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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. AS WE NEAR YEAR-END ... UNCERTAINTY, <u>CONFUSION & DELAY</u>. Let's face it, we've run out of time. As we approach year-end, no one really knows what is going to happen in the way of tax changes for 2012 (or for 2013, for that matter).

Until Congress decides what to do and tax legislation is drafted, no one knows whether many of the tax breaks which expired at the end of 2011 will be "reinstated" for 2012 or what the tax rate changes will be for businesses and for individuals in 2013.

This uncertainty makes it difficult to advise clients on precise planning strategies for this year or for next year. Eventually, we'll know what the situation is. But until then, your guess is as good as mine.

One thing is reasonably foreseeable. It's going to be a really difficult tax filing season for all of us.

Right now, the IRS is on "hold" as far as programming its computers for tax rates and changes for 2012 returns. The Service also can't print (let alone even draft) forms for taxpayers to use. Tax return software providers can't program their own software - they're in the same quandary as the IRS. And, the IRS probably won't be able to accept electronically filed tax returns until February 1 ... and that's being optimistic.

As if that's not bad enough, the after-effects of Sandy's destruction for many has created large-scale business disruptions. Also, vast areas of the country are Federal disaster areas, and this involves special tax provisions to be considered (on top of everything else) and extended filing dates for tax returns.

It looks like almost all of next year will be one long, extended, "tax filing season" for many of us. Refund-minded taxpayers (and practitioners) who are in a hurry to get even a partial refund of their overpaid 2012 taxes will undoubtedly file a "first-efforts" return as early as possible in 2013 to get back the major part (or at least some) of "their tax refund" from the IRS sooner.

Then, at a later date, their preparers (that's you) will have the happy task of filing "amended" returns for 2012 to reflect all of the changes that are relevant to their tax return. At that time, they will either pay back or collect the difference. This amended return process might even involve filing a second "amended" return to correct the first one. (Good grief!)

So much for speculation. Let's talk about a few sure things.

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WATCHING OUT FOR

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#2. 2012 TIMELINE ... THE YEAR IN REVIEW. During the year, there were several significant developments, some of which we reported at mid-year and others which are included here in our Year-End Edition of the *DTW*.

On pages 4 - 7, you'll find timelines showing IRS activities, Court decisions and other developments for 2012, with 2011 added for continuity and comparison.

#3. IRS AUDIT ACTIVITY & MAJOR TAX ISSUES. There doesn't seem to be much IRS audit activity involving dealerships to report at the present time. At least nothing major has risen to a level of general awareness.

But, there are still two major tax issues affecting dealerships which seem to be getting equal coverage and emphasis at this time.

The first issue is the tax treatment of the receipt by dealerships of payments from manufacturers under their image upgrade programs. This continues to receive considerable attention, as evidenced by several presentations at the AICPA National Auto Dealership Conference a few weeks ago in October and at the NADA Convention earlier in February.

The second major issue relates to the efforts practitioners are now beginning to make to understand the Temporary Regulations which provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property.

These Regulations were supposed to become effective January 1, 2012. However, the IRS recently postponed the effective date to January 1, 2014.

These provisions are extremely important to all dealerships - and most other businesses, as well. Some of these account for the focus of the article beginning on page 30 in this Edition of the *Dealer Tax Watch*.

#4. A REMINDER TO BE CAREFUL ABOUT TIMELY FILING COPIES OF FORM 3115. Letter Ruling 201237003 involved a taxpayer whose accounting firm was supposed to prepare a Form 3115, *Application for Change in Method of Accounting*. This change was being made under Rev. Proc. 2011-14.

The ***original*** of Form 3115 was timely filed. However, there was a "miscommunication" between the taxpayer's tax department and the accounting firm regarding the filing dates of the Form 1120, and the signed ***copy*** of the original Form 3115 was not timely mailed to the IRS Office in Ogden, Utah.

To make a long story short, the IRS granted the taxpayer an extension of time to file the copy of the Form 3115 with the Ogden Office. However, this result was not obtained without the expenditure of considerable time, effort and money (filing fees) which otherwise could have been avoided.

For more of the story, see page 10.

#5. AICPA NATIONAL AUTO DEALERSHIP CONFERENCE. This year, the AICPA Annual National Auto Dealership Conference was held at the Venetian in Las Vegas on October 25-26. Attendance there was approximately 450, up from 350 attendees last year.

It was a very good Conference this year, and beginning on page 11, I've highlighted comments from several of the sessions I attended.

#6. CREATING BASIS (IN STOCK & IN DEBT) SO THAT S CORP. LOSSES CAN BE CURRENTLY DEDUCTED. At mid-year, there were two developments that affect this significant planning area.

In June, there was an interesting taxpayer victory in the Tax Court. In *Maguire,* with the helpful advice and strategy provided by its CPA, the family shareholders in a Buy-Here, Pay-Here (BHPH) dealership and its Related Finance Company (RFC) successfully maneuvered stock basis from one of the Subchapter S Corporations to the other S Corp.

As a result, the shareholders were able to offset all of the operating losses that were incurred during the year by the BHPH dealership against other ordinary income in their personal income tax returns. Note: This case relates to the matter of increasing the tax basis for the ***stock*** of an S Corporation.

The second development also occurred in June. The Treasury issued proposed Regulations that are intended to clarify the requirements for increasing the tax basis of ***indebtedness*** and to assist S Corporation shareholders in determining with greater certainty whether their particular financing arrangement creates basis for certain indebtedness (which basis can also be used to absorb current-year operating losses incurred by the S Corporation).

These proposed Regulations require that in order to increase basis of indebtedness, the loan transactions must represent bona fide indebtedness of the S Corporation to the shareholder.

Both of these developments are discussed in the article beginning on page 18.

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#7. UPDATE ON DEALERSHIP TAX TREATMENT OF MANUFACTURER PAYMENTS FOR FACILITY UPGRADES & IMPROVEMENTS. This continues to be the most important issue affecting the entire spectrum of dealerships in the country. However, at this time, there's not much new to report.

In August 2012, NADA asked the IRS to accept into its Industry Issue Resolution (IIR) program the general issue of how the Internal Revenue Code applies to payments that dealers receive under these programs.

NADA said it was seeking guidance on "whether it is proper for (dealer) taxpayers to treat certain payments made pursuant to these programs as a reduction to the basis of specified depreciable assets rather than treating the payments as income in the year received."

In October, the IRS informed NADA that it would not include this issue in the IIR Program because "... Sections 61 and 118 of the Internal Revenue Code as well as case law adequately address this issue."

A brief update of this and other developments begins on page 28.

#8. THE NEW TANGIBLES REGULATIONS ... THE TREASURY'S "NEW" PARADIGM SHIFT. A portion of the Mid-Year Edition of the *Dealer Tax Watch* focused on the Temporary Regulations which provide guidance on capitalization versus repair (deduction) issues concerning buildings and all other tangible property.

That coverage included an overview of the new Regulations and an analysis of the specific provisions and examples in the Regulations which Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, has - on several occasions - specifically referred to as warranting special attention by dealerships and their advisors. She has mentioned three particular examples because they might be more directly related to dealership facility expansion, modernization and upgrade activities.

After listening to a few seminars presented by others on these new Regulations, I have come to believe that these new Regulations reflect the collective frustration that the IRS must have experienced as a result of analyzing - and apparently finding significant fault or at least differences of opinion with respect to - so many of the "Repair Studies" prepared for Fortune 500 companies by the Big Four and other large accounting firms.

Unfortunately, instead of limiting the scope of the impact of these Regulations to the Fortune 500 and multi-billion dollar conglomerates, the Treasury decided to force all taxpayers - regardless of size - to comply with these excruciatingly complex and vague Regulations. So, here we are.

Beginning on page 30, I have included extended coverage of the Regulations focusing more attention on some of the aspects that were briefly covered in the previous *DTW*.

In my opinion, so far, the most beneficial provisions in the Regulations involve the expansion of the definition of what constitutes a "disposition" and the changes in accounting method related to the so-called *"Roof Repair Scenario."*

What I am referring to as the *"Roof Repair Scenario"* relates to the automatic change in accounting method (Designated Change No. 177) which now permits a deduction for previously capitalized improvements to buildings and building components when major building "repairs" or renovations occur at a later date.

As part of the audio seminars offered recently by the *De Filipps University* Resource Center, I presented three 2-hour audio seminars on these Regulations. Parts I and II were general background presentations on October 3 and on October 10, respectively. Part III, on October 16, focused on the impact on auto dealerships. If you are interested, On Demand Recordings of these audio seminars are available at www.krm.com/wjd.

These audio seminars (through the *De Filipps University* Resource Center) are becoming more and more the primary vehicle for keeping you up-to-date with in-depth technical discussions of relevant dealership tax issues.

IRS Notice 2012-73 hints at relief for smaller businesses. In IRS Notice 2012-73, the Service said that it anticipates that the final Regulations will contain changes from the temporary Regulations. As a result, the Regulations now will apply to taxable years beginning on or after January 1, 2014. That's a 2-year postponement of the "drop-dead" date for implementing the new provisions.

One more pleasant surprise is that the IRS will give taxpayers the option to apply the ***final*** Regulations to years beginning on or after January 1, 2012.

Furthermore, taxpayers (again, at their option) will be permitted to choose to apply the ***temporary*** Regulations to taxable years beginning on or after January 1, 2012 and before the applicability date of the final Regulations.

Notice 2012-73 states that certain sections of the temporary Regulations may be revised in ways that will simplify the implementation of these rules, espe-

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Timeline	***January 1, 2012 to Date***
January	• ***New Tangibles Regulations.*** In January 2012, the IRS issued two Revenue Procedures which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations. ◆ These CAMs are for taxable years beginning on or after January 1, 2012. • Rev. Proc. 2012-19 is for CAMs involving ... ◆ Materials and supplies ... Under Reg. Secs. 1.162-3T & -4T ◆ Capital expenditures in general ... Under Reg. Sec. 1.263(a)-1T ◆ Transaction costs ... Under Reg. Sec. 1.263(a)-2T ◆ Improvements ... Under Reg. Sec. 1.263(a)-3T • Rev. Proc. 2012-20 is for CAMs involving ... ◆ Leased property ... Under Reg. Sec. 1.167(a)-4T ◆ General asset accounts ... Under Reg. Sec. , 1.168(i)-1T ◆ MACRS (Modified Accelerated Cost Recovery System) property ... Under Reg. Sec. , 1.168(i)-7T ◆ Dispositions of MACRS property ... Under Reg. Sec. 1.168(i)-8T.
January	• ***Request for relief from LIFO recapture due to natural disasters in 2011.*** On January 13, 2012, NADA sent a letter to the Treasury/IRS requesting expedited Section 473 relief for certain franchised auto and truck dealers (Honda, Subaru and Toyota/Scion). • These dealers experienced significant decreases in their new vehicle year-end Dec. 31, 2011 LIFO inventories as a result of the earthquake and tsunami that occurred in Japan in march 2011 and/or the flooding that occurred in Thailand in July 2011. • In March, the Treasury's Office of Tax Policy responded by stating its position that ... ◆ Section 473 cannot be used to provide relief in situations that do not involve a "politically motivated" inventory disruption. ◆ The inventory disruptions caused by (these) natural disasters do not rise to the level of urgency that would justify granting relief under Section 473.
February	• ***Repeal of LIFO and other inventory accounting methods.*** President Obama's Administration again included the repeal of the use of the LIFO method as a tax break to be eliminated as part of the fiscal year 2013 revenue proposals. • The repeal of LIFO would start in the first taxable year beginning after the December 31, 2013. ◆ This, in effect, is a 2-year postponement of the repeal advocated by the Administration in prior years' revenue proposals. ◆ The recapture of the LIFO reserve into taxable income would occur ratably over a 10-year spread period. • The Administration's revenue proposals for 2013 would also prohibit the use of (1) the lower-of-cost-or-market method and (2) the subnormal goods method for valuing inventories. ◆ The repeal of these methods would start in the first taxable year beginning after the December 31, 2013. ◆ The Sec. 481(a) adjustments would be taken into income ratably over a 4-year spread period.
February	• ***IRS issues* Automotive Alerts** ◆ *"Factory Image Upgrade Payments"* ◆ *"IRS Issues New Regulations ... Deduction and Capitalization of Expenditures Related to Tangible Property,"* which includes Addendum. ▪ *"Regulation Examples #6,-7 and -8 re: Store Remodels and Refreshes"* ... Addendum to IRS *Automotive Alert*
February	• ***Issuance of "Factory Facilities Programs:*** *An NADA Research Project"* by Glenn Mercer. • This *Report* summarizes the findings of the NADA Factory Facilities Programs Research Project which began in August, 2011 in response to significant expressions of concern and frustration by dealers over how the various manufacturers facility programs were being designed and implemented.
February	• ***2012 NADA Convention Dealer Tax Issues Workshop*** includes significant discussion by panelists of manufacturer assistance payments to dealerships for facility improvements. • Consensus of panelists is that generally, these payments received by dealerships would be includable (i.e., taxable as ordinary income) upon receipt. However, this adverse tax impact can be minimized by the consideration and appropriate use of several techniques.

Timeline	***JANUARY 1, 2012 TO DATE***
March	• ***Moratorium on raising Sec. 263(a) issues.*** On March 15, 2012, the LB&I (Large Business & International) Directive stated that for taxpayers who had adopted a method of accounting (change) relating to the conversion of capitalized assets to repair expense under Section 263(a), examining agents should discontinue any current exam activity with regard to these issues and not begin any new exam activity with regard to these issues. • Also, if the taxpayer under exam files a Form 3115 with regard to these issues on or after December 23, 2011, the examining "should risk assess the Form 3115 and determine (in consultation with the *Change in Accounting Method Issue Practice Group*)" whether to examine the Form 3115. ◆ In effect, this is a 2-year "moratorium" or a "stand-down order" on auditing these issues.
March	• ***Form 3115 Instructions.*** The IRS revised the Instructions for Form 3115 (to be used with the December 2009 revision of Form 3115). • This revision of the Form 3115 Instructions lists all of the changes in accounting methods that might be made in connection with the new Tangibles Regulations under Sections 162, 167, 168 and 263(a). ◆ These changes in accounting method may be made under Rev. Procs. 2012-19 or 2012-20.
April	• ***April 15 tax return filings.*** For the first time, some dealers may be required to file Form 8938 ... *Statement of Specified Foreign Financial Assets* with their 2011 income tax returns. • This new annual filing disclosure requirement applies to individuals 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. ◆ The married filing jointly value threshold for filing Form 8938 is met if the aggregate value of all *specified foreign financial assets* exceeds $100,000 at Dec. 31st or $200,000 at any point during the tax year ($50,000 or $100,000 respectively for individuals filing as single taxpayers). ◆ Failure to comply with these new requirements can result in an extension of the statute of limitations, fines starting at $10,000 and additional related penalties. • From an automobile dealer perspective, *specified foreign financial assets* may include stock ownership in an offshore reinsurance company. ◆ These disclosures are not required for shareholders of offshore reinsurance companies with valid IRC Section 953(d) elections.
May	• ***Sec. 263(a) Regulations public hearings.*** On May 9, 2012, the IRS held a public hearing at which interested parties presented comments on the Temporary and Proposed Regulations regarding deduction and capitalization of expenditures related to tangible property.
June	• ***Limited potential LIFO repeal.*** On June 7, 2012, a bill was introduced in the House of Representatives (H.R. 5906) that would repeal the use of the LIFO inventory method by integrated oil companies (as defined in Section 167(h)(5)(B)) effective for taxable years beginning after December 31, 2011. ◆ The Section 481(a) adjustment to recapture the LIFO reserve into the income must be taken into account ratably over a period not greater than 8 taxable years, beginning with the first such year.
June	• ***Buy-Here, Pay-Here dealer successfully shifts basis between two related S Corporations in order to be able to deduct 100% of the pass-through Net Operating Losses.*** ◆ *Maguire v. Comm.* (T.C. Memo 2012-160, June 6, 2012) ◆ The individual shareholders of two S Corporations (a buy-here, pay-here dealer and its related finance company) successfully maneuvered stock basis from one S Corporation to the other so that the individual shareholders could absorb 100% of the net operating losses.
June	• ***Proposed Regs. under Section 1366 re: Increasing basis of indebtedness in an S Corp.*** On June 12, 2012, the Treasury issued proposed Regulations that are intended to clarify whether the basis of debt held by the S Corporation shareholders can be increased by certain transactions. • The loan transactions must represent *bona fide* indebtedness. • The Regulations include examples involving (1) shareholder loan transactions, (2) guarantees, (3) back-to-back loan transactions and (4) loan restructuring through distributions.

Timeline	JANUARY 1, 2012 TO DATE
September	• ***Revenue Ruling 2012-25 ... Another nail in the coffin for tool plans.*** In September, 2012, the IRS issued a revenue ruling that examined four situations involving attempts by taxpayers to come up with arrangements that recharacterized taxable wages as non-taxable reimbursements under the accountable plan requirements of Section 62(c). ◆ Three out of the four situations examined did not qualify. The situation that did resulted in a reduction in hourly pay for employees when reimbursement levels were below expectations. ◆ Although none of the four situations involved a dealership, the IRS reasoning and the underlying principles would clearly be applicable to dealerships. ◆ The three situations that did not meet the business connection requirement of the accountable plan rules involved (1) a company that provided technicians to install cable television systems where the technicians were required to provide their own tools, (2) a staffing contractor that employed nurses who provided services to hospitals on short-term work assignments and (3) employees of a construction firm where the employees were required to travel between instruction sites using their personal vehicles. ◆ The fourth situation - which did meet the business connection requirement of the accountable plan rules - involved a cleaning company that required its employees to provide cleaning products and equipment necessary for their cleaning activities. In this situation, the employer prospectively altered its compensation program by reducing the hourly compensation paid to all employees.
October	• ***IRS rejects request by NADA to consider taxation of manufacturer facility upgrade payments under the IRS IIR Program.*** ◆ On August 31, 2012, NADA requested that the IRS accept into its Industry Issue Resolution (IIR) program the general issue of how the Internal Revenue Code applies to payments that dealers receive under these programs. ◆ NADA said it was seeking guidance on "whether it is proper for (dealer) taxpayers to treat certain payments made pursuant to these programs as a reduction to the basis of specified depreciable assets rather than treating the payments as income in the year received." ◆ NADA raised three points that it thought justified including this issue in the IIR program. ▪ First, the case most frequently cited in support of treating these payments as income (*John B. White, Inc. v. Comm.*) is limited to the application of a single Code provision (Section 118) to a single fact pattern. ▪ Second, that "there is disagreement among many dealer tax advisors as to the proper treatment of the payments." ▪ Third, to date, the IRS has not offered formal, industry-specific guidance on the matter and, in particular, has not addressed the extent to which other Code provisions (e.g., Sec. 1016) may apply to the many different manufacturer facility image programs that exist today. • The IRS' letter of rejection (dated October 11, 2012) said that it would not include this matter in the IIR program "...We reviewed your submission and determined that guidance under Sections 61 and 118 of the Internal Revenue Code as well as case law adequately address this issue. Consequently, the IRS will not be accepting your submission into the IIR program."
November	• ***Delay in effective date of Tangibles Regulations*** ... IRS Notice 2012-73 (Nov. 20, 2012) ◆ Taxpayers will not be required to apply the ***Final*** Regulation rules to years before 2014. ◆ This is because the Treasury anticipates finalizing the Regulations sometime during 2013. ◆ However, taxpayers will be permitted to apply the rules in the ***Temporary*** Regulations to their 2012 and/or 2013 tax years (i.e., to tax years starting on or after January 1, 2012 and before the applicability date of the ***Final*** Regulations). ◆ The Notice says that the Treasury expects the ***Final*** Regulations will affect - and in certain cases, simplify - the implementation of (1) the *de minimis* rules, (2) the safe harbor rules for routine maintenance, and (3) the rules under Sec. 168 for dispositions of depreciable property.
Schedule UTP Reminder for 2012	• If a dealership files a corporate income tax return (i.e., ***Form 1120***), it will be required to file Schedule UTP *(Uncertain Tax Position Statement)* with its 2012 income tax return if ... ◆ The dealership, or an entity related to the dealership, issues an audited financial statement, ***and*** ◆ The dealership has total assets in excess of $50 million. • Disclosure(s) on Schedule UTP should be considered by dealerships if they do not report manufacturer assistance payments for facility improvements as ordinary income when received.

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.
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.
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)).
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.
September 15 and/or October 15	• These are the latest extended due dates (depending on the entity) 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.
December	• On December 27, 2011, the Treasury published temporary Regulations (T.D. 9564) that provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property. ◆ Correlative amendments were also made to Regulations under Sections 167 and 168 with respect to depreciation and disposition of MACRS assets. ◆ Collectively, these Regulations are referred to as the ***new Tangibles Regulations***. • These Regulations became effective January 1, 2012 and also serve as proposed Regulations. • These Regulations have a significant bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received. • See January 2012 for issuance of related Revenue Procedures 2012-19 and 2012-20 which provide procedures for automatic changes in accounting methods under these Regulations.

(Continued from page 3)

cially by smaller-sized taxpayers. It says that the revisions being contemplated will take into consideration all comments, including comments requesting relief for small businesses.

#9. STATUS OF LIFO ... WILL LIFO BE AROUND NEXT YEAR? We still don't know and we'll just have to wait and see what, if anything, Congress decides to do.

Meanwhile, year-end 2012 inventories for many dealers are reaching stratospheric levels. Not many are complaining because floorplan interest rates are low to non-existent.

And, inflation for 2012 is expected to be a bit higher this year. It should be a good year for dealerships that are still on LIFO.

#10. THE IRS REORGANIZES ITSELF YET AGAIN. There's been another reorganization within the IRS at the Large Business and International Division. The Service will no longer manage issues through the previous Tiered Issue Process which was set up in 2006.

Instead, the IRS has now created (1) Issue Practice ***Groups*** (IPGs) - which will be responsible for dealing with domestic issues - and (2) Issue Practice ***Networks*** (IPNs) - which will handle international issues.

The IPGs are intended to insure consistency in the treatment of industry issues by the IRS. IRS audit team members are encouraged to discuss technical issues with the IPGs and taxpayers should be informed when a discussion with a member of an IPG Group is involved. Apparently, IPGs are staffed by a few full time technical specialists and some part-time subject matter experts.

These IPGs and IPNs seem to be similar to the old Industry Specialist Groups (from a few reorganizations ago) and are designed to provide internal guidance and support for examination teams.

However, conclusions reached by members of each division are apparently not binding on the Service, but instead are "advisory." Apparently, the IPN's purpose is to shed some greater light or clarity on the issues, but they are not meant to resolve technical issues raised by the IRS auditors. (To many practitioners, this seems a rather vague job description.)

One can't help but thinking this is just another Kabuki dance. That feeling was not dismissed when *Tax Notes* recently reported (Nov. 19, 2012) that these "New LB&I Knowledge Management Groups (Are) Still Causing Confusion."

Completion of business systems modernization. Former IRS Commissioner Shulman reported at the AICPA National Tax Conference in November that the IRS has recently completed its technology modernization effort known by insiders as CADE 2.

Customer Account Data Engine 2 or "CADE 2" for short is the IRS' core account database of taxpayer information. It now has a daily processing cycle, and this is a significant improvement over the previous weekly or bi-weekly processing cycle.

Mr. Shulman reported that "last year, every single tax return, every individual return that came in, got posted on a daily cycle." This is important because "this means faster refunds for all taxpayers, up-to-date information at the fingertips of our customer service representatives, and means we have a single sole-source database of records with all the key information that we can use for analytics purposes, both for compliance and for customer service."

It appears that this new system, in part, accounts for the change made by the IRS for the filing of copies of Forms 3115 with the IRS Director in Ogden, Utah, rather than with the IRS National Office in Washington, DC.

All of this is very impressive, indeed. We'll see how well that works out over the next few months when the 2012 returns start to flow in.

But, what about the training of IRS personnel and the quality of the answers that will be forthcoming when taxpayers flood the IRS hotlines with questions about how to handle the new tax laws and how soon they can expect to receive ***their*** "refunds." Will the IRS be up-to-speed in these areas?

Again, time will tell, and this may compound - or it may alleviate - other difficulties that are anticipated to occur in the upcoming "filing season."

#11. SCHEDULE UTP FOR REPORTING UNCERTAIN TAX POSITIONS LOOMS SOMEWHAT LARGER THIS YEAR. Some dealerships may have taken the position that manufacturer assistance payments for facility upgrades received in prior years could be treated as reductions of basis (either under the theory that Section 118 applied or under some other theory).

For these dealerships, Schedule UTP and reporting uncertain tax positions in corporate income tax returns may be an important consideration this year.

If four requirements are met, Schedule UTP must be filed ... (1) the corporation has assets equal to or exceeding $50 million for tax years 2012 and 2013, (2) the corporation files Form 1120 - *U.S. Corporation Income Tax Return*, (3) the corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and (4) the corporation has one or more tax positions that must be reported on Schedule UTP.

Many dealerships will not have to file Schedule UTP if they do not satisfy the third requirement relating to audited financial statements. That seems to be the easiest loophole by which taxpayers may avoid filing Schedule UTP.

Note that the $50 million threshold for total assets reduces to $10 million starting with 2014 and that will include virtually all dealerships under that lower filing size requirement.

Currently, pass-through entities (i.e., S-Corps, Partnerships and LLCs filing as partnerships) are not required to file Schedule UTP with their income tax returns. However, that could change in the near future.

#12. FORM 8938 ... REPORTING REQUIREMENTS FOR SPECIFIED FOREIGN FINANCIAL ASSETS. The importance of filing this form, in circumstances where it is required, was continually discussed throughout the year at various conferences and presentations ... NADA, AICPA, etc. Everyone is stressing its importance.

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 for underpayment of taxes on income related to specified foreign financial assets.

Be sure to check this out before finalizing 2012 personal income tax returns for your dealer - and all other - clients.

For automobile dealers who are shareholders in offshore reinsurance companies, this filing requirement may include stock ownership in the entity unless an election under Section 953(d) has been made.

#13. REV. RUL. 2012-25 ... FOUR MORE NAILS IN THE COFFIN FOR TOOL PLANS. In September, 2012, the IRS issued a Revenue Ruling that examined four situations involving attempts by taxpayers to come up with arrangements that recharacterized taxable wages paid to employees as non-taxable reimbursements under the accountable plan rules of Section 62(c).

Losers. Three situations described in the Revenue Ruling did not meet the business connection requirement of the accountable plan rules.

The first involved a company that provided technicians to install cable television systems where the technicians were required to provide their own tools.

The second involved a staffing contractor that employed nurses who provided services to hospitals on short-term work assignments.

The third involved a construction firm whose employees were required to travel between construction sites using their personal vehicles.

Winner. The fourth situation - which did meet the business connection requirement - involved a cleaning company that required its employees to provide cleaning products and equipment necessary for their cleaning activities. In this case, the employer prospectively altered its compensation program by reducing the hourly compensation paid to employees when reimbursement levels were below expectations.

Although none of these situations involved an automobile dealership, the IRS' reasoning in Revenue Ruling 2012-25 and the underlying principles would clearly be applicable to dealership tool plan situations.

#14. *De Filipps University* AUDIO SEMINARS. During 2012, I presented 9 audio seminars to supplement this publication and various speaking engagements. In 2011, I had presented 12 seminars.

Complete information about *De Filipps University* and each 2-hour audio seminar is available on our web site (www.defilipps.com). 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).

Many firms use the information and materials from these seminars to develop, enrich and customize their own in-house training programs. We are registered as a sponsor of continuing education with the National Association of State Boards of Accountancy (NASBA).

As indicated earlier in this update, these audio seminars (through the *De Filipps University* Resource Center) are becoming more and more the primary vehicle for keeping you up-to-date with in-depth technical discussions of relevant dealership tax issues.

#15. UPDATED INDEX OF *DEALER TAX WATCH* ARTICLES ... 19 YEARS. Our web site (www.defilipps.com), now includes an updated *Index* of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December 2012.

This electronically searchable and user-friendly *Index* is available for your reference purposes. You can search the *Index* by keyword(s) or case names; you can also save the *Index* on your computer for handy future reference.

LTR 201237003 — *Be Careful About Timely Filing Copies of Form 3115*

When a taxpayer files for an automatic change in method of accounting pursuant to Revenue Procedure 2011-14, it must complete and file Form 3115 in duplicate. The original application (i.e., Form 3115) must be attached to the taxpayer's timely filed (including any extension) original Federal income tax return implementing the change in method of accounting for the year of change.

For certain changes in method, a copy of Form 3115 must be filed with the IRS in Ogden, Utah. For example, a copy of all Forms 3115 for automatic changes in method under Revenue Procedures 2012-19 and 2012-20 implementing the new Tangibles Regulations must be filed with the IRS in Ogden, Utah.

In these cases, the signed copy must be filed with the Ogden Office no earlier than the first day of the year of change and no later than the date when the taxpayer files the original Form 3115 as part of its Federal income tax return for the year of change.

The situation in Letter Ruling 201237003 involved a taxpayer who had engaged an accounting firm to prepare a Form 3115, *Application for Change in Method of Accounting*, to change its method of accounting for asset retirements under Section 168. This change was being made under Rev. Proc. 2011-14.

Although the original Form 3115 was timely filed, "due to a miscommunication between the taxpayer's tax department and the accounting firm and the lack of confirmation regarding the filing dates of the Form 1120 and the Form 3115," the copy of the Form 3115 was not timely mailed to the Ogden Office.

Subsequently, the accounting firm learned that the copy of the Form 3115 had not been timely filed. The accounting firm advised the taxpayer of this fact and began evaluating options to correct the late filing of the Form 3115. After evaluating various options, the taxpayer engaged the accounting firm to prepare a request to the IRS asking it to grant an extension of time to file the duplicate of Form 3115 with the Ogden Office.

The Commissioner has discretion to grant a taxpayer a reasonable extension of time to make certain Regulatory elections including a request to adopt, change or retain an accounting method. (Reg. Sec. 301.9100)

Relief - in the form of an extension of time to make the filing - will be granted if the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the Government.

A taxpayer will be deemed to have acted reasonably and in good faith if the taxpayer ...

- Requests relief before the failure to make the Regulatory election is discovered by the Service,
- Failed to make the election because of intervening events that were beyond the control of the taxpayer,
- Failed to make the election because, after exercising due diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election,
- Reasonably relied on the written advice of the Service, or
- Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make or advise the taxpayer to make the election.

A taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer, among other considerations, uses hindsight in requesting relief. Also, if specific facts have changed since the original deadline that make the election advantageous to a taxpayer, the Service will not ordinarily grant relief.

The information provided and representations made by the taxpayer in LTR 201237003 established that the taxpayer acted reasonably and in good faith with its request. In addition, granting an extension would not prejudice the interests of the Government.

Accordingly, the IRS granted the taxpayer an extension of time for a period of 30 days (from the date of the Ruling) to file the necessary signed copy of the Form 3115 with the Ogden Office.

This recent Letter Ruling, as many others like it in the past, emphasizes the importance of carefully complying with ***all*** of the filing requirements.

2012 AICPA NATIONAL AUTO DEALERSHIP CONFERENCE REPORT

This year, the AICPA Annual National Auto Dealership Conference was held at the Venetian in Las Vegas on October 25 & 26. About 450 attendees heard a variety of very good presentations on dealership tax, operations and business management subjects.

Although the AICPA did not record the conference presentations, it did offer virtual streaming of a few sessions so that one could listen from his or her office or home if making the trip to Las Vegas was not possible.

Since many presentations were offered as concurrent sessions, I cannot comment on them all. In this report, I've included highlights from a few of them.

Most notably, one of the non-tax major problems for dealers discussed by several speakers at the Conference was the increasing concern over the excessive and possibly unauthorized access that many DMS providers seem to have obtained over fields of confidential customer information in the dealerships' electronic records. This raises issues under the Privacy Rules and the Safeguards Rules. It also raises concerns over what other uses of this information might be made by others to help them "shop around" when they are getting ready to purchase a new vehicle.

THE SHAPE OF THINGS TO COME ... JAMES ZIEGLER

The keynote speaker for the Conference was Jim Ziegler, a highly-regarded industry analyst with vast experience. His rapid-fire presentation included many pertinent observations, some of which I will attempt to summarize with limited comment.

Comments on the "Factory." Toyota has put more money back into the U.S. economy through wages, parts and assembly operations than any other manufacturer. Ford is second on the list. General Motors- the bail-out poster child continuing to export jobs to Mexico and China - was not even in the list of top ten contributors to the U.S. economy.

Audi has becomethe benchmark against which all high line manufacturers are now comparing their own operations.

Hyundai and Kia have excellent product (despite missteps in labeling fuel economy for its vehicles). Hyundai has become another benchmark target because it is doing so many things so well. The *Eqqus* is a great car and at its current price point; it is a great value. Mr. Ziegler predicts that eventually Hyundai will create a separate brand for its "*Genesis*" vehicles.

Ford and Lincoln have some really good product in the pipeline for the future ... meaning a few years, hence 2016/2017. Subaru has great low-end product.

Toyota is not building the quality products that it used to, and the "pizazz is out of the franchise."

"Suzuki is on a respirator." (R.I.P. ... now in bankruptcy.)

General Motors ... Mr. Ziegler is very critical of GM, in part because he does not like its leadership at the present time.

Mitsubishi has good product, but its business plan is awful.

Carfax "stepped over the line when it started doing the sale."

Manufacturers stair-step programs "are ludicrous."

Data wars are big business. Many vendors are taking data out of dealers DMSs and sharing that information with others - often in unauthorized and/or excessive ways.

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Conference Report

2012 AICPA National Auto Dealership Conference

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Dealers should go to their DMS providers to find out who is taking data out of the dealership records. Who in the dealership has authorized the DMS provider to do so? Is the vendor taking personally identifiable information out of the dealership?

Mr. Ziegler suggested that dealers should ask vendors point-blank what information they need to extract to do business with the dealership, and then dealers should limit their vendors to taking from the dealership records only that data which is necessary for appropriate business purposes.

Mr. Ziegler's warning is ... "Don't let the vendors take over the industry." To the detriment of the overall industry, many vendors are providing information so that potential customers can price the deals by pricing the components of the sale ... i.e., using separate knowledge regarding the cost and other transactional aspects pertaining to the dealer's cost for vehicles, incentives offered by the Factory, trade-in models and valuations and financing information.

Some vendors have provisions in their contracts with the dealerships which permitthe vendors to "use" dealership data. Mr. Ziegler contends that these vendors don't need (access to) transactional information such as (1) how much a vehicle was sold for, (2) the amountthe trade-in was valued at and (3) what the financing terms were.

Other comments.As far as dealership operations go, "dealers are having to rethink the way they are doing business." They need to have video on their website to give the dealership a "personality."

China's economy is contracting and "China is going to get uglier before it gets nicer." China is having problems with Japan and China is a great counterfeiter, stealing U.S. technology from every company it deals with.

The green initiative is not working. Hybrids are a niche market which the Volt has captured. The public is not buying into the green initiative, even though the government is pushing it.

THE LEGAL HORIZON FOR THE FRANCHISED AUTO DEALER

Richard N. Sox, Esq. a partner in the firm of Bass Sox Mercer (Tallahassee, FL),again this year presented an excellent update on various dealer franchise legal issues.Mr. Sox's materialsand comments superbly reflect the extensive litigation and representation services that his firm provides for dealers and dealer associations.

Volkswagen. Volkswagen has implemented an aggressive strategy to become the largest volume vehicle manufacturer in the world. This corporate strategy is affecting U.S. dealers in many ways, including creating a serious problem because of the limited availability of cars and the "discretionary pool of cars" out of which allocations are made. All of these factors are combining to create "winners and losers."

Apparently, many VW dealers are being forced to sell their vehicles at a loss in order to be competitive. These dealers are faced with arbitrarily determined monthly and quarterly sales targets.

To make matters worse, Volkswagen is aggressively sending default notices and termination notices when dealers are unable to get enough vehicles to sell, and consequently, fail to meet sales objectives that VW has set for them.

Mr. Sox referred to several cases his office is currently handling where VW dealers are alleging VW has violated state franchise laws that requiremanufacturers to allocate a sufficient supply of vehicles to dealers. These dealers are claiming that VW is failing to act in good faith in setting sales and bonus objectives for its dealers.

Audi. Similar problems have arisen with Audi, VW's sister company. Some dealers, especially in growing market areas, seem to be caught in an "allocation death spiral." This meansthat they are not being allocated more than one car for each car that they have sold.This one-for-one ratio is hurting the dealers.

In a very unusual - but effective -countermove, one dealer obtained an injunction which forcedAudi to allocate a greater number of vehicles to the dealer than Audi was otherwise planning to provide.

General Motors.Four dealer issues concerning General Motors were discussed ... (1) GM's *Essential Brand Elements*Program, (2) franchise laws restricting facility incentive programs, (3) quarterly sales performance reports and (4) dealers' responses to the receipt of GMSales Performance Reports.

General Motors states that participation in its *EBE* Program is entirely voluntary on the part of the dealer. However, GM will withhold per car incentive payments if a dealer does not participate in its *EBE*Program. In states where dealer franchise protection laws are favorable, some dealers have contested GM's per-car incentive payment policy which they allege constitutesa "two-tier" pricing program.

The lawsuit involving a Florida dealer (Braman) presents the unusual situation where the dealer actually went ahead and constructed its facility notwithstanding the fact that the improvements were not strictly in compliance with the *EBE* Program's construction requirements.

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The dealer is suing GM under Florida's dealer protection laws which require the manufacturer to pay a percentage of its overall program payments if the manufacturer's program includes both (1) facility improvements and (2) other requirements. In this current lawsuit, the dealer's position is that it has substantially complied with the requirements of the *EBE* Program.

*No claw-back?*Apparently, many dealers have received payments from GM under the *EBE* Program in advance of the dealership's either commencing construction or meeting various percentage of completion objectives as of specific dates.

Interestingly, there are no "claw-back" provisions in the program that would require dealers to return payments to GM if they fail to perform. Apparently, when a dealer reaches the point where it has not complied with its commitments or construction obligations (i.e., the dealer has a "red light" status on the green-yellow-red light signal continuum), GM simply stops paying the dealership any more incentive money.

Another area relating to GM arises from its sending all dealers quarterly Sales Performance Reports in which the performance of dealers is rated according to a Retail Sales Index (RSI).

If the dealership's performance relative to the RSI is equal to or greater than 100%, the dealership is performing "satisfactorily." If the dealer's performance is between 85% and 100%, the dealer "needs improvement." If the dealer's performance is less than 85% - but not lower than 15% - the dealership "***needs significant improvement***." And, finally, if the dealer's performance is below 15%, the dealership's performance is deemed to be "unsatisfactory."

In many instances, dealers have challenged GM's Sales Performance Reports because they are based on state averages and/or the dealer's market may not be consistent with other parts of the state. In addition, dealers may be able to argue that GM's calculations/ expectations are faulty because of specific circumstances that are unique to the dealer or that the area of responsibility GM has established for the dealer has not been properly drawn or determined.

In discussing the importance of dealers responding to these GM Sales Performance Reports, Mr. Sox emphasized the importance of responding to all communications and creating a paper trail for possible future action.

Once again, he emphasized how important it is for the dealership to have 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 might 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.

As a result, 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."

Chrysler.It appears that Chrysler is continuing the consolidation of its brands. Chrysler was successful in post-bankruptcy litigation involving dealers who tried to protest what Chrysler had done by giving new ad points to Chrysler dealers that survived the bankruptcy (rather than giving new points to those dealers that were forced to go under as a result of Chrysler's bankruptcy reorganization). This allowed Chrysler to avoid the "intent of reinstatement" provisions in various laws.

Ford. Ford's relationships with its dealershave soured in some cases as a result ofa new strategy that has emerged over the last few months.

When a dealer approaches Ford requesting Ford to approve a change in ownership (perhaps as a part of the dealer trying to initiate a succession plan), at that time Ford says that it will have to have the dealer sign a letter of understanding which would require the dealer to meet certain facility upgrade standards, etc., in the future.

Mr. Sox advised that dealers should not sign such letters of understanding without first consulting with their attorneys. He indicated that dealers should insist upon Ford granting approval of the change requested without imposing any contingencies.

He warned that once a dealer has signed a letter of understanding with Ford, the dealer is not likely to be able to be released from the commitments he/she agreed to by signing the letter.

Mercedes Benz. The Autohaus Facility Program continues to pressure dealers to make improvements by offering significant per car incentives. The reality is simply that many dealers cannot afford not to participate in the programs.

Chargebacks for exported vehicles.Another significant issue - not necessarily limited to Mercedes Benz - involves the chargebacks that manufacturers are making to dealers when vehicles are resold outside the United States.

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If a vehicle is sold to a customer, and subsequently, the customer exports the vehicle from the U.S., then the dealer is required to repay to the manufacturer all of the incentive monies that the dealer originally received with respect to that vehicle.

Often, the dealer has no way or knowing at the time when the vehicle is sold to the customer whether that vehicle will be exported. It was suggested that dealers have new car buyers sign a one-page acknowledgement indicating that the buyer does not intend to export the car out of the country.

He also suggested that before the sale, someone in the dealership should go to the manufacturer's website for a list of known exporters and print out a screen which (hopefully) indicates that "no matches found" with respect to names on the exporter list.

Warranty reimbursement. Approximately 40 states now require manufacturers to reimburse dealers at retail rates for warranty work. Some dealers may not be aware of their rights to reimbursement at these higher rates. These higher reimbursement rates, obviously, could have a significant favorable impact on the overall profitability of the dealership.

In some cases, manufacturers have been adding a surcharge to new vehicle invoices which is intended to cover the anticipated increased warranty costs. Apparently, Nissan and General Motors have been particularly aggressive in this regard.

The franchise laws of some states prohibit manufacturer surcharges for this purpose. This is an area that CPAs should be aware of, and they should be assisting their dealer clients in seeing if some recovery is duefrom the manufacturer for such surcharges.

Dealership acquisition activity. A few years ago, out of necessity, many dealers who were thinking about selling their dealerships had to postpone any potential sales activity because the significant downturn in the economy in 2008-2009 depressed dealership valuations.

More recently, as the overall business climate for dealerships has improved, opportunities to sell dealerships have been increasing, and Mr. Sox reported that his firm has seen a substantial increase in acquisition activity.This also probably is heightened by a selling dealer's desire to sell before December 31, 2012 in order to have capital gains taxed at the favorable 15% rate which is scheduled to expire after year-end.

Mr. Sox reported that domestic dealerships are much more active in this area, and multiples have been improving as a result of post-bankruptcy increases in the value of dealerships. He indicated that import dealerships continue to hold their value, especially German brands. However, there seems to be some concern over production and supply chain interruptions,and this has affected the value of some Japanese brands.

The publicly-held dealership groups have become very active in seeking out dealership acquisitions of both domestic and import brands. However, in some instances, state franchise law protections have acted as a brake on their ability to add dealerships that they are interested in acquiring. Also, some manufacturers don't want to have a publicly-held group holding too many of their brand dealerships.

On a related note, there were two other sessions at the AICPA Conference that emphasized various aspects of this increasing activity. Todd M. Berko, a partner in Bel Air Partners, gave an excellent presentation, and so did Edward Alden.

DEALERS OVERWHELMED BY FEDERAL REGULATIONS

This year, the NADA Regulatory Update was presented by Paul Metrey, Chief Regulatory Counsel for NADA.

Mr. Metrey discussed the request that NADA made to the IRS for clarification of the tax treatment for manufacturers' payments under facility upgrade programs. On August 31, 2012, NADA requested that the IRS accept into its Industry Issue Resolution (IIR) program the general issue of how the Internal Revenue Code applies to payments that dealers receive under these programs.

Specifically, NADA said it was seeking guidance on "whether it is proper for (dealer) taxpayers to treat certain payments made pursuant to these programs as a reduction to the basis of specified depreciable assets rather than treating the payments as income in the year received."

In support of its request, NADA raised three points that it thought justified including this issue in the IIR program. First, NADA noted that the case frequently offered in support of treating these payments as income (*John B. White, Inc. v. Comm.*, 55 T.C. 729 (1971)) is limited to the application of a single Code provision (Section 118) to a single fact pattern.

Second, it stated that "there is disagreement among many dealer tax advisors as to the proper treatment of the payments."

Finally, it added that, to date, the IRS has not offered formal, industry-specific guidance on the matter, and in particular, the Service has not addressed the extent to which other Code provisions (e.g., Section 1016) may apply to the many different manufacturer facility image programs that exist today.

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The IRS informed NADA by letter dated October 11, 2012 that it would not include this matter in the IIR program. The IRS said that "...We reviewed your submission and determined that guidance under Sections 61 and 118 of the Internal Revenue Code as well as case law adequately address this issue. Consequently, the IRS will not be accepting your submission into the IIR program."

Turning to other non-tax matters, Mr. Metrey reported on recent Dodd-Frank Act Developments, FTC Motor Vehicle Roundtables and FTC Advertising and Privacy Enforcement Actions.

In a discussion of various regulatory attacks against spot deliveries and dealer participation, Mr. Metrey detailed NADA's response and counter-arguments. He referred to a letter to the FTC earlier this year (March 30, 2012) and statistics which showed that in considering the "Meet or Beat" argument, rates charged by banks were higher than rates charged by dealers by 77 basis points in 2008, 125 basis points in 2009 and 181 basis points in 2010.

Mr. Metrey's discussions of FTC advertising enforcement, closed-end credit advertising (Reg. Z trigger terms) and closed-end lease advertising (Reg. M trigger terms) were very detailed and his PowerPoint presentation was very helpful. He also commented on FTC privacy enforcement and e-security aspects that dealerships should be considering.

I am reasonably confident that if you request a copy of Mr. Metrey's presentation slides from him (pmetrey@nada.org), he will oblige.

UPDATE FROM THE IRS MOTOR VEHICLE TECHNICAL ADVISOR

This year, Ms. Terri Harris returned and her update included a discussion of six topics.

First, she reported that as part of the new IRS Tiered Issue Strategy, the Service will no longer manage issues through the previous Tiered Issue Process which was set up in 2006. Ms. Harris discussed the new IRS Tiered Issues and Issue Practice ***Groups*** (IPGs) - which handle domestic issues- and Issue Practice ***Networks***- which handle international issues.

These are similar to the old Industry Specialist Groups and are designed to provide support for examination teams.However, conclusions reached by members of each division are apparently not binding on the Service, but instead are "advisory."

Second, Ms. Harris reviewed the question of whether a dealership may deduct goodwill associated with terminated franchises. Apparently, this issue continues to be raised frequently on IRS audits.

Essentially, her discussion was a review of Field Attorney Advice (FAA) 20111101 regarding a dealership that wanted to write off goodwill associated with a terminated franchise as worthless.

In that situation, the dealership had purchased several franchises at the same time, and the franchise which was being terminated at a later date was one that had been acquired as part of that initial group. Not surprisingly, the FAA held that the dealership was not permitted to take a deduction for worthlessness of the franchise that was being terminated. Under Section 197(f)(1), the dealership must adjust the basis of the remaining goodwill (for all of the other franchises) by adding to it the unamortized basis for the franchise that was being terminated.

The third area that Ms. Harris discussed was the tax treatment for manufacturers' payments under facility upgrade programs. She said examiners are now starting to ask questions about how dealerships should be treating payments received and her presentation included a review of the guidance available on this subject. (For a thorough discussion of this guidance, see previous Editions of the *Dealer Tax Watch*.)

Ms. Harris indicated that the IRS may be issuing some guidance in the future on this subject, but right now, only the *Automotive Alert* issued by her office in February discusses this. And this *Alert* states that, generally, Section 118 does not apply to exclude these payments from dealership income and that *John B. White, Inc.* seems to be the strongest case law precedent for the IRS holding.

(Note: This is the same issue that Mr. Metrey had reported that NADA could not get the IRS to include in its IIR Program.)

Fourth, Ms. Harris briefly discussed the tangibles Regulations related to the deduction or the capitalization of amounts paid to improve and/or repair tangible property. She emphasized the importance of determining the correct "unit of property" to be analyzed when determining whether (or not) there has been an improvement to buildings and building structures. Ms. Harris placed special emphasis on improvements (betterments, restorations and/or adaptations to new uses). Here again, she mentioned the examples in the Regulations under -6, -7 and -8 at Reg. Sec. 1.263(a) -3T(h)(4).

Fifth, Ms. Harris called attention to recent Revenue Ruling 2012-25. In this Revenue Ruling, the IRS analyzed four situations to determine whether any of them qualified for accountable plan treatment. Only one of the four met the requirements.

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Ms. Harris indicated that she thought this might be the last time she needed to raise the issue of accountable plan treatment with (indirect) reference to technician tool plan arrangements. See *Watch Out* item #13 on page 9 of this Edition of the *Dealer Tax Watch*.

Finally, Ms. Harrisreminded dealers to be careful in their approaches to inventory writedowns for used vehicles. She cited the *Best Auto Sales* case in which the Tax Court held that the dealership was required to maintain objective evidence relating to its used car writedowns. She added that this documentation must be made and applied on a car-by-car basis. Apparently, this is a recurring cause for adjustments in IRS audits of dealerships.

BUY-HERE, PAY-HERE: IS IT RIGHT FOR YOUR DEALERSHIP?

In his presentation which addressed the opportunities for dealers to expand into Buy-Here, Pay-Here (BHPH) operations, Mr. Ken Shilson discussed 5 reasons for dealers to do so, and 4 reasons why they should not procrastinate.

The 5 reasons for going into BHPH operations are ... (1) exceptional margins are available, (2) the return on investment is excellent, (3) the customer market for BHPH vehicles is growing, (4) these operations allow dealers to conduct their business without interference from the manufacturers, and (5) these operations may permit the utilization of excess facilities.

According to Mr. Shilson, there are 4 good reasons why dealers should not be procrastinating in evaluating the possibility of going into BHPH operations. First, right now there are more customers with lower credit scores ... and that demographic seems to be increasing daily. Second, capital to start the business is more readily available at this time. Third, new technology is available, and industry operation statistics and benchmarking baselines have been →

BHPH Dealers

TEN FATAL UNDERWRITING MISTAKES BUY-HERE, PAY-HERE DEALERS MUST AVOID TO BE SUCCESSFUL

By Kenneth B. Shilson, CPA*

	Mistake	*Comment / Observation*
#1	• Not determining that your installment contracts and documents are compliant with all the applicable laws and Regulations.	• Making legal and Regulatory mistakes can bring you down.
#2	• Improper deal structure: not properly matching the customer, the vehicle and the deal structure when granting credit.	• Selling a customer the vehicle he wants instead of the one he can afford is not a good idea.
#3	• Not running a credit bureau report before granting credit to customer.	• Initially saving a few dollars ends up costing you millions.
#4	• Emphasizing sales growth over good underwriting.	• Growing too fast can be fatal.
#5	• Not independently (separate from the sale function) verifying stipulations or customer application information.	• There is an inherent conflict of interests between sales and good underwriting practices.
#6	• Not learning from your losses ... Repeating underwriting mistakes.	• Making trial and error mistakes can cost you millions.
#7	• Modifying or extending the term of the loan in order to meet the customer's payment requirements.	• In BHPH, time is your enemy.
#8	• Letting a large down payment (like a tax refund) make the deal instead of making the deal better.	• Down payment does not mean repayment.
#9	• Not properly managing portfolio risk by adapting to changes in economic conditions.	• Dealer education, reading and networking are your best defenses here.
#10	• Not monitoring or using credit scoring or deal stipulations to make underwriting decisions more consistently.	• Frequent changes in underwriting policies and practices can be very costly.

* Based on the presentation *"Buy-Here, Pay-Here ... Is It Right for Your Dealership?"* by Mr. Kenneth B. Shilson, CPA, President/Founder - NABD (www.bhphinfo.com) & President - Subprime Analytics (www.subanalytics.com) at the 2012 AICPA National Auto Dealership Conference, October 26, 2012.

established for virtually all sizes and types of BHPH dealerships. And, finally, newly developed synergies include access to trade inventory, availability of facilities, the creation of new profit centers and the extension of a dealer's existing used car operations.

Mr. Shilson listed a number of questions that dealers should ask before starting. These questions include...

- Capital? How much will I need?
- Capital? Where will it come from?
- Logistics? Separate from franchise operations?
- Appetite? Can I manage the risk?
- Personnel? Where do I find staff?
- Education? How do I learn the business?
- Business model? What are appropriate ranges for ACVs? Sales price? Recon? Add-ons?

Mr. Shilson is a good friend and a long-time contributor of informative articles on BHPH operations to the *Dealer Tax Watch*. His PowerPoint presentation includes many useful charts and graphs, as well as industry loss statistics and static pool loss analysis that have been developed by his company, Subprime Analytics.

You can request a copy of Mr. Shilson's presentation slides from him at ken@kenshilson.com.

On a related note, don't overlook the analysis of the *Maguire* case (beginning on page 18) which involves a Buy-Here, Pay-Here dealership and its Related Finance Company!

NEW TANGIBLES REGULATIONS & TACKLING THE TOUGH TAX QUESTIONS

The temporary Regulations on capitalization versus repair issues were discussed in three different presentations. Ms. Harris' comments on the Regs. in the IRS Update have already been mentioned.

On Friday morning at 7:00 AM,many attendees turned out for a presentation by representatives from SourceCorp entitled "Recap and Analysis of the Temporary Tangible Property Capitalization Regulations." This presentation was a basic overview and included a number of practical suggestions. It included a discussion of the "roof repair scenario" which may afford dealers an opportunity to deduct previously capitalized expenditures for roofs or other building components if they are subsequently replaced and the replacement expenditure is capitalized.

SourceCorp is in the business of providing cost segregation studies. Therefore, its representatives understandably emphasized the benefits that such a study might provide in situations where exact cost allocations for components of the original structure had not been documented at the time the building was placed in service.

And this would usually be the case if a cost segregation study had been prepared at the time when the initial construction was done because, at that time, the emphasis in the analysis would have been on dividing the building costs between Section 1250 property (with longer useful lives for tax depreciation purposes) and Section 1245 property (with shorter useful lives for tax depreciation purposes).

The point is that the new Regulations now emphasize distinctions between a building structure and newly created "building systems," and it now becomes important to allocate construction costs among the components of the building structure and the building systems.

A third Conference session entitled "Tackling the Tough Tax Questions" included in part, some emphasis on the new tangibles regulations. This session was presented by Leslie Frye and Wayne Robbins, partners in Dixon Hughes Goodman LLP. Most of the discussion of the Tangibles Regs overlapped the presentation by SourceCorp.

The other "Tough Tax Questions" that were discussed in this presentation included (1) surtax/compensation planning for the 2010 Health Care Act Tax Changes - i.e., both the 0.9% Medicare tax on wages and self-employment income and the 3.8% additional Medicare tax on investment income, (2) compensation planning for S Corporations and their stockholders, (3) the taxation of Factory incentive image upgrade payments received by dealerships and (4) specified foreign financial asset reporting and Form 8938 filing requirements.

OTHER EXCELLENT PRESENTATIONS

I listened to three other excellent presentations this year: (1) *Setting a New Course in Your Business and Estate Transition Plan* by Rich Thornton, a partner in the Portland office of Moss Adams, (2)*Metrics for Evaluating a Buy/Sell Opportunity* by Todd M. Berko, a partner in Bel Air Partners, and (3) *Mergers & Acquisitions Fundamentals - Due Diligence and Case Studies* by Edward Alden, CFO of Greenway Automotive (Orlando, Florida). For all of these presentations, the PowerPoint slides were excellent,and the presenters' comments and experiences were comprehensive.

BOTTOM LINE

Overall, I was very impressed with the quality of the 2012 AICPA Conference and came away with much useful information and several new networking contacts.

CREATING BASIS (IN STOCK & IN DEBT) SO THAT S CORP. LOSSES CAN BE DEDUCTED

There are many advantages for dealerships - and for other types of businesses - organized as corporations but electing to be taxed as S Corporations. One advantage is that, in general, there is only one level of income tax imposed on the corporation's earnings, and that tax is imposed at the shareholder level.

Income of an S Corporation "flows through" to the individual shareholders - in proportion to their shareholder ownership percentages - and is taxed in their individual income tax returns. The amounts to be included in the individual income tax returns of S Corporation shareholders is reported by the corporation when it issues each shareholder a Schedule K-1 after the end of the year.

The year-end tax planning for S Corporations and their shareholders involves at least two aspects ... (1) projecting the amount of income or loss that the S Corporation will have to report of the year and (2) determining the impact of the inclusion of the pro rata amounts of S Corporation income or loss on the individual income tax returns (Forms 1040) of the shareholders.

As to the second aspect, if the S Corporation is anticipated to report a loss, there are specific rules which may limit the amount of the loss that individual shareholders can deduct for that year in their individual returns.

Accordingly, S Corporation shareholders and their advisors frequently encounter situations where potential problems exist because Code Section 1366 limits the deductibility of a shareholder's loss from an S Corporation to the sum of (1) the shareholder's adjusted basis in the shareholder's stock in the S Corporation and (2) the adjusted basis of any indebtedness of the S Corporation to the shareholder.

After a brief discussion of the general rules, this article will examine two recent developments that affect the amount of S Corporation losses that shareholders may currently deduct.

The first development is the recent Tax Court decision in *Maguire* (June 2012) in which the family shareholders in two related S Corporations ... one, a Buy-Here, Pay-Here (BHPH) dealership, and the other, its Related Finance Company (RFC) ... successfully shuffled around the basis in their stock in their two S Corporations so that they would be able to offset all of the operating losses that were incurred during the year by the BHPH dealership against other taxable income reported in their personal income tax returns.

The second development relates to the changes in the Regulations that were proposed by the Treasury at almost the same time (June 12, 2012). These changes affect the ability of shareholders to increase their basis in ***debt obligations*** issued to them by their S Corporations in return for money they loan to their S Corporations.

In other words, these proposed Regulations deal with ways to increase the basis of bona fide indebtedness (in the form of loans by the shareholders to the corporation, etc.) so that additional S Corporation losses can be deducted by the shareholders.

The distinction to keep in mind is that the Tax Court case addresses transactions that are intended to enhance or increase the shareholders' basis for its investment in the ***stock*** of the corporation. In contrast, the proposed Regulations address transactions that would be intended to enhance or increase the shareholders' basis for its investment in the ***debt*** or ***indebtedness*** of the corporation.

Both developments are "taxpayer-friendly" and warrant further consideration in year-end planning discussions and activities.

OVERVIEW ... BASIS IN STOCK & LIMITS ON DEDUCTIONS FOR S CORP. LOSSES

Congress has always intended to limit the amount of loss that a shareholder may take into account (in its individual income tax return) to an amount equal to that shareholder's *investment* in the corporation.

This intention of Congress is embodied in Code Section 1366 and in Reg. Sec. 1.1366-2 which provides the rules relating to limitations on the deduction of pass-through items of an S Corporation to its shareholder(s).

The *investment* of a shareholder in the S Corporation includes two elements: (1) the adjusted basis of the stock in the corporation owned by the shareholder and (2) the adjusted basis of any indebtedness of the corporation to the shareholder.

Accordingly, the aggregate amount of losses and deductions that a shareholder may take into account for any taxable year cannot exceed the sum of that shareholder's adjusted basis in stock ***plus*** the adjusted basis of any indebtedness of the S Corporation to that shareholder.

An S Corporation shareholder's basis for his stock in the corporation originates when the shareholder contributes money and/or other property to the →

corporation. Subsequently, a shareholder's basis in the stock of an S Corporation is increased by the shareholder's pro rata share of the corporation's income, and it is decreased by the shareholder's pro rata share of the corporation's losses and deductions. It is also decreased by the amounts of distributions that are not includable in income.

Generally, a distribution made by an S Corporation out of previously taxed undistributed earnings and profits is not included in income to the extent it does not exceed the adjusted basis of the stock. If the distribution is made by an S Corporation which has no accumulated earnings and profits, the distribution is not included in gross income to the extent that it does not exceed the adjusted basis of the stock, and the amount of the distribution which exceeds the adjusted basis of the stock is be treated as gain from the sale or exchange of property.

A shareholder's basis in the stock of an S Corporation is also increased by any contributions that the shareholder makes to the capital of the corporation. However, case law has held that in order for a particular transaction to qualify as an "investment" in the corporation, the shareholder must make an actual ***"economic outlay."*** In other words, the shareholder must incur a cost or be left poorer in a material sense after the transaction.

Published guidance (Rev. Rul. 81-187) holds that a shareholder of an S Corporation does not increase basis in ***stock*** for purposes of Section 1366(d)(1)(A) upon the contribution of the shareholder's own unsecured demand promissory note to the corporation. This is consistent with other published guidance (Rev. Rul. 80-235) and case law in the partnership context that the contribution of the partner's own note will not increase that partner's basis in its partnership interest under Section 722.

MAGUIRE ET AL., V. COMM.

The most significant issue in *Maguire, et al., v. Comm.* (T.C. Memo 2012-160, dated June 6, 2012) was whether the taxpayers - the Maguire families - were entitled to deduct losses from one of their S Corporations for the years 2004, 2005 and 2006. There were other issues in this case, but they are not relevant to the focus of this article.

Two generations of Maguire families were the taxpayers/petitioners ... The father (James Maguire, married to Joy Maguire) and the son (Marc Maguire, married to Pamela Maguire).

The families controlled two S Corporations. One S Corporation was an auto dealership which conducted its activities as a Buy-Here, Pay-Here (BHPH) dealership. The second S Corporation was a Related Finance Company (RFC) which purchased customer notes from the operating BHPH dealership.

In the first year under audit, the father and his wife owned 100% of the auto dealership and roughly 51% of the Related Finance Company. The son and his wife owned the other 49% of the Related Finance Company. In the second and third years under audit, the ownership in both Corporations was roughly 51%-49%. These percentages are approximate; the exact percentages are not critical to the discussion and/or holdings of this case.

As part of its usual operations, the BHPH dealership (named "Auto Acceptance") sold used vehicles (which it had purchased at auction or taken as trade-ins) to customers who typically did not have good credit ratings. In order for a customer to finance its purchase of a vehicle, the customer usually issued an interest-bearing note for the bulk of the purchase price. The BHPH dealership subsequently *sold* these notes to the Related Finance Company (named "CNAC"). The end result was that CNAC ended up holding the notes that were given by the customers for the purchase of their vehicles.

During the years that were audited by the IRS, the BHPH dealership operated at a loss, and the Related Finance Company operated at a profit. Note: This fact pattern is fairly typical within the BHPH dealership industry - the dealership operates at a loss and the RFC is profitable because of the interest income it receives as the customers make payments on the notes they signed when they purchased their vehicles.

At the end of each year, various other transactions had taken place between the BHPH dealership and the RFC that resulted in the dealership owing substantial amounts of money to the Related Finance Company. These "accounts receivable" due to CNAC (the RFC) are to be distinguished from the other customer notes received by the BHPH which CNAC had purchased from the BHPH dealership.

THE PROBLEM & THE PLAN AROUND IT

As indicated above, in each of the 3 years under audit, (2004, 2005 & 2006), the dealership (Auto Acceptance) operated at a loss, and the RFC (CNAC) operated at a profit. During their year-end planning discussions before the end of 2004, the Maguires were advised by their CPAs (Katz, Sapper & Miller), that the father did not have sufficient basis in his stock in Auto Acceptance (the BHPH) to deduct 100% of its losses in his individual income tax return.

As a result, the CPAs advised the father (James Maguire) that he could increase his basis in the stock of Auto Acceptance (the BHPH) by receiving distribu-

see **CREATING BASIS**, page 20

(Continued from page 19)

tions of approximately $1.7 million from CNAC, which he could then contribute to Auto Acceptance.

The effect of this distribution/contribution scenario would be to increase the father's basis in the stock of Auto Acceptance so that he could fully deduct Auto Acceptance's losses on his individual income tax return.

Since the father and the son in the first year (2004) each owned roughly 50% of the RFC, it would be necessary for the father to borrow the son's portion of the distribution from CNAC.

"Plan A." Plan A called for the father to execute a note to the son for his (i.e., the son's) share of the distribution from CNAC. The plan was to involve the issuance of checks totaling $1.7 million from the RFC to the father and the son, which the father could then contribute to the BHPH dealership (Auto Acceptance). The father and the son had an adjusted basis in the stock of the RFC (CNAC) of at least $1.7 million. The practical obstacle, however, was that the RFC (CNAC) did not have sufficient funds in its bank account to make a cash distribution of $1.7 million to its owners.

"Plan B." After learning of CNAC's inability to make a cash distribution, the CPAs came up with an alternative strategy in order to increase the father's basis in Auto Acceptance. This alternative method would not require CNAC to make a cash distribution to its owners.

Remember the "other accounts receivable?" The CPAs did. So, the CPAs advised the Maguires that an identical result would be reached if a distribution of accounts receivable owed to CNAC by Auto Acceptance were made from CNAC to the father and the son. The son would lend his portion of the accounts receivable to his father, who would then contribute (all $1.7 million worth of) the accounts receivable to Auto Acceptance, thereby increasing the father's basis for his stock in Auto Acceptance enough to allow for the 100% deduction of Auto Acceptance's losses on his 2004 Federal income tax return.

This strategy ... Plan B ... was followed.

CNAC distributed $1.7 million in accounts receivable to the father and the son on or before December 31, 2004. The dealership (Auto Acceptance) owed at least this amount to CNAC (the RFC) before the distribution. Then the son lent his share of accounts receivable to his father, and his father then contributed the entire $1.7 million worth of accounts receivable to Auto Acceptance. Contemporaneously, the father executed a note to his son for the amount of the loan (i.e., roughly 50% of the amount of $1.7 million).

Plan B was followed in subsequent years. The CPAs' advice was followed in subsequent years ... In 2005, CNAC distributed $1.5 million in accounts receivable to its shareholders on December 31, 2005, and the receivables were then contributed by the taxpayers to Auto Acceptance.

In 2006, CNAC distributed $3.5 million in accounts receivable to its shareholders on December 31, 2006, and the accounts receivable were then contributed to Auto Acceptance. Auto Acceptance owed at least these amounts to CNAC before the distributions in 2005 and 2006. The respective distributions from CNAC and the respective contributions to Auto Acceptance were apportioned according to the father's and the son's respective ownership interests.

The distributions and contributions of the accounts receivable were carried out by the execution of separate written shareholder resolutions regarding the distributions and contributions, which were signed at the end of 2004, 2005, and 2006, respectively. Adjusting journal entries were made to the corporate books in the year following the taxable year to which they related, and these journal entries were made at the time Auto Acceptance's and CNAC's yearly audits were conducted.

At the end of each of the tax years 2004, 2005, and 2006, the taxpayers' respective bases in CNAC equaled or exceeded the amounts of distributions they received from CNAC.

In summary. Although the taxpayers did not originally have sufficient bases in their respective stockholdings of the BHPH operating dealership to be able to deduct their respective percentages of its operating losses, they did, however, have substantial bases in their respective stockholdings of the Related Finance Company. Their bases in their stock in the Related Finance Company was large enough so that if it could be "moved over" or "transferred" to their bases in their stock in the operating company, they would be able to deduct in their individual income tax returns their proportionate shares of all of the BHPH dealership's operating losses.

THE IRS DISAGREES

The IRS disallowed the loss deductions claimed by the shareholders in their individual returns. The IRS' theory was that the taxpayers' actions were insufficient (i.e., they were "not substantial enough") to increase their bases in the stock of the BHPH dealership.

The IRS' argument was that the transactions between the shareholders and their related S Corporations did not result in the shareholders making an actual ***"economic outlay"*** when they contributed the accounts receivable to the dealership.

see **CREATING BASIS**, page 24

Maguire v. Comm.
T. C. Memo 2012-160 ... June 6, 2012

Taxpayers

Father (& Wife)	Son (& Wife)
James & Joy Maguire	Marc & Pamela Maguire

S Corporation #1

Buy-Here, Pay-Here (BHPH) Operating Dealership
Auto Acceptance Inc.

Ownership at Year-End

	2004	2005	2006
Father	100%	51%	51%
Son	0%	49%	49%

Basis in Stock: Not much basis

Loss Operations ... NOLs

- Sells customer notes to RFC.
- Has other transaction with RFC resulting on other debt/indebtedness to RFC.

Plan B

- Receives the notes for indebtedness that it had issued to the RFC from the shareholders as a contribution to capital.
- This cancels the debt the BHPH owed to the RFC.

S Corporation #2

Related Finance Company (RFC)
CNAC, Inc.

Ownership at Year-End

	2004	2005	2006
Father	51%	51%	51%
Son	49%	49%	49%

Basis in Stock: Large amount of basis

Profitable Operations

- Purchases customer notes from BHPH.
- Holds notes (indebtedness) from BHPH arising from other transactions between them.

Plan B

- Distributes (to the shareholders) the notes from the BHPH that it held, so that it no longer has receivables from the BHPH.
- These distributions by the RFC reduce the shareholders' ability to receive "tax-free" distributions from the RFC in the future.

<table>
<tr><td>Maguire, et al.</td><td>THREE CHALLENGES BY THE IRS TO THE TAXPAYERS' STRATEGY & WHAT THE TAX COURT SAID IN UPHOLDING THE MAGUIRES
Page 1 of 2</td></tr>
<tr><td>Citation</td><td>• James & Joy Maguire, Mark & Pamela Maguire v. Comm.
T.C. Memo 2012-160 (June 6, 2012)</td></tr>
<tr><td>IRS' Three Challenges</td><td>#1. The taxpayers written year-end resolutions and the subsequent corporate adjusting journal entries are insufficient to increase petitioners' bases in the stock of the operating company.
#2. The close relationships between the shareholders and the two S Corporations warrants disregarding their attempt to increase their bases in the stock of the operating company.
#3. The taxpayers did not make an "economic outlay."</td></tr>
<tr><td colspan="2">#1. Journal Entries on the Books, etc., Are Not Enough</td></tr>
<tr><td>Why the Tax Court Rejected The IRS' Argument #1</td><td>• Much of IRS position is rooted in its factual conclusion that the distributions and contributions of accounts receivable never actually took place.
• However, the record sufficiently establishes that the taxpayers were advised by Katz, Sapper & Miller (their CPAs), before the end of each year, to use the distributions and contributions of the accounts receivable in order to increase their bases in Auto Acceptance for the years and that this advice was actually followed.
• The taxpayers both testified that their CPAs advised them to effectuate the accounts receivable transaction at the end of each year in issue and that they followed this advice.
• In addition, one partner in the CPA firm and a second partner who was also a tax attorney testified that ...
◆ They advised the taxpayers to make the distributions and contributions of accounts receivable before the end of each of the taxable years in issue and
◆ They determined the best way to implement their plan was to have them execute the corporate resolutions and make adjusting journal entries on the corporate books.
• The taxpayers followed their CPAs' advice and effected the distributions and contributions at the end of each year in issue. This is supported by persuasive evidence ...
◆ Corporate resolutions for each year were dated December 31, 2004, 2005, and 2006.
◆ There were adjusting journal entries for each year.
◆ Relevant testimony in court.
◆ The pattern of following this procedure for three consecutive years.</td></tr>
<tr><td colspan="2">#2. The Close Relationship of the Parties Negates the Intended Result</td></tr>
<tr><td>Why the Tax Court Rejected The IRS' Argument #2</td><td>• While it is appropriate to scrutinize the validity of transactions between related parties, there is no reason why shareholders in two related S Corporations should be prohibited from taking distributions of assets from one of their S Corporations and investing those assets into another of their S Corporations, in order to increase their bases in the latter.
◆ The effect is to decrease the shareholders' bases in the S Corporation making the distribution, thereby reducing the shareholders' potential future tax-free distributions from the distributing S Corporation, while increasing the shareholders' bases in the S Corporation to which the contribution to capital is made.
◆ The transactions did actually occur.
◆ The taxpayers made an actual economic outlay when they contributed the accounts receivable to Auto Acceptance.
• The fact that the two S Corporations have a synergistic business relationship and are owned by the same shareholders should make no difference so long as the underlying distributions and contributions actually occurred.
◆ "[T]he existence of * * * [a close relationship between the parties] is not necessarily fatal if other elements are present which clearly establish the bona fides of the transactions and their economic impact." (Bhatia v. Commissioner, T.C. Memo. 1996-429.)
• The fact that the taxpayers were motivated by tax considerations is not fatal.
◆ "Anyone may so arrange his affairs that his taxes shall be as low as possible." (Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).)</td></tr>
</table>

THREE CHALLENGES BY THE IRS TO THE TAXPAYERS' STRATEGY & WHAT THE TAX COURT SAID IN UPHOLDING THE MAGUIRES

#3. The Taxpayers Did Not Make an "Economic Outlay"

Why the Tax Court Rejected The IRS' Argument #3

- The IRS also argued that no *economic outlay* was made, because the resolutions and adjusting journal entries made to the books of the related companies (1) were devoid of any economic reality and (2) did not alter the economic positions of the parties.
- The Tax Court held that the distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses.
  - The distributions and contributions created actual economic consequences for the parties, because the accounts receivable had real value in that they were legitimate debts that Auto Acceptance owed to CNAC and thus were legitimate assets of CNAC.
  - These "accounts receivable" that Auto Acceptance owed to CNAC were to be distinguished from the interest-bearing notes that Auto Acceptance received from car buyers and then ***resold*** to CNAC.
- The taxpayers' contribution of the accounts receivable (to the capital of Auto Acceptance) resulted in the taxpayers being poorer in a material sense in that the accounts receivable were no longer collectible by them individually.
- When the taxpayers received the accounts receivable from CNAC (as they had every right to do) and contributed them to Auto Acceptance, those transactions...
  - Reduced the liabilities of Auto Acceptance,
  - Made Auto Acceptance solvent in terms of its assets exceeding its liabilities, and
  - Increased the net worth of Auto Acceptance, thereby exposing a greater amount of its assets to its general creditors.
- The risk involved in exposing more of Auto Acceptance's assets to its creditors was more than hypothetical. In mid-2004, the Kentucky Attorney General had instituted a lawsuit against them and their businesses claiming millions of dollars based on alleged consumer fraud claims.
  - The taxpayers argued that the risk of the loss to Auto Acceptance's creditors - including vendors that it alone dealt with ... when viewed in consideration of the Attorney General's lawsuit - was very real and the additional net worth in Auto Acceptance created by the capital contribution was put at greater risk, making them poorer in a material sense.
- At the same time, the taxpayers' bases in the stock of CNAC were reduced by the amounts of the accounts receivable that CNAC had distributed to them, thereby reducing their ability to receive future tax-free distributions from CNAC.
  - As a result of the transactions, the values of the taxpayers' investments in CNAC were diminished by the amounts of the receivables distributed to them.
  - When the taxpayers contributed the accounts receivable to Auto Acceptance, the contributions increased their bases in Auto Acceptance and made them poorer individually because they no longer owned the receivables in their individual capacities.
- ***The fact that the BHPH accounts receivable held by CNAC were distributed to the taxpayers and then contributed by them to a related entity does not require a finding that there was no economic outlay.***
- The Tax Court has previously considered this issue and held that "the fact that funds lent to an S Corporation originate with another entity owned or controlled by the shareholder of the S Corporation does not preclude a finding that the loan to the S Corporation constitutes an 'actual economic outlay' by the shareholder."
  - Cases cited ... *Ruckriegel v. Commissioner*, T.C. Memo. 2006-78 ... *Yates v. Commissioner*, T.C. Memo. 2001-280 ... *Culnen v. Commissioner*, T.C. Memo. 2000-139).
- The fact that the taxpayers contributed intangible assets to Auto Acceptance, rather than cash, does not preclude increases in their bases.
  - The tax basis of an S Corporation may be increased through the contribution of cash, tangible assets, or intangible assets (such as accounts receivable). See *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988), aff'd, 875 F.2d 420 (4th Cir. 1989).

Holding

- The Tax Court held that the taxpayers were entitled to their claimed bases increases in the stock of Auto Acceptance and their claimed S Corporation losses (totaling $6.7 million) for the years 2004, 2005, and 2006.

 (Continued from page 21)

In opposition, the IRS raised three arguments ... (1) the distributions and contributions of the accounts receivable never actually took place, (2) no economic outlay was made, and (3) the transactions between the shareholders and their S Corporations should be disregarded because of their related party relationships.

TAX COURT HOLDING

The Tax Court rejected all of the IRS' arguments.

The Tax Court held that the Maguires were not prohibited from receiving a distribution of assets from one of their S Corporations and then contributing those assets into another of their S Corporations in order to increase their bases in the latter.

The effect of these transactions was to decrease the shareholders' bases in the S Corporation making the distribution (i.e., in the Related Finance Company), and this reduced the shareholders' ability to obtain future tax-free distributions in later years from the distributing S Corporation. This was a *quid pro quo*.

Simultaneously, the contribution of the accounts receivable by the Maguires to the BHPH operating dealership resulted in an equivalent increase in their basis in the stock of the S Corporation to which the contributions of capital were made.

The Tax Court held that the fact that the two S Corporations had "a synergistic business relationship" and were owned by the same shareholders did not prevent the taxpayers from accomplishing their goal, so long as the underlying distributions (from the Related Finance Company) and the contributions (to the operating company) actually occurred.

For a thorough discussion of the Tax Court's rejection of the IRS' arguments, see pages 22-23.

TECHNICAL ASIDE

As a technical matter, the BHPH dealership did not realize ordinary income when the shareholders contributed/transferred the receivables they had received from the RFC to the capital of the BHPH. Section 108(e)(6) provides that for purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation acquires its own indebtedness from a shareholder as a contribution to its capital, Section 118 (requiring inclusion in income) does not apply. Furthermore, the debtor corporation is treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness. Therefore, the BHPH realized no income/gain when it received its own indebtedness back from its shareholders.

OVERVIEW ... BASIS IN INDEBTEDNESS & LIMITS ON DEDUCTIONS FOR S CORP. LOSSES

As stated previously, a shareholder's aggregate amount of losses and deductions taken into account for any taxable year of the S Corporation cannot exceed that shareholder's adjusted basis in stock in the corporation and the adjusted basis of any indebtedness of the corporation to that shareholder.

The Internal Revenue Code does not define basis of ***indebtedness***. However, several court cases involving pass-through losses from an S Corporation have interpreted Section 1366 to require that in order to create basis of indebtedness, an investment in the S Corporation must constitute "an actual economic outlay" by the shareholder. These cases include ... (1) *Maloof v. Comm.*, 456 F.3d 645, 649-650 (6th Cir. 2006) ... (2) *Spencer v. Comm.*, 110 T.C. 62, 78-79(1998), aff'd without published opinion, 194 F.3d 1324 (11th Cir. 1999) ... (3) *Hitchins v. Comm.*, 103 T.C. 711, 715 (1994), and ... (4) *Perry v. Comm.*, 54 T.C. 1293, 1296 (1970).

Often, the cases involve back-to-back loan transactions. These are simply attempts by an S Corporation shareholder to obtain basis of indebtedness by borrowing from another person - typically, a related entity - and then lending the proceeds to the S Corporation. Alternatively, an S Corporation shareholder might seek to restructure an existing loan of the S Corporation into a back-to-back loan by assuming the S Corporation's liability on the loan and creating a commensurate obligation from the S Corporation to the shareholder.

Disputes between the IRS and taxpayers have occurred over whether back-to-back loan transactions give rise to an actual economic outlay. The focus of these disputes in court cases is on whether a shareholder has been made "poorer in a material sense" as a result of the loan. These cases include *Oren v. Comm.*, 357 F.3d 854, 857-859 (8th Cir. 2004), and *Bergman v. U.S.*, 174 F.3d 928, 932 (8th Cir. 1999).

PROPOSED REGS & TRANSACTIONS TO INCREASE BASIS IN INDEBTEDNESS

On June 12, 2012, the Treasury issued proposed Regulations that are intended to clarify the requirements for increasing basis of indebtedness and to assist S Corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness.

These proposed Regulations require that loan transactions represent bona fide indebtedness of the S Corporation to the shareholder in order to increase basis of indebtedness. As a result, an S Corporation shareholder will not be required to also satisfy the →

elusive "actual economic outlay" doctrine for purposes of Section 1366(d)(1)(B).

Accordingly, the key requirement of these proposed Regulations is that the purported indebtedness of the S Corporation to a shareholder must constitute bona fide indebtedness to the shareholder.

These proposed Regulations do not attempt to provide a different standard for purposes of Section 1366 as to what constitutes bona fide indebtedness. Rather, general Federal tax principles - many of which have developed outside of Section 1366 - determine whether indebtedness is bona fide. A list of thirteen factors to be considered is included below.

Recently, in *Herrera* (T.C. Memo 2012-308), the Tax Court said that the thirteen factors listed "are not equally significant nor is any single factor determinative.... The various factors 'are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship.' ... Or, as this Court (i.e., the Tax Court) has phrased it ... 'Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?'"

Loan guarantees. In contrast to bona fide indebtedness, the IRS has long held that shareholder guarantees of S Corporation debt do not result in basis of indebtedness. And, the IRS has been upheld on this point.

An overwhelming majority of courts considering whether shareholders may increase basis of indebtedness from their guarantees of S Corporation debt has held that the shareholders' guarantees did not create basis of indebtedness.

Where an S Corporation shareholder acts merely as a guarantor of a loan made by another party

see **CREATING BASIS**, page 27

Bona Fide Indebtedness ... Factors to Consider

In the *Estate of Travis Mixon v. USA*, the U.S. Court of Appeals for the 5th Circuit (1972) stated that guidelines for determining the "debt versus equity" question have developed by the courts in a number of cases.

The Court listed thirteen factors or guidelines which merit consideration in determining the existence of bona fide indebtedness. It also indicated that other factors may be considered. In this regard, see the Tax Court's discussion (in the text above) from the *Herrera* case (T.C. Memo 2012-308).

1. The names given to the certificates evidencing the indebtedness
2. The presence or absence of a fixed maturity date
3. The source of payments
4. The right to enforce payment of principal and interest
5. Participation in management flowing as a result
6. The status of the contribution in relation to regular corporate creditors
7. The intent of the parties
8. "Thin" or adequate capitalization
9. Identity of interest between creditor and stockholder
10. Source of interest payments
11. The ability of the corporation to obtain loans from outside lending institutions
12. The extent to which the funds advanced were used to acquire capital assets
13. The failure of the debtor to repay on the due date or to seek a postponement

Basis of Indebtedness	**TRANSACTIONS TO INCREASE THE BASIS OF S CORPORATIONS' DEBT OBLIGATIONS**
Example 1 ***Shareholder Loan Transaction***	• A is the sole shareholder of S, an S Corporation. • S Corporation received a loan from A. • Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. • If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness. • The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under Reg. Sec. 301.7701-3 (i.e., a single-member LLC that has elected not to be taxed as a corporation).
Example 2 ***Guarantee***	• A is a shareholder of S, an S Corporation. • In 2013, S received a loan from Bank X. • Bank X required A's guarantee as a condition of making the loan to S. • Beginning in 2014, S could no longer make payments on the loan and A made payments directly to Bank X from A's personal funds until the loan obligation was satisfied. • For each payment A made on the note, A obtains basis of indebtedness. • Thus, A's basis of indebtedness is increased during 2014 to the extent of A's payments to Bank X pursuant to the guarantee agreement.
Example 3 ***Back-to-Back Loan Transaction***	• A is the sole shareholder of two S Corporations, S1 and S2. • S1 loaned $200,000 to A. • A then loaned $200,000 to S2. • Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. • If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2.
Example 4 ***Loan Restructuring Through Distributions***	• A is the sole shareholder of two S Corporations, S1 and S2. • In March 2013, S1 made a loan to S2. • In December 2013, S1 assigned its creditor position in the note to A by making a distribution to A of the note. • Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. • Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. • If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2.
Citation	• Proposed Reg. Sec. 1.1366-2(a)(2)(iii) Examples #1-4

AICPA Recommends an Additional Example to Illustrate Bona Fide Indebtedness

The AICPA submitted two comments on the proposed Regulations in a letter to the IRS (November 13, 2012).

- The Treasury should permit ***retroactive*** application of the Regulations to loan transactions
- An example (see below) should be included to emphasize that indebtedness can be bona fide indebtedness but still not provide basis for a deduction of losses under Section 1366(d)(1)(B).

Suggested Example: Bona Fide Debt Without Basis

"KC Corporation is an S corporation. Shareholder K owns all of the stock. At the end of 2012, KC has accrued payroll and bonus payments to K, totaling $25,000. The payment is in compliance with all provisions of local law, has the board of directors' approval and is consistent with K's employment contract. Thus, at the end of 2012, there is bona fide debt directly from KC to K. However, if K uses the cash method of accounting, and has not yet taken the $25,000 into income, K has no basis in that debt. Therefore K cannot use this debt to support losses passing though from KC in 2012."

directly to the S Corporation, then the courts have held that the shareholder adjusts basis of indebtedness only to the extent the shareholder actually performs under the guarantee. This result would also follow if the shareholder acts in a capacity similar to a guarantor (for example, as a surety or accommodation party).

The proposed Regulations provide that an S Corporation shareholder who merely acts as a guarantor or in a similar capacity has not created basis of indebtedness unless the shareholder actually makes a payment, and then only to the extent of such payment. This is comparable to the IRS' holding in Rev. Rul. 70-50.

"Incorporated pocketbook." In other situations, taxpayers have relied on an "incorporated pocketbook" theory to claim an increase in basis of indebtedness in circumstances that involve a loan directly to the S Corporation from an entity related to the S Corporation shareholder.

In these transactions, an S Corporation shareholder claims that a transfer from the related entity directly to the shareholder's S Corporation was made on the shareholder's behalf and is, in substance, a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S Corporation.

A few court decisions have allowed shareholders to increase basis of indebtedness as a result of incorporated pocketbook transactions. See, for example, *Yates v. Comm.* (T.C. Memo. 2001-280), and *Culnen v. Comm.* (T.C. Memo. 2000-139).

Under the proposed Regulations, an incorporated pocketbook transaction increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S Corporation.

PROPOSED RULES w/r/t DETERMINING THE BASIS OF INDEBTEDNESS

(1) The term *basis of any indebtedness of the S Corporation to the shareholder* means the shareholder's adjusted basis (as defined in Reg. Sec. 1.1011-1 and as specifically provided in Section 1367(b)(2)) in any bona fide indebtedness of the S Corporation that runs directly to the shareholder.

(2) Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

(3) A shareholder does not obtain basis of indebtedness in the S Corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan.

(4) When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, the shareholder may increase its basis of indebtedness to the extent of that payment; however, this result will be dependent upon the facts and circumstances of the specific situation.

To interpret these rules, the proposed Regulations include the four (4) Examples shown on page 26.

CONCLUSION

Although the fact pattern in *Maguire* happens to involve a Buy-Here, Pay-Here / Related Finance Company situation, the conclusions reached by the Tax Court (which affirmed the transactions in which the corporations and their shareholders engaged) are by no means limited to the type of businesses that the Maguires operated.

The Tax Court's holding is more broadly applicable in any similar situation if all of the other facts and circumstances are favorable and comparable.

The *Maguire* case dealt with the enhancement of a shareholder's basis for his/her ***investment in the stock*** of an S Corporation.

The favorable outcome in the *Maguire* case could only have been accomplished by following the advice and strategies suggested by the CPAs for the family and related entities. In fact, the CPAs first came up with a "Plan A" which could not be executed for various reasons. Then, they developed "Plan B" which was carefully documented, implemented and (ultimately) upheld by the Tax Court.

Furthermore, the CPAs even testified in Tax Court with the Judge indicating that their backgrounds demonstrated that "they were individuals whose advice (the taxpayers) sought regarding their income tax situation, on the basis of their experience and qualifications."

When all reasonable efforts to enhance or increase the basis for a stock investment in an S Corporation have been exhausted, if the S Corporation losses seem to be greater than the ability of the shareholders to deduct, then attention needs to be focused on any indebtedness of the S Corporation held by the shareholders.

The reason for this attention is that shareholders want to increase their basis in the ***debt obligations*** issued by their S Corporations in order to increase the amount of S Corporation operating losses that they can deduct in their individual income tax returns.

Accordingly, with respect to the enhancement of a shareholder's basis for its ***investment in the bona fide indebtedness*** of an S Corporation, the examples included in the proposed Regulations should be studied carefully for the possibility of setting up similar scenarios.

UPDATE ON MANUFACTURER ASSISTANCE PAYMENTS TO DEALERSHIPS FOR FACILITY IMAGE UPGRADES

The proper tax treatment of manufacturer assistance payments to dealerships for facility image upgrades continues to be the most important issue affecting the entire spectrum of dealerships in the country. For some dealership 2012 tax returns, this issue will also have to be considered in connection with the filing of Schedule UTP for disclosing uncertain tax positions.

BACKGROUND

In the Year-End 2011 Edition of the *DTW*, I included an extensive discussion of the taxability of manufacturer payments. Following up on this, in the Mid-Year 2012 Edition of the *DTW*, I added as Part II several other articles, including a summary of the discussion of this topic at the NADA Convention in Las Vegas in February, 2012.

In addition, I wrote a long article entitled *"Why Basis Reduction Treatment is Inappropriate for Manufacturer Payments,"* and included a ***Practice Guide*** - *"Checklist for Evaluating Ramifications of Dealership-Manufacturer Facility Programs."*

On September 19, 2012, I presented a two-hour audio seminar ... *"Taxation of Manufacturer/Factory Upgrade Program Payments to Automobile Dealers"* for *De Filipps University*. This included a 27-page outline and 42 pages of supplementary discussion materials. A recording of this audio seminar is available through www.krm.com/wjd.

Other than what follows below, I've already said ... and written ... just about all I can on this topic.

TAX TREATMENT OF MANUFACTURER PAYMENTS

The "consensus of opinion" - if it can be called that - among industry advisors seems to be that payments received by dealerships under manufacturer facility upgrade programs should be included currently in dealership income. They should not be offset against the (cost) basis of facilities or facility improvements.

This "consensus of opinion" is based upon presentations by several practitioners at two major conferences during the year ... (1) NADA Convention in February, 2012 *Tax Workshop* re: Factory Facilities Programs and (2) the AICPA National Auto Dealership Conference (Oct. 25-26, 2012).

However, at least one major accounting firm continues to strongly assert its dissent to this consensus opinion.

STILL NO IRS PRECEDENTIAL GUIDANCE ON TAX TREATMENT

The IRS has not (to date) come out with any precedential statement or IRS official position on the tax treatment of these payments.

IRS Automotive Alert. The IRS *Automotive Alert... "Factory Image Upgrade Payments"* released in February, 2012 by the office of the IRS Motor Vehicle Technical Advisor is basically all that practitioners have to work with.

The unofficial position of the Service (or at least that of the Motor Vehicle Technical Advisor) - as stated in the Conclusion on page 2 of the *Alert* is below...

"In general, analysis of a number of legal authorities ... leads to the conclusion that manufacturer payments to auto dealerships for facility and image upgrade payments should be reported in income.

"The *White* case in particular appears to be on point with the general facts surrounding the payments and should be considered carefully when evaluating the proper treatment of image upgrade payments.

"Additionally, each program must be evaluated individually and treatment determined based on the facts and circumstances of those facts."

The *Automotive Alert* is qualified by the following statement ... "It should be noted that this document is not an official Service pronouncement and may not be cited as authority."

IRS refused to include this issue in its IIR Program. At the AICPA National Auto Dealership Conference, Paul Metrey, Chief Regulatory Counsel for NADA, included one item relating to this area in his NADA Regulatory Update Presentation.

Mr. Metrey indicated that in late August, NADA requested that the IRS include in its Industry Issue Resolution Program (IIRP) the general issue of how dealers/dealerships should treat payments received pursuant to manufacturer facility image programs.

Specifically, NADA was seeking guidance on "whether it is proper for (dealer) taxpayers to treat certain payments made pursuant to these programs as a reduction to the basis of specified depreciable assets rather than treating the payments as income in the year received."

NADA presented the IRS with three reasons it thought this issue should be considered in the IIR Program.

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First, the *John B. White, Inc.* case frequently cited in support of treating manufacturer payments as income "is limited to the application of a single Internal Revenue Code provision (Section 118) to a single fact pattern."

The second reason given is that "there is disagreement among many dealer tax advisors as to the proper treatment of the payments."

Finally, "the IRS has not offered formal, industry-specific guidance on the matter and, in particular, has not addressed the extent to which other Code provisions (e.g., Section 1016) may apply to the many different manufacturer image facility programs that exist today."

Mr. Metrey reported that the IRS (in a letter dated October 11, 2012) informed NADA that its request had been denied. In its response, the IRS said that "... We reviewed your submission and determined that guidance under Sections 61 and 118 of the Internal Revenue Code as well as case law adequately address this issue. Consequently, the IRS will not be accepting your submission into the IIR program."

Future guidance from the IRS. At the AICPA Conference, the Motor Vehicle Technical Advisor said that the IRS might issue some form of guidance on this matter. However, that guidance might be in the form of a Generic Legal Advice Memoranda (a GLAM) or some other letter of advice by the Chief Counsel's Office that is issued in response to a request from someone within the IRS for advice on a technical matter.

As we all know, this type of guidance usually has no precedential value, although practitioners read these documents with great interest since they reflect the thinking of at least one or two individuals in the IRS on the matter.

As an aside, I'm not sure that the second argument advanced by NADA necessarily represents a valid generalization that "there is disagreement among *many* dealer tax advisors as to the proper treatment of the payments." This may possibly represent only the minority viewpoint of some advisors to NADA on this matter, rather than a broader consensus of opinion drawn from a larger body of dealership tax advisors.

NO CLAW-BACK FOR GM *EBE* PAYMENTS?

At the AICPA National Auto Dealership Conference in October, Richard N. Sox discussed new developments on the legal horizon for franchised auto dealers, and one of his comments touched on the overall issues involving the taxability of manufacturer payments. This related to the position that some practitioners might take against the current taxability of payments received under some programs by claiming that these payments were in the nature of loans from the manufacturer which the dealerships may have to repay.

Apparently, many dealers have received payments from GM under the *Essential Brand Elements (EBE)* Program in advance of the dealership's either starting construction or meeting various percentage of completion objectives as of specific dates.

Mr. Sox commented that he has been unable to find any "claw-back" provisions in the *EBE* Program that would require dealers to return payments to GM if they fail to follow through on their commitments to upgrade their facilities.

Apparently, when a dealer reaches the point where it has failed to comply with its commitments or construction obligations, GM simply stops paying the dealership any more incentive money. But, there seems to be no provision requiring the dealership to repay GM for any *EBE* monies that GM has sent to the dealership under the Program.

"MERCER REPORT" FOLLOW-UP

As discussed on pages 12-15 in the last Edition of the *Dealer Tax Watch*, *The Mercer Report* (formally titled *"Factory Facilities Programs: An NADA Research Project,"* by Glenn Mercer dated Feb. 4, 2012) was first released at the 2012 NADA Convention.

This report summarized the findings of the NADA Factory Facilities Programs Research Project which began in August, 2011 in response to significant expressions of concern and frustration by dealers over how the various manufacturers facility programs were being designed and executed.

Mr. Mercer came up with a "3-layer" model for classifying Factory facility programs into three different modes or "layers" of activity and investment ... ***Expansion***, ***Modernization*** or ***Standardization***.

It was reported recently that there would be further follow-up by NADA and Mr. Mercer on the findings and recommendations in this Report. However, to date, nothing new has been reported, although NADA has created an Industry Relations Task Force, and NADA has reported that Phase II of its facilities image study will analyze return-on-investment aspects of manufacturer facility programs.

Apparently, the results of follow-up on these efforts will be announced at the NADA Convention in Orlando in February 2013.

The *Mercer Report* can be downloaded at http://www.autonews.com/mercer.

THE NEW TANGIBLES REGULATIONS ... WITH EMPHASIS ON DEALERSHIP FACTORY IMAGE UPGRADE & IMPROVEMENT EXPENDITURES

WILLARD J. DE FILIPPS, CPA ⁎ *DECEMBER 2012*

CONTENTS

SUPPLEMENTARY INFORMATION

SOURCE MATERIAL FOR THIS ARTICLE

This article includes materials from several recent audio seminars presented through *De Filipps University*.

- *Part I ... The New Tangibles Regulations: Section 263(a) & Others* (October 3, 2012)
- *Part II ... The New Tangibles Regulations: Section 263(a) & Others* (October 10, 2012)
- *Part III ... The New Tangibles Regulations: Impact on Auto Dealerships* (October 16, 2012)
- *2012 Year-End Dealer Tax Update ... Tax Strategies & IRS Activities* (December 6, 2012)

Please visit www.krm.com/wjd for information on these seminar recordings and materials.

THE NEW TANGIBLES REGULATIONS ... WITH EMPHASIS ON DEALERSHIP FACTORY IMAGE UPGRADE & IMPROVEMENT EXPENDITURES

The Mid-Year 2012 Edition of the *Dealer Tax Watch* included an overview of the new Regulations and an analysis of the specific provisions and examples in the Regulations which Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, specifically referred to (in the IRS *Automotive Alert*) as warranting dealers' attention because they might be more directly related to dealership facility expansion, modernization and upgrade activities.

This article (Part II) will expand on the discussion in the Mid-Year Edition of the *DTW* and provide additional update and commentary on several developments.

After listening in recent months to a few seminars presented by others on these new Regulations, I have come to the following conclusion. These new Regulations (to some extent or degree) reflect some of the frustration the IRS has been feeling after analyzing - and apparently finding significant fault or at least differences of opinion with respect to - so many of the "Repair Studies" prepared for Fortune 500 companies by the Big Four accounting firms.

Unfortunately, instead of limiting the scope or impact of these Regulations to the very large Fortune 500 companies and the multi-billion dollar conglomerates causing the IRS most of the problems, the Treasury decided to require all taxpayers - regardless of size - to comply with these Regulations regardless of how difficult that may be.

When these Regulations were issued, the IRS readily conceded the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs. It also conceded the difficulty in applying the standards or new general concepts in practice.

Given these provisos ... for the time being, at least ... there are two overall relief provisions in place.

RELIEF #1 ... TWO-YEAR POSTPONEMENT OF EFFECTIVE DATE

The new "Tangibles" Regulations, which affect ***all*** taxpayers, were issued on December 27, 2011. These ***Proposed*** Regulations were originally slated to be effective January 1, 2012.

However, in Notice 2012-73 the IRS announced that it would delay the effective date of the Tangibles Regulations.

Taxpayers will not be required to apply the ***Final*** Regulation rules to years before 2014. This is because the Treasury anticipates finalizing the Regulations sometime during 2013.

see **NEW TANGIBLES REGULATIONS**, page 32

T-Regs

THE NEW "TANGIBLES" REGULATIONS

IMPROVEMENTS VS. REPAIRS ... CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES

- The new "Tangibles" Regulations include nine (9) sets of Regulations which clarify and expand the standards for proper capitalization of specific expenditures associated with tangible property. These Regulations relate to ...
  - Materials and supplies ... *[Reg. Sec. 1.162-3T]*
  - Repairs ... *[Reg. Sec. 1.162-4T]*
  - Capital expenditures in general ... *[Reg. Sec. 1.263(a)-1T]*
  - Amounts paid to ***acquire*** or produce tangible property ... *[Reg. Sec. 1.263(a)-2T]*
  - Amounts paid to ***improve*** tangible property ... *[Reg. Sec. 1.263(a)-3T]*
  - Capital expenditures made by either a lessee or a lessor on leased property ... *[Reg. Sec. 1.167(a)-4T]*
  - General asset accounts and accounting ... *[Reg. Sec. 1.168(i)-1T]*
  - Accounting for MACRS (Modified Accelerated Cost Recovery System) property ... *[Reg. Sec. 1.168(i)-7T]*
  - Dispositions of MACRS property ... *[Reg. Sec. 1.168(i)-8T]*.

(Continued from page 31)

Taxpayers have been given the option (i.e., taxpayers may elect) to apply the rules in the ***Temporary*** Regulations to their 2012 and/or 2013 tax years - i.e., to tax years starting on or after January 1, 2012 and before the applicability date of the ***Final*** Regulations.

"Pick and choose." Apparently, taxpayers will be permitted to make "favorable" changes in accounting methods right away (i.e., in 2012 or 2013), while deferring the making of less favorable or adverse changes until 2014.

Although this is not stated in the text of the Notice, at the AICPA National Tax Conference in October, a representative from the IRS stated that taxpayers could selectively choose which provisions to implement earlier and which provisions they would not attempt to cope with until after the Regulations are finalized.

The Notice says that the Treasury expects the ***Final*** Regulations will affect - and in certain cases, simplify - the implementation of (1) the *de minimis* rules, (2) the safe harbor rules for routine maintenance, and (3) the rules under Sec. 168 for dispositions of depreciable property.

The Notice encourages the expectation of further relief by saying that "the revisions being contemplated by the (IRS/Treasury) take into consideration all comments received, including comments requesting relief for small businesses."

"Taxpayers choosing to apply the provisions of the temporary Regulations to taxable years beginning on or after January 1, 2012, and before the applicability date of the final Regulations may continue to obtain the automatic consent of the (IRS) to change their methods of accounting under Revenue Procedures 2012-19 and 2012-20.

"For taxpayers choosing to apply the provisions of the final Regulations to taxable years beginning on or after January 1, 2012, the (IRS) expects to publish procedures for obtaining automatic consent to change a method of accounting when the final Regulations are published."

RELIEF #2 ... TWO-YEAR POSTPONEMENT OF IRS AUDIT ACTIVITY

The IRS is also giving taxpayers a break ... or at least more time to digest the new Regulations ... by calling off any audit activity involving the capitalization versus repair deduction issues. On March 15, 2012, the IRS announced a moratorium or "stand-down order" restricting audit activity during 2012-2013.

This LB&I (Large Business & International) Directive stated that for taxpayers who had adopted a method of accounting (change) relating to the conversion of capitalized assets to repair expense under Section 263(a), examining agents should discontinue any current exam activity with regard to these issues and not begin any new exam activity with regard to these issues.

Also, if a taxpayer under audit files a Form 3115 with regard to these issues on or after December 23, 2011, the examining agent is instructed to "risk assess the Form 3115 and determine (in consultation with the *Change in Accounting Method Issue Practice Group*)" whether the Form 3115 should be examined.

In effect, this is a "moratorium" or a "stand-down order" for 2 years.

UNIT OF PROPERTY (UOP) DETERMINATIONS

The Regulations clarify and expand the standards for proper capitalization of specific expenses associated with tangible property by providing two separate sets of rules for determining what is a "unit of property."

One set of rules applies to all tangible personal property other than buildings. The other set of rules applies to all buildings, building components and building systems.

The concept of a unit of property must be properly understood because the unit of property serves as the foundation for understanding all of the discussions in the Regulations of expenditures that are required to be capitalized (under Section 263(a)) versus what expenditures may be deducted as repairs (under Section 162). As a general rule, a taxpayer must capitalize the aggregate of all related amounts paid to improve a unit of property.

"NEW" UOP CONCEPT FOR ALL TANGIBLE PERSONAL PROPERTY *OTHER THAN BUILDINGS*

The first set of rules (for UOP determinations) is to be applied to all tangible personal property other than buildings.

In general, for this property, the unit of property determination is based upon the functional interdependence standard. All the components that are functionally interdependent comprise a single unit of property. Components of property are ***functionally interdependent*** if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

A major component or substantial structural part of a component includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a

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discrete and critical function in the operation of the unit of property. The Regulations do not provide a bright-line test for what constitutes a ***"major"*** component or a "large portion" of a structure.

On the other hand, the replacement of a ***minor*** component of the unit of property (even though such component may affect the function of the unit of property) will not generally, by itself, constitute a major component or substantial structural part under the Regulations.

The two Examples below are directly from the Regulations and may be helpful in illustrating the rules.

The Regulations provide that ***all of the facts and circumstances*** must be considered in determining whether an amount is paid for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property. Facts and circumstances to be considered include the ***quantitative or qualitative significance*** of the part or combination of parts in relation to the unit of property.

There is no percentage threshold or recovery period limitation for determining whether a replacement rises to the level of a major component or substantial structural part of a unit of property.

An improvement to a unit of property (other than a lessee improvement) is not a unit of property separate from the unit of property improved.

"NEW" UOP CONCEPT FOR ALL *BUILDINGS, BUILDING COMPONENTS AND BUILDING SYSTEMS*

The second set of rules (for UOP determinations) is to be applied only to buildings, building components and building systems.

In the case of a building, each building and its structural components is a single unit of property (building).

An amount is paid for an improvement to a building if the amount paid results in an improvement to the building structure ***or*** any of the structural components defined as "building systems."

Each building system, including the components thereof, is separate from the building structure, and must be the subject of the separate application of the capitalization rules relating to building improvements.

In determining whether an amount paid is for an improvement to the building, consideration must be given to the effect of the expenditure on certain significant and specifically defined components of the building (rather than the building and its structural components as a whole).

see **NEW TANGIBLES REGULATIONS**, page 34

UOP Examples

UOP Tangible Property - Other Than Buildings

Example #1 ... *Locomotives, Vehicles, etc.*
(Example 8 at Reg. Sec. 1.263(a)-3T(e)(6))

Facts

- X owns locomotives that it uses in its railroad business.
- Each locomotive consists of various components, such as an engine, generators, batteries and trucks.
- X acquired a locomotive with all its components.
- X treats all the components of the locomotive as being within the same class of property under Section 168(e) and it depreciates all the components using the same depreciation method.

Conclusion

The initial unit of property (UOP) is comprised of the components that are functionally interdependent. ***Accordingly,*** the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

Example #2 ... *Computers, Printers, Most Office Equipment, etc.*
(Example 9 at Reg. Sec. 1.263(a)-3T(e)(6))

Facts

- X provides legal services to its clients.
- X purchased a laptop computer and a printer for its employees to use.
- When X placed the computer and printer into service, X treated the computer and printer and all their components as being within the same class of property under Section 168(e), and it depreciated all the components using the same depreciation method.

Conclusion

The initial units of property are comprised of the components that are functionally interdependent. ***Accordingly,*** the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

(Continued from page 33)

Unfortunately, again, there are no percentage thresholds or recovery period limitations for determining whether a replacement activity rises to the level of affecting a ***major*** component or substantial structural part of a unit of property. (The previous Regulations had included certain percentage thresholds, but these have been eliminated from the new Regulations.)

In dealing with this set of UOP determinations for buildings, etc., the proper analysis requires the application of the general rules for improvements, and this includes the rules for determining whether the costs are incurred for - or relate to - (1) a betterment, (2) a restoration to the building or to the building systems, or (3) an adaptation of the building or any of its systems to a new or different use.

Replacement of a major component or a substantial structural part. In analyzing the activities and expenditures related to these replacements, *all the facts and circumstances* must be considered in order to determine whether an amount has been paid for the replacement of a part or a combination of parts that comprise a ***major component*** or a ***substantial structural part*** of the unit of property.

These facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property.

Here is what the Regulations add for clarification.

A ***major component*** or ***substantial structural part*** includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property. However, the replacement of a ***minor*** component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.

Other than by way of certain examples, the Regulations provide no real guidance, clarification or interpretation of the adjectives ... *major, minor* or *substantial.* The essence of these terms is apparently to be derived from an analysis of the specific *facts and circumstances* attending each situation.

Further discussion of *Unit of Property (UOP) Determinations for Buildings, Building. Components and Building Systems* is included on pages 48-50. A summary or overview of the three classes of improvements (*Betterments, Restorations & Adaptations*) is included on pages 51-52.

COST SEGREGATION STUDIES ... STILL RELEVANT AND IMPORTANT

Historically, these studies have emphasized separating what costs are attributable to a building from what costs are not attributable to a building. In other words, the emphasis in previous cost segregation studies was usually on maximizing the amounts that could be allocated to shorter-lived Section 1245 property and minimizing costs attributable to the longer-lived building which is Section 1250 property.

Any cost segregation studies that are being prepared now should also focus on identifying the various "building systems" and structural components and arriving at an allocation of overall cost to each.

Building component and building systems information/allocations are important in connection with the need to allocate cost when there is a "retirement." Rev. Proc. 2012-20 provides that taxpayers may use "reasonable" methods to determine costs allocated to assets that are retired. Current cost segregation studies should also consider the allocation of costs to building systems which are part of newly constructed improvements.

A previous cost segregation study may provide useful information - or at least a starting point - for estimating the cost of a building component that a taxpayer disposes of in a later year.

If a previous cost segregation study does not have this specific information, in some cases that cost seg study may still provide the basis for making reasonable allocations or estimates of the cost of building systems that were installed at the time when the property was placed in service and the cost segregation study was prepared.

DEALERSHIP FACILITY UPGRADES & IMPROVEMENTS ... IMPACTED BY NEW CONCEPTS FOR BUILDINGS

The Mid-Year 2012 Edition of the *Dealer Tax Watch* discussed on pages 39-41 the applicability of the new Regulations to upgrades on dealership facilities. This discussion included an analysis of the examples which the Motor Vehicle Technical Advisor had referred to as "most likely to be of interest to dealers who periodically upgrade, remodel, refresh or otherwise improve dealership facilities."

The Mid-Year 2012 Edition of the *Dealer Tax Watch* (on pages 12-15) also reviewed the *"Mercer Report"* which analyzed facility improvements by dealerships in a 3-layer model which classified these expenditures as relating to either (1) expansion, (2) modernization or (3) standardization. See the facing page for a summary.

see **NEW TANGIBLES REGULATIONS**, page 32

Mercer Report Summary	FACTORY FACILITIES PROGRAMS ... NADA RESEARCH PROJECT *THE MERCER REPORT*
Background	• For years, the National Automobile Dealers Association had received strenuous comments from dealers who were critical of the pressures, terms and conditions that they felt were being imposed on them by various manufacturer facilities programs. • The "Mercer Report" - formally titled *"Factory Facilities Programs: An NADA Research Project"* - was first released at the 2012 NADA Convention, followed by a workshop during which Mr. Glenn A. Mercer discussed the Report he had prepared at the request of NADA. • His Report was based upon in-depth, confidential interviews with many dealers, representatives of the manufacturers and other professionals and advisors to the industry. • He identified several issues that were common to all manufacturers' programs. These "cross-cutting" issues relate to ... (1) timing, (2) size bias that is adverse to smaller dealerships, (3) impact of incentives offered to dealerships by manufacturers and (4) the potential impact of the Internet and its effect on "the Dealer of the Future."
Three Types of Programs	• Mr. Mercer concluded that most Factory upgrade programs include elements having three different types or "layers" of emphasis. • He created a "3-layer" model which divides Factory facilities program objectives into three different modes or "layers" of activity and investment ... (1) ***Expansion***, (2) ***Modernization*** and (3) ***Standardization***.

#1 - Expansion ... *Adding Asphalt, Showroom Space and Service Stalls to Support Expected Growth in Either Units in Operation or Expanded Product Lines.*

- *Report comments* ... "When an OEM and a dealer discuss adding parking space (for customers or for vehicle inventory), service stalls, and interior space (such as showroom or service waiting area square footage), they are discussing Expansion.
- "Typically the Expansion discussion starts because a brand's Units in Operation (UIO) has grown rapidly (necessitating adding service bays to repair the larger fleet), or because an OEM is adding new models (necessitating a larger showroom), or forecasting higher future sales or market share (requiring expansion of the entire store).
- "Tension here tends to arise when the factory asks for more expansion than the dealer thinks is necessary, e.g. due to inflated volume forecasts."

#2 - Modernization ... *Upgrading the Exterior and/or Interior of the Dealership to Contemporary Standards Relating to Such Items as Furniture, Fixtures, Tile, Carpet, Paint, Décor, etc.*

- *Report comments* ... "Assuming the dealership facility is sized correctly, the next layer at issue is Modernization: bringing the store up to contemporary standards both inside and out, for example with new building fascia or windows outside, or with upgraded furniture, fixtures, and equipment (e.g. free Wi-Fi) inside.
- "The goal of Modernization is ... to attract more customers and to better satisfy them, by surrounding them with a pleasant and up-to-date environment.
- "Tensions can arise both on the cost and benefit side of the equation: one dealer might see the value in the upgrade, but believe that the factory's approved materials vendors are too costly; another might not have a problem with the cost of the specified fixtures, but not see any value in the project, in terms of either increased sales (in cars or service work) or customer satisfaction."

#3 - Standardization ... *Designing the Exterior and Interior Elements of the Dealership to Ensure that Every Dealership Representing that Manufacturer's Brand Looks Similar to All of the Other Dealerships that Represent that Manufacturer's Brand*

- *Report comments* ... "If the store is now the right size and is sufficiently up-to-date, the next layer facility programs often tackle is Standardization: ensuring that the updated facility looks as much as possible like those of other dealers carrying the same brand, via the use of similar or identical materials, floorplan templates, and commonized furniture and fixtures.
- "The goal of Standardization seems to be to somehow reinforce the power of the brand by providing a similar look, feel, and experience for a customer of a given brand - whichever store she or he happens to visit.
- "Tensions arise here in part over the cost of Standardization, but especially over its worth: ... many interviewees had trouble seeing why Standardization - as defined by some but not by all OEMs - might be valued by a customer."

Source	De Filipps University, *"Taxation of Manufacturer/Factory Upgrade Program Payments to Automobile Dealers"* audio seminar (September 19, 2012)

(Continued from page 34)

When one compares the actual expenditures and degree of structural work involved in the current dealer upgrades that are referred to in the *Mercer Report* with the examples and rules in the Regulations, there does not seem to be much hope for finding any significant amounts of deductible costs. But, let's try to do so anyway.

In February, 2012, the Motor Vehicle Technical Advisor issued an *Automotive Alert* entitled "*IRS Issues New Regulations ... Deduction and Capitalization of Expenditures Related to Tangible Property.*" The *Alert* includes an addendum entitled "*Regulation Examples #6, -7 and -8 re: Store Remodels and Refreshes.*" The addendum is nothing more than a reprint of the text of the Regulations in an almost unreadable format.

This *Automotive Alert* stated that dealers/dealerships should especially consider three examples in the Regulations relating to "refurbishment and refreshment" activities in connection with their facility upgrades and improvements.

The conclusion paragraphs of the *Alert* are as follows ... "Whether or not amounts paid in a store remodel or refresh qualify as an improvement may be a question of degree. The temporary Regulations include many examples intended to clarify all of the provisions. Examples relevant to store remodels and refreshes are found in Treas. Reg. 1.263(a)-3T. Examples 6, 7 and 8 discuss the refresh and remodel of a retail store (not a dealership specifically) and include facts intended to clarify when the activities rise to the level of a betterment requiring capitalization. We have included the three examples in the addendum to this *Alert*.

"The Regulations related to amounts paid to improve tangible property are complex and each transaction must be analyzed individually. In addition, the Regulations contain provisions other than those discussed above that may affect the determination of whether amounts expended in a remodel or refresh result in costs that must be capitalized...."

These Examples are found at Reg. Sec. 1.263(a)-3T(h)(4) as Examples #6, 7 and 8, and were more fully discussed in the Mid-Year *DTW* Edition on pages 40-41 and 54-57. However, just to refresh your memory, these Examples are summarized below and a more complete analysis of each is included on pages 53-54-55 of the Supplementary Information.

Example #6 involved a *Refresh (activity) that Kept a Building in Ordinary Efficient Operating Condition and Did Not Include an Improvement to a Building System.* In this situation, there were no material improvements, or corrections of material defects or conditions. Instead, there was only a *refresh* activity that kept the building in ordinary efficient operating condition.

Therefore, the taxpayer was permitted to expense (i.e., deduct) the *refresh* expenditures, but it was required to capitalize any expenditures which related to the Section 1245 property (i.e., those expenditures related to the reconfiguration of the display tables and racks).

Example #7 involved a *Larger Scale Refresh (activity) that Also Included an Improvement to a Building System. Example 7* reflected a greater degree of involvement ... It involved a *refresh* with additional work that also included an improvement to a building system.

Within that fact pattern, the taxpayer was still permitted to deduct the expenditures related to the refreshment activity. But note the deduction allowable was only for the portion of the expenditure that was related to the refreshment activity. All of the other expenditures (relating to the building systems and improvement activities or aspects) were required to be capitalized ... in addition to any expenditures which related to the Section 1245 property (i.e., those expenditures related to the reconfiguration of the display tables and racks).

Example #8 involved a *Larger Scale Refresh & Remodel (activity) that Involved an Improvement to the Building.* Example #8 started with the refresh activities that were included in Example #6 but then added further assumptions relating to additional work that was done. It was further assumed that (1) "The work performed to refresh the stores directly benefited or was incurred by reason of a substantial remodel to X's store buildings" and (2) "X performed significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume."

As a result, *Example 8* involved both a betterment activity ***and*** a remodeling activity. The consequence was that any work on a building system had to be capitalized. In other words, the cost of ***all*** of the work done in *Example 8* is required to be capitalized, including the portion of the work that related to refreshing the building.

Caution. Overall, these three examples are not specific to auto dealerships. Upon close analysis, these examples provide little helpful insight except to create the expectation that significant amounts usually will have to be capitalized when all of the facts and circumstances are taken into consideration.

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After sorting through all of the discussion and examples, it seems that it all comes down to "facts and circumstances" determinations and a matter of degree.

Further caution. Practitioners should not be lulled into the false sense of security that the *Automotive Alert* might give by suggesting that only the three Examples (i.e., -6, -7 and -8) should be analyzed and compared to expenditures for current facility improvements. It should be noted that, technically, these three Examples are "simply" examples of *betterments*, and betterments are just one of the three classes of improvements that need to be considered.

The other two classes of improvements are ... (1) restorations and (2) adaptations to a new or different use. Each of these has its own pitfalls, ambiguities and examples intended to illustrate their own unique applications.

The "rules" (if they may be called that) which discuss the "replacement of major component or substantial structural part" have some bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received.

This hoped for reduction of the tax impact would come from dealerships being able to claim deductions for repair activities or from the deduction of negative Section 481(a) adjustments arising from beneficial changes in accounting methods which the new Regulations afford.

These rules are at Reg. Sec. 1.263(a)-3T(i)(4) which is included under the broader category of "restorations." This broader category of restorations includes six repair and replacement situations, one of which specifically addresses restorations. (Reg. Sec. 1.263(a)-3T(i)(1)(vi))

The Regulations include rules intended to clarify the application of the improvement standards to a building. However, these rules are basically expressed in the form of examples which, in turn, are intended to further illustrate the application of these rules. In this regard, the use of the word "intended" is intentional because many commentators have complained that the "examples" are deficient in many respects, especially because many fail to clearly express the "rules" or show how various facts included in the examples have been weighed or prioritized in arriving at the stated conclusion.

Final caution. Even if a dealership's expenditures somehow (miraculously) are able to avoid fitting onto one of these three classes of improvements (that require capitalization), it is still possible that the expenditures may have to be capitalized. This is because under Section 263A, if costs are incurred by reason of some larger project, then those costs incurred would have to be capitalized.

Based on all of the foregoing, perhaps you can better understand why I have cautioned practitioners (in the *Executive Summary* on pages 44-45) to approach their interpretations of the new Tangibles Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures for improvements unless there are unusually favorable extenuating "facts and circumstances" that would supersede the detailed rules.

SELECTED CAMS MORE GENERALLY ACCEPTABLE TO DEALERSHIPS

In general. As practitioners explore the meaning of these Regulations, they should understand that if taxpayers are going to make changes to comply with these new Regulations, they will be dealing with other provisions involving (1) changes in accounting methods (CAMs), (2) the filing of Forms 3115 and (3) the need - in most cases - to compute Section 481(a) adjustments ... some of which will be positive, and others, negative.

For example, CAMs may be necessary in order to re-characterize previously capitalized expenditures as currently deductible repairs (or vice-versa), or to deduct the undepreciated tax basis of a structural component (such as a roof) if it has been subsequently replaced and the cost of the replacement has been capitalized.

In January 2012, the IRS issued two Revenue Procedures (2012-19 and 2012-20) which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations. These CAMs are for taxable years beginning on or after January 1, 2012.

Rev. Proc. 2012-19 covers changes in methods of accounting related to the "capitalization versus repair" provisions in Reg. Secs. 1.162-3T, 1.162-4T, and 1.263(a)-1T, -2T and -3T.

Rev. Proc. 2012-20 covers changes in methods of accounting related to fixed asset depreciation and the tax accounting treatment for dispositions of fixed assets which are discussed in Reg. Secs. 1.167(a)-4T and 1.168(i)-1T, -7T and -8T.

And, as discussed previously, a taxpayer may choose to selectively make changes which it finds advantageous for either 2012 or 2013, even though IRS Notice 2012-73 has deferred the overall applicability date of the Regulations to January 1, 2014.

see **NEW TANGIBLES REGULATIONS**, page 38

(Continued from page 37)

To assist taxpayers in the mechanics of making these changes, the Instructions for Form 3115 were revised (by revision dated March, 2012) to include in the Appendix all of the automatic changes in accounting methods related to the Temporary Regulations and described in Revenue Procedures 2012-19 and 2012-20.

Some of these changes have been discussed on pages 42-43 and 58-59 of the Mid-Year 2012 Edition of the *Dealer Tax Watch*. Pages 58 and 59 of that Edition listed selected automatic CAMs that are applicable to dealerships and facilities upgrades. But, see also pages 56-57 of this Edition.

A few are discussed in more detail below, with the discussion based upon the Regulations as issued in December 2011 ... but which may change when the Regulations are eventually finalized.

Materials & supplies ... including the de minimis rule ... CAM #164 and/or #165. A dealership that is currently using (a method of accounting which employs) a higher cost threshold for capitalizing materials and supplies (for example, $250 per item) will be allowed to deduct the cost of materials and supplies which cost more than $100 per item if it satisfies the four conditions that must be met in order to apply the *de minimis* rule.

In many instances, dealerships which do not have audited financial statements will not be able to elect to use the *de minimis* rule. Even if a dealership has audited financial statements, it will not be able to elect to use the *de minimis* rule unless it also has a ***written*** policy in effect as of the ***beginning of the year*** regarding the cut-off or threshold level for expenditure amounts to be capitalized.

The qualifications for electing the application of the new *de minimis* rule, and the "ceiling" threshold limitations are the same for materials and supplies as they are for other tangible property. It may be necessary to make multiple changes in accounting methods in order to either comply with or to derive benefits from the provisions introduced in the new Regulations.

Amounts paid to acquire tangible property ... including the de minimis rule ... CAM #169 and/or #173. This includes a *de minimis* rule (the application of which may also be elected separately with respect to the treatment of materials and supplies).

A dealership that is currently using (a method of accounting which employs) a cost threshold for capitalizing asset acquisition costs (for example, $500 per item) will be allowed to deduct the cost of all such asset acquisitions if the dealership satisfies the four conditions - including the ceiling limitation amounts - that must be met in order to apply the *de minimis* rule.

Dealerships may agree upon other (higher) *de minimis* thresholds with the IRS. Treasury Decision 9564 states that the new *de minimis* rule is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agents that, as an administrative matter, based on risk analysis or materiality, the IRS examining agents will not review certain items.

In other words, it is not the intention of the new *de minimis* rule that examining agents must now revise their materiality thresholds in accordance with the *de minimis* rule ceiling.

If examining agents and a taxpayer agree that certain amounts in excess of the *de minimis* rule ceiling are immaterial and should not be subject to review, that agreement should be respected, notwithstanding the requirements of the *de minimis* rule in the temporary Regulations. However, a taxpayer that seeks a deduction for amounts in excess of the amount allowed by this rule or by agreement with IRS examining agents will have the burden of showing that such treatment clearly reflects income.

Special rules apply to lessors, lessees and leased property. Automatic CAM #175 applies to CAMs involving changing methods ***from*** improperly depreciating or amortizing leasehold improvements over the term of the lease (including renewals, if applicable) ***to*** properly depreciating or amortizing these leasehold improvements under Sec. 167(f)(1), 168 or 197.

Dispositions of a building or of a structural component. This automatic change (CAM #177) can be so significant for dealerships and/or other taxpayers that it warrants separate discussion.

THE "ROOF REPLACEMENT" SCENARIO ... DISPOSITIONS OF BUILDING COMPONENTS

The following discussion expands the summary in the Mid-Year 2012 article. This section covers - in some detail - the automatic change (#177) which is probably the most important change for many dealerships at the present time.

What I am referring to as the roof repair scenario relates to the automatic change in accounting method (designated change no. 177) which permits the deduction for previously capitalized improvements to buildings when major building "repairs" occur.

One of the changes in the Regulations that is more frequently discussed - because it is very favorable to all classes of taxpayers - relates to the change in the definition of the term *"disposition."*

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The term "disposition" has been expanded to include the retirement of a structural component of a building. This expanded definition allows a taxpayer to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building, so that a taxpayer will not have to continue to depreciate amounts allocable to structural components that are no longer in service.

Accordingly, a taxpayer is not required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties. In other words, the combination of these changes in the rules prevents the contemporaneous depreciation of both the retired component and the replacement component.

The key to obtaining the "benefit" of these new rules lies in the new definition for ***dispositions of property*** depreciated under the Modified Accelerated Cost Recovery System (MACRS).

A ***disposition*** occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income.

The facts and circumstances of each disposition are to be considered in determining what is the appropriate asset disposed of. The asset for disposition purposes cannot be larger than the unit of property.

A ***disposition*** includes (1) the sale, exchange, ***retirement***, physical abandonment, or destruction of an asset, (2) ***the retirement of a structural component of a building***, or (3) the transfer of an asset to a supplies, scrap, or similar account.

For purposes of determining the asset disposed of ... each structural component (including all components thereof) of a building, ... is the asset. (Note: the definition has not been expanded to include the disposition of a "building *system*.")

To obtain the benefit (i.e., a deduction for the adjusted tax basis of the component that was replaced), Rev. Proc. 2012-20 requires the filing of Form 3115 indicating automatic change #177 (i.e., for making the effective year of change either 2012 or 2013).

Rev. Proc. 2012-20 contains two examples (below) which clarify the application.

USE OF "REASONABLE" METHODS TO DETERMINE COSTS ALLOCATED TO ASSETS THAT ARE RETIRED

To determine the adjusted tax basis of the asset disposed of (for purposes of determining gain or loss) ... if the asset disposed of is a component of a larger asset, and it is impracticable from the taxpayer's records to determine the unadjusted depreciable

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CAM #177 — *DISPOSITION OF BUILDING COMPONENTS*

Example #1

Facts

- X, a calendar year taxpayer, acquired and placed in service a building and its structural components in 1990.
- X depreciates this building and its structural components under Section 168.
- In 2000, X replaced the entire roof of the building.
- X did not recognize a loss on the retirement of the original roof and continues to depreciate the original roof.
- X also capitalized the cost of the replacement roof and has been depreciating this roof under Section 168 since 2000.

Conclusion

"X may file a Form 3115 to change to treating the building as an asset and each structural component of the building as a separate asset and also to change from depreciating the original roof to recognizing a loss upon its retirement." (This is done in accordance with Section 6.29(3)(a) and (b) of this *Appendix* and solely for purposes of Reg. Sec. 1.168(i)-8T(c)(4).)

Example #2

Facts

- Y, a calendar-year taxpayer, acquired and placed in service a building and its structural components in 2000.
- In 2005, Y constructed and placed in service an addition to this building.
- Y depreciates the building, the addition, and their structural components under Section 168.

Conclusion

"Y may file a Form 3115 to change to treating the original building as an asset, the addition to the building as a separate asset, and each structural component of the original building and the addition as a separate asset." (This is done in accordance with Section 6.29(3)(a) of this Appendix and solely for purposes of Reg. Sec. 1.168(i)-8T(c)(4).)

basis ... of the asset disposed of, the taxpayer may use any ***reasonable method that is consistently applied*** to the taxpayer's ... larger assets for purposes of determining the unadjusted depreciable basis of assets disposed of.

Alternatively, to determine the adjusted tax basis of the asset disposed of (for purposes of determining gain or loss) ... if the asset disposed of is a component of a larger asset ... the adjusted depreciable basis is computed (proportionately?) with reference to (1) the depreciation allowed or allowable for the asset disposed of, (2) the depreciation method, (3) the recovery period, (4) the convention applicable to the larger asset of which the asset disposed of is a component, and (5) by including the portion of the additional first year depreciation deduction claimed for the larger asset that is attributable to the asset disposed of. [Reg. Sec. 1.168(i)-8T(e)(2)].

But ... What is a "reasonable" method? ... No one knows yet.

Rev. Proc. 2012-20 does not include any examples to indicate - or provide any guidance to suggest - what the IRS might consider to be a ***"reasonable method."*** The final Regulations may provide some clarification as to what the IRS will accept as a "reasonable allocation" of asset cost when a building component is retired.

Possible approaches for determining the cost of building components that have been replaced in prior years (where exact amounts were not previously determined), might be based upon extrapolations working back in time from current price indexes as published in construction industry guides such as *Marshall & Swