Document Request Where Payments Received Are Not Treated as Taxable Income.* [Note: Text of IDR is on pages 42-43.]

Section 118
IRS IDR

IRS AUDITS ... INFORMATION DOCUMENT REQUEST WHERE PAYMENTS RECEIVED ARE NOT TREATED AS TAXABLE INCOME

This IDR seeks documents and information for the purpose of determining whether **[Taxpayer]** (or any of its subsidiaries or affiliates), during the years at issue, obtained from Federal, state or local governmental units, or from any quasi-governmental units with authority delegated from a Federal, state or local government, or from the public and/or from any public or private civic groups, any amounts in the form of, but not limited to, subsidies, grants, payments, support, incentives, or supplements, etc. (referred to hereinafter as a "Payment", solely for purposes of this IDR), that it did not report as gross income under Section 118 and/or any other tax provisions and/or any common law doctrines or principles.

For each entity (including **[Taxpayer]**, its subsidiaries, and its affiliates) please respond to the following requests for documents and information:

1. During the tax year ____, did such entity obtain or receive from any Federal, state, or local governmental unit, from any quasi-governmental unit with authority delegated from a Federal, state or local government, or from the public, and/or from any public or private civic groups, "Payments" (as defined above)? If so, please list from whom the Payment was received, the form of the Payment, and the amount of the Payment.
2. Of the Payments listed in item 1, identify which Payment(s) were excluded from gross income on the Federal income tax return(s) under Section 118, any other provisions of the Internal Revenue Code and/or its accompanying Regulations, and/or any common law doctrines or principles. If none were excluded, stop here and do not continue. Otherwise, provide responses to the remaining questions. Section 118(a) provides an exclusion from gross income for, in the case of a corporation, any contribution to the capital of the taxpayer. This Section applies to capital contributions made by shareholders as well as to capital contributions made by persons other than shareholders such as governmental units and/or public or private civic groups.
3. Please list each Payment identified in item 2 above and identify from whom the Payment was received, the form of the Payment, and the amount of the Payment. Also, if the same type of Payment was received in more than one year, how was the Payment reported in previous years and what was the first year in which you excluded the Payment from income.
4. For each Payment excluded, describe how the excluded item was treated for book purposes.
    a. Identify Schedule M-1/3 entries reflecting difference between financial and tax accounting treatment;
    b. Provide supporting workpapers for Schedule M-1/3 entries.
5. Provide your written explanation why the item was excluded from income. Include an explanation why the entity did not report the Payment(s) as gross income. The explanation should identify the case law, statutes, and other legal authority on which the entity relied in support of its position and explain how the authority supports that position.
6. For each Payment excluded state the process by which the entity received or otherwise obtained the amounts and provide all documents related thereto including but not limited to any letters, term sheets, contracts, agreements, memoranda of understanding, promotional materials, applications (including all attachments) between Taxpayer and/or any of its subsidiaries and affiliates and the entity providing the payment.
7. For each Payment excluded, provide an explanation how the Payment was calculated or determined. (E.g. formula based, bargained for, standard grant amount, etc.?)
8. For each Payment excluded, explain any conditions or requirements imposed by the entity that provided the Payment. If Taxpayer or any of its affiliates or subsidiaries was required to provide documentation, such as receipts, application, claim forms, contracts, etc., please provide copies of such documentation.

(continued)

9. ***With respect to correlative basis reductions under Section 362(c),*** for each excluded Payment:

   a. Indicate whether Taxpayer or any of its affiliates or subsidiaries recorded a correlative basis reduction under Section 362(c) for Federal income tax purposes.

   b. To the extent a correlative basis reduction was made, identify the methodology used to determine which asset bases would be reduced.

   c. Identify the assets the bases of which were reduced under Section 362(c) and by how much. Furnish the depreciation computations for each asset of which the basis was reduced and support with the following information:

      1. Provide the specific fixed asset general accounts that were reduced;

      2. Identify the amount of the reduction to each general ledger account;

      3. Describe how this reduction flowed through to the tax return via the depreciation deduction.

   d. If a correlative basis reduction under Section 362(c) was not made, please explain why not.

10. ***With respect to professional and/or other advice received regarding tax treatment,*** for each excluded Payment:

   a. ***Did Taxpayer or any of its affiliates or subsidiaries receive advice from outside counsel, accountants, auditors, investment bankers, consultants, or any other third party professionals (hereinafter "Outside Professionals") in forming its position regarding the tax treatment of any Payment discussed above?***

   b. If so, for each excluded item state the advice provided, and state the fee arrangement, provide the engagement letter, and provide copies of all communications, discussing the tax treatment of the excluded item between Taxpayer and the Outside Professional(s), including but not limited to any legal opinions, comfort letters, analyses, memoranda, recommendations, and emails.

   c. Did Taxpayer or any of its affiliates or subsidiaries receive advice from its internal legal or tax departments regarding the tax treatment of any of the Payments discussed above?

   d. If so, for each excluded item state the advice provided, who provided the advice, and provide copies of all communications, discussing the tax treatment of the excluded item between Taxpayer and members of its internal tax and/or legal departments, including but not limited to any meeting minutes or notes, analyses, memoranda, recommendations, and emails.

   e. If the advice between Taxpayer's outside professional and internal departments differed, state the basis of the difference and the steps that Taxpayer undertook to reconcile the difference in forming its tax position.

   f. State whether Taxpayer or any of its affiliates or subsidiaries relied upon the internal and/or the outside advice provided.

   g. If any information responsive to this paragraph 10 is not provided, provide a comprehensive explanation of the reasons for withholding the information.

Source: ***Industry Directive #3 on Section 118 Abuse*** **... dated October 5, 2007 (last reviewed or updated on www.irs.gov on March 17, 2011).**
Memorandum for Industry Directors
Director, Field Specialists
Director, Prefiling and Technical Guidance
Director, International Compliance Strategy and Policy

[Emphasis Added]

INTRODUCTION ... DE FILIPPS COMMENTARY

John B. White, Inc. is one of the important cases to consider in evaluating the potential application of Section 118 to assistance payments that a dealer receives from a manufacturer for facility improvements and/or image upgrades.

The dealership Corporation operated an authorized Ford dealership in Philadelphia, Pa. In 1965, Ford, which held none of the Corporation's stock, paid the Corporation $59,290 to induce it to move to another location within Philadelphia. Ford offered the payment in order to increase the sales of its products and enhance its image by having the Corporation's dealership located in a more desirable neighborhood and in a more attractive and better equipped building than its current location.

The IRS and the Tax Court (in 1971) held that the payment received by the dealership was taxable as ordinary income upon receipt and that Section 118 was inapplicable to the transaction. The decision of the Tax Court (55 T.C. 729) was upheld by the United States Court of Appeals for the Third Circuit ... April 24, 1972 (71-1 USTC ¶9368; 458 F2d 989 - affirming Tax Court *per curiam*). Supreme Court *Cert* denied, 409 US 876; 93 SCt 127.

Because of the importance of this case, the full text of the substance of the Tax Court decision appears on the following pages. Slight editing (i.e., the addition of captions, placement of emphasis, etc.) is intended to assist in reviewing this material.

It is instructive to note that the Tax Court reviewed the dealership's franchise agreement and all of the correspondence the dealer had received from the manufacturer (and the dealer's responses) as part of its determination of the factual basis supporting its conclusion.

Tax Court Opinion in *John B. White, Inc.*

The issues for decision are whether an incentive payment made by Ford Motor Co. is income to the taxpayer under Section 61, I.R.C. 1954, and if so, whether it is excludable from the taxpayer's gross income as a contribution to capital under Section 118. The facts have been stipulated.

FORD SALES AGREEMENT

On February 1, 1955, John B. White, Inc. (White) executed a form "Ford Sales Agreement" with Ford Motor Co. (Ford) ... . Under the Agreement, White (identified therein as "Dealer") was designated as an authorized Ford dealer. The preamble to the instrument (which identified Ford as "Company") provided in part:

> *"Company has created a line of quality motor vehicles bearing the trade-mark "Ford" and parts, accessories and equipment therefor. These products are distributed and serviced primarily by authorized dealers. There has been established and maintained over a period of many years the good will of the public toward Company, its products and its dealers. The success of Company and the success of its dealers are dependent upon the continuation of this good will. In order to maintain and further this good will, it is essential that all dealers give prompt, satisfactory and courteous service to their customers, treat their customers fairly, and handle complaints properly.*

> *"Company has built and acquired, and is continuing to build and acquire, extensive plants, facilities and tooling necessary to the production and distribution of its products on a competitive basis, and has made, and is continuing to make, large investments in engineering and research for the improvement of its products. In order for Company and its dealers to obtain maximum benefits from such plants, facilities, tooling, engineering and research, it is essential that each dealer in the products of Company possess the qualifications, personnel and facilities requisite to cultivating and developing the market to its full potential in his locality, assume and carry out the obligation and responsibility for thus cultivating and developing the market, and adopt sound management practices in the conduct of his business.*

"In order to assist its dealers to achieve maximum results, Company has made available, and will continue to make available, to its dealers experience and technical knowledge that it has acquired and developed over the years with respect to the merchandising and servicing of automotive vehicles, parts, accessories and equipment; has offered, and will continue to offer, to its dealers advice, information and guidance with respect to management, finance, merchandising and service in a dealership; and has employed, and will continue to employ, various means to assist its dealers to achieve success in their businesses. It is deemed desirable and in the best interests of the dealers and Company that the dealers adopt a uniform accounting system in order that Company may be able to evaluate the relative operating performance of each of the dealers and to develop standards that will enable the dealers to obtain the most satisfactory results from their businesses.

"Since the dealers are the primary retail sales outlet for Company's products, it is essential that the dealers periodically furnish to Company reports and estimates with respect to their respective operations and future requirements to the end that Company may make its commitments for raw materials and plan the production and distribution of its products in line with potential retail sales."

The preamble also recited that White's stock was held by John B. White (43%), J. W. Fullem (43%), and M. M. Bennett (14%).

The dealership established by the Agreement was nonexclusive; Ford reserved the right to make sales to other dealers, and White reserved the right to make purchases from others.

REQUIREMENTS FORD IMPOSED ON THE DEALERSHIP

Under the Agreement White was required, *inter alia*, to

(1) Sell and service Ford products in a manner satisfactory to Ford,

(2) "Establish, maintain, and equip a place or places of business, including a salesroom, service facilities and a used passenger automobile and truck outlet, in a manner satisfactory to [Ford] * * * and display conspicuously thereat an assortment of Ford signs reasonably satisfactory to [Ford],"

(3) Employ adequate trained sales and service personnel, and send representative employees to training schools conducted from time to time by Ford,

(4) Maintain an accounting system in accordance with the "Manual of Accounting Procedure for Ford Dealers,"

(5) Furnish Ford with monthly financial statements and with other periodic reports describing its operations,

(6) Maintain a stock of new automobiles, trucks, and chassis, as determined by a formula specified in the Agreement, as well as adequate stocks of Ford parts and accessories,

(7) Maintain regular contact with owners and users of Ford products within its "locality,"

(8) Conduct business "in a manner that will reflect favorably at all times on" Ford, its products, and its reputation,

(9) Allow Ford representatives to examine its place of business and its records and to test its equipment and facilities, and

(10) Contribute certain sums to the "Cooperative Ford Dealers' Advertising Fund," administered by Ford.

The Agreement expressly provided that it did not establish an agency relationship between Ford and White:

"This Agreement does not in any way create the relationship of principal and agent between Company and Dealer; and under no circumstances shall Dealer be considered the agent of Company. Dealer shall not act or attempt to act, or represent himself, directly or by implication, as agent of Company or in any manner assume or create, or attempt to assume or create, any obligation on behalf or in the name of Company."

LIMITATION OF FORD'S LIABILITY

The following provision, designed to limit Ford's liability for expenditures made by White, was also included in the Agreement:

> *The requirements of this Agreement as to the facilities to be supplied by Dealer, as to the conduct of the business of dealing in* ***Company Products*** *and as to relationships between Dealer and others are intended only to protect the good name, good will and reputation of Company, to assure Company that its products will be made available to the public and that service facilities will be made available to users of its products, and to assure or inform Company of the financial stability of Dealer. This Agreement contemplates that Dealer shall acquire Dealer's own place or places of business, facilities and equipment in accordance with Dealer's own discretion and shall purchase* ***Company Products*** *as Dealer's own and resell them to customers selected by Dealer, all in conformity with the requirements and limitations herein specified but otherwise in Dealer's own discretion. Except as herein specified, nothing herein contained shall impose any liability on Company for any expenditure made or incurred by Dealer in preparation for performance or in performance of Dealer's obligations under this Agreement."*

FORD'S LETTER TO THE DEALERSHIP PROPOSING RELOCATION

On June 14, 1965, Ford's District Sales Manager, W. S. Walla, sent the following letter to John B. White, president of the corporation:

> *"The proposed relocation of your Ford dealership from 4920 North Broad Street, Philadelphia 41, Pennsylvania, to the facilities currently occupied by H. B. Robinson at 6600 North Broad Street, Philadelphia, Pennsylvania, has been approved by the Ford Division.*
>
> *"Further, approval has been granted to repurchase from John B. White, Inc., tools and equipment and signs in the amount of 20,000 within the limitations of Paragraph 21 of the Ford Sales Agreement, and to pay 59,290 in a lump sum for leasehold improvements and eligible premises assistance within the terms of Paragraph 22 of the Ford Sales Agreement, for a total of 79,290, as an incentive to complete this relocation. This payment will not be processed, however, until the actual relocation is accomplished."*

Ford offered the $59,290 incentive payment in order to increase the sales of its products and enhance its image by having White's dealership located in a more desirable neighborhood and in a more attractive and better equipped building than its current location. The reference to the "Ford Sales Agreement" in the letter was intended to refer to a 1960 revision of the form Agreement which Ford and White had executed in 1955. Paragraph 22 of the revised form required Ford to assist the dealer in selling or leasing its business premises if the sales Agreement had expired and not been renewed by Ford or if the Agreement had been terminated by Ford under specified circumstances. "Eligible premises" were properties which qualified for assistance under the Agreement. The "Ford Sales Agreement" which Ford and White had executed in 1955 also contained provisions providing for such assistance. Ford and White subsequently executed the revised form Agreement on December 27, 1965.

TRANSITIONAL & OTHER ASPECTS

White continued to conduct its business at 4920 North Broad Street, Philadelphia from February 1, 1955 through September 15, 1965. On September 16, 1965, White moved the business to leased premises at 6600 North Broad Street in Philadelphia. During 1965 White spent $57,335.59 on leasehold improvements at its new location, and on its books, it charged that amount to a leasehold improvement account. In 1966 White spent an additional $2,051.45 for leasehold improvements, bringing its total expenditures for leasehold improvement to $59,387.04.

It does not appear that Ford held stock in White during 1965.

During that year, White received a total of $79,290 from Ford in accordance with the letter of June 14, 1965. On its Federal corporate income tax return for 1965, White reported $20,000 of the $79,290 as ordinary income to the extent that it exceeded the adjusted basis of the tools and equipment which Ford had repurchased.

However, White did not include the remaining $59,290 in income on its return. It credited that amount on its books to a leasehold improvement account, and on its 1965 income tax return, it reduced the cost of leasehold improvements by that amount, presumably in reliance upon Sections 118 and 362(c)(2), I.R.C. 1954. The return disclosed no tax due for the calendar year 1965.

IRS AUDIT DISPUTE OVER TAX TREATMENT & WHITE'S POSITION

In his statutory notice of deficiency, the Commissioner determined that the sum of $59,290 received from Ford was income to White in 1965 and increased White's taxable income by that amount. ....

The central dispute in this case concerns the proper tax treatment of the $59,290 incentive payment. Since the parties have stipulated that White's 1965 return was not timely filed, the addition to tax is in issue only because the amount of tax due, upon which the addition to tax is computed as a percentage, is in question.

White's position with regard to the incentive payment is that the payment is not income to it within the meaning of Section 61, I.R.C. 1954, and alternatively that even if it is income, it is excludable from gross income as a contribution to capital under Section 118. We [The Tax Court] disagree with both [of White's] arguments.

TAX COURT'S REBUTTAL OF WHITE'S DEFENSE - POSITION #1

"Gross income," as defined by Section 61(a), "means all income from whatever source derived." In enacting it and its statutory predecessors, Congress exerted "the full measure of its taxing power," *... [Cases cited by Court here are on page 6 of 6.]*

Thus, in holding that the punitive element of a damage award constituted taxable income, the Supreme Court stated that punitive damages were income because they represented "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Glenshaw Glass Co.*, 348 U.S. at 431. Likewise, ***in the case now before us, Ford's incentive payment enhanced White's wealth by enabling it to acquire suitable facilities at an improved location for its dealership.***

White's contention that the incentive payment is not income rests upon an analogy which it has attempted to draw between the facts of this case and situations where a lessee has been reimbursed or has a right of reimbursement against a lessor for expenses which the lessee has incurred for improvements made upon the leased property.

In such cases it has been held that since the lessor is ultimately liable for the expenditures in question, the expenditures are not deductible or depreciable by the lessee. See, e.g., *Levy* v. *Commissioner*, 212 F. 2d 552 (C.A. 5), affirming a Memorandum Opinion of this Court; *379 Madison Ave., Inc.*, 23 B.T.A. 29, 41-42, reversed on other grounds 60 F. 2d 68 (C.A. 2). It follows, the argument continues, that in such cases, the reimbursement from the lessor would not be treated as income to the lessee. White urges that the same treatment be accorded here to the payment from Ford.

The cases cited have only limited relevance to the problem before us. In each of them, the expenditure made by the lessee was made on behalf of the lessor; the lessor had already agreed to pay for the improvements in question, and the funds were used to improve the lessor's property. Thus, the lessor's payment in each of those cases would enhance the value of its own property; and in making its expenditure, the lessee was simply acting on behalf of the lessor, the party which would ultimately pay for and benefit from the expenditure.

Here, on the other hand, ***White was not acting on behalf of Ford.*** The "Ford Sales Agreement" expressly disclaimed an agency relationship between the parties, and also provided that White would acquire its own place of business, facilities, and equipment. The leasehold improvements were thus the property of White, not of Ford. Accordingly, the incentive payment, which financed the improvements, was an undeniable accession to White's wealth and is includable in its income under Section 61(a).

TAX COURT'S REBUTTAL OF WHITE'S DEFENSE - POSITION #2

White contends that even if the payment otherwise qualifies as income under Section 61, it is nevertheless excludable from gross income under Section 118 of the 1954 Code as a contribution to capital. Indeed, it places primary reliance upon this point.

In amplification of Section 118, Reg. Sec. 1.118-1 provides in part:

> *"Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. * * *"*

The distinction thus drawn by the regulations between expenditures made in return for such direct benefits as goods or services and payments made in return for the indirect benefits of generally increased business in the community is reflected in the case law which Section 118 was intended to codify. ... *[Cases cited by Court here are on page 6 of 6.]*

The parties herein have stipulated that Ford made the incentive payment to White in order to derive the benefits which it expected to flow from the relocation of White's dealership: increased sales of Ford products and enhancement of the Ford image. ***The importance of these benefits is underlined by the "Ford Sales Agreement," executed by both Ford and White in 1955, which recited that Ford's success was dependent upon its dealers' ability to maintain and develop Ford's goodwill and sales within their localities. Ford thus anticipated that as the result of the relocation of White's dealership, it would derive valuable direct benefits from improved sales and promotional activities.***

We conclude that Ford made the incentive payment in consideration for enhanced promotional activities by White through the use of its new facilities and the increase in the sale of Ford products which could reasonably be expected to follow; such payment is not excludable from White's income as a contribution to capital. ... *[Cases cited by Court here are on page 6 of 6.]*

WHITE'S MISPLACED RELIANCE ON *FEDERATED DEPARTMENT STORES, INC.*

White has relied primarily upon *Federated Department Stores, Inc.* [51 T.C. 500, 518-519, affirmed 426 F. 2d 417 (C.A. 6)], in support of its position. However, we think it distinguishable from the case presented here. There the Court held that payments made by a real estate developer to a taxpayer in order to induce it to operate a department store within the developer's shopping center were excludable from the taxpayer's income as contributions to capital. The Court of Appeals stated (426 F. 2d at 421):

> *"The payments by Sharpstown to taxpayer were admittedly made with the expectation that the existence of taxpayer's department store would promote Sharpstown's financial interests. However, this expectation was clearly of such a speculative nature that any benefit necessarily must be regarded as indirect. In all the cases relied on by the government, the contributions had a reasonable nexus with the services which it was the business of the recipient corporation to provide. Such is not this case. Under these circumstances, we agree with the Tax Court that any benefit expected to be derived by Sharpstown was so intangible as not to warrant treating its contribution as a payment to taxpayer for future services."*

Here, on the other hand, Ford's payments clearly had a "reasonable nexus" with the services which White customarily provided: the sale and promotion of Ford products. Moreover, the benefits which Ford anticipated were neither "indirect" nor "intangible;" they were the very benefits which Ford relied upon on establishing authorized dealerships.

To be sure, ***the line between the two classes of cases is a shadowy one***, but in our judgment *Federated Department Stores* is on the other side of that line and is more to be associated with the cases of contributions by community groups with which Section 118 was primarily concerned as disclosed by the legislative history.

CONCLUSION

We (the Tax Court) sustain the Commissioner's determination that the incentive payment from Ford is includable in White's income. (We also uphold his determination with regard to the addition to tax.)

CASES CITED BY THE TAX COURT IN ITS OPINION...

In rebuttal of White's defense position #1 ... (text page 4 of 6) ... *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-432; *Helvering* v. *Clifford*, 309 U.S. 331, 334; *Helvering* v. *Midland Mutual Life Ins. Co.*, 300 U.S. 216, 223; *Douglas* v. *Willcuts*, 296 U.S. 1, 9; *Irwin* v. *Gavit*, 268 U.S. 161, 166; H. Rept. No. 1337, 83d Cong., 2d Sess., A18 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess., 168 (1954), and intended to "tax all gains except those specifically exempted." *Commissioner* v. *LoBue*, 351 U.S. 243, 246; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. at 430.

In rebuttal of White's defense position #2 ... (text page 5 of 6) ... Compare *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, with *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583. See also *Teleservice Co.* v. *Commissioner*, 254 F. 2d 105 (C.A. 3), certiorari denied 357 U.S. 919; *Federated Department Stores, Inc.*, 51 T.C. 500, 518-519, affirmed 426 F. 2d 417 (C.A. 6); S. Rept. No. 1622, 83d Cong., 2d Sess., pp. 18-19, 190 (1954).

[Footnote 4 states: This [Sec. 118] in effect places in the Code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services. [S. Rept. No. 1622, 83d Cong., 2d Sess., pp. 18-19 (1954)]. ... End of Footnote 4.]

Also in rebuttal of White's defense position #2 ... (text page 6 of 6) ... (See *Commissioner* v. *Arundel-Brooks Concrete Corp.*, 152 F. 2d 225 (C.A. 4); See also *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583, 591 fn. 13. See also *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98; *Teleservice Co.* v. *Commissioner*, 254 F. 2d 105 (C.A. 3), *certiorari* denied 357 U.S. 919.)

[Footnote 5 states: "Commissioner v. Arundel-Brooks Concrete Corp., 152 F. 2d 225 (C.A. 4th Cir. 1945), relied upon by the court below, involved only the issue whether the full cost of a concrete mixing plant, the construction of which was financed in part by payments from a nearby supplier of a raw material used in mixing concrete, was depreciable to the taxpayer; there was no 'contribution to capital' issue, the only question being one of cost basis. However, the payments in that case were made in consideration of service rendered. The construction of the concrete plant directly benefited the supplier of raw materials by insuring the use of its sole product by the taxpayer; the supplier was also served through a business affiliation with the parent of the wholly owned taxpayer in the form of an exclusive marketing arrangement which saved the supplier the expense of a sales organization. See Arundel-Brooks Concrete Corp., v. Commissioner, 129 F. 2d 762 (C.A. 4th Cir. 1942)."

Cf. Detroit Edison Co. v. Commissioner, 319 U.S. 98, 100 fn. 2; Denver & Rio Grande Western R.R. Co., 32 T.C. 43, 45, affirmed 279 F. 2d 368 (C.A. 10); Commissioner v. Revere Land Co., 169 F. 2d 469, 482-483 (C.A. 3), certiorari denied 335 U.S. 853. ... End of Footnote 5.]

James Brown, et al. v. Comm.

Payment Received to Induce Purchase of Stock Was a Reduction of Cost Basis

10 B.T.A. 1036 ... Feb. 28, 1928

The Factual Essence of *James Brown*

Before

- Mr. A owns the majority interest in Corporation XYZ.
- Mr. X owns the minority interest in Corporation XYZ.
- Mr. X is an unfriendly/hostile minority interest holder who does not agree with Mr. A on how Corporation XYZ should be run.
- Along comes Mr. B (an acquaintance of Mr. A) who is not a shareholder, but who is friendly to Mr. A.
- Mr. A suggests that Mr. B should purchase the minority interest in Corporation XYZ currently owned by Mr. X.
- However, Mr. B thinks the price Mr. X wants for his stock is too high. Mr. B is unwilling to purchase the minority interest shares in Corporation XYZ at the high price that Mr. X requires.

The Inducement Transaction

- Mr. A tells Mr. B that he will give/reimburse Mr. B $20,000 if Mr. B purchases the stock from Mr. X for the price Mr. X desires.
- Mr. B purchases the minority interest in Corporation XYZ owned by Mr. X. This replaces Mr. X (the hostile owner of the minority interest) with Mr. B who is a friendly owner of the minority interest.
- Mr. A pays Mr. B $20,000, per their agreement.

After ... Part I

- Mr. B's position is that the payment of $20,000 that he received from Mr. A should be treated as a reduction of the cost of his purchase of the minority interest in Corporation XYZ.
- The Board of Tax Appeals agrees with Mr. B that the $20,000 payment is a non-taxable reduction of his cost basis in the stock of Corporation XYZ.

After ... Part II

- Mr. B (the new owner of the minority interest) is happy because he is not taxed on the receipt of the $20,000 that he received from Mr. A. The payment is not taxable as ordinary income. Instead, it is a reduction of his basis for his minority interest in Corporation XYZ.
- Mr. B is also happy because the amount he paid, when reduced by the $20,000 he received from Mr. A, leaves him feeling satisfied that the (net) price he paid was a "fair price" for the minority interest in Corporation XYZ.
- Mr. A (the owner of the majority interest) is happy because Mr. B is now the friendly minority shareholder of Corporation XYZ.
- Mr. X (the former hostile owner of the minority interest) is happy because he is out of the picture and he has received the price he was asking for his stock.

Comment: In the *James Brown* case, the unfriendly minority interest in Corp. XYZ was held by the *estate* of Mr. X.

FACTS

During 1920, and for some time prior thereto, one Franklin Bache was president and principal stockholder of the Kali Inla Coal Co., (hereinafter referred to as the "Coal Company"). Upon the death of J. T. Jackson, who held the remainder of the stock, the estate of Jackson offered the stock for sale. At this time there were suits pending in connection with the Coal Company and Bache was desirous that this minority interest should not be purchased by persons hostile to the Coal Company. Bache, not having funds to purchase the entire minority interest, urged petitioner, James Crosby Brown, to purchase the stock, but Brown was reluctant to make the purchase for the reason that he considered the price asked of $125 per share excessive. At this time and for some time prior thereto, Bache had been serving the Coal Company at a low salary and there was an understanding that when the condition of the Coal Company would warrant such action, Bache would be paid a substantial amount as back salary.

In order to induce James Crosby Brown to purchase some of the stock at the price offered, Bache agreed with Brown that if he (Brown) would purchase a certain amount of the stock at the price offered, he (Bache) would give him (Brown) 15% of the aforementioned back salary when received.

Accordingly, in February, 1920, Brown purchased 90 shares of the Coal Company stock at $125 per share from the Jackson estate. During 1920, Bache received certain back salary and made payments to Brown of $2,200.14 on August 30, 1920, and $1,050 on October 19, 1920. Brown made book entries on account of the foregoing amounts as payments to reduce the cost of the Coal Company stock. The Commissioner included the payment of August 30, 1920, as a part of Brown's gross income for 1920.

OPINION

The question is whether the amount paid petitioner, James Crosby Brown, by one Bache to induce Brown to purchase certain stock of the Kali Inla Coal Co. is a reduction of the cost of the stock to Brown or whether it is to be treated as taxable income.

The substance of the transaction is that when the minority stock was offered for sale, Bache, the majority stockholder, was unable to purchase the stock himself and was desirous that the stock be purchased by some one friendly to the Coal Company as it then existed.

Bache accordingly urged Brown to purchase the stock at the price offered, but Brown was reluctant to make a purchase at this price because he said he thought the price too high. Bache then agreed to pay certain amounts to Brown if he would purchase some of the stock.

Our question is whether this is to be treated as a reduction of the cost of the stock to Brown, or whether it is taxable income to him.

The Board is of the opinion that the amount paid to petitioner by Bache does not constitute taxable income to him, but was a reduction of the cost of the stock.

This amount was paid in furtherance of an understanding between petitioner and Bache under which petitioner made the purchase and, in the minds of both parties, represented a reduction of the investment by petitioner.

Petitioner acquired the stock from the Jackson estate coupled with a contract that Bache would, in effect, make the cost to petitioner less than the agreed consideration between petitioner and the Jackson estate.

When the two contracts are considered together upon the basis of the intent of the parties when made, and in the light of the results reached in their final consummation, we fail to see how the amount in question can be considered as taxable income. The action of the respondent in treating the amount paid by Bache to Brown as taxable income is accordingly reversed.

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First-class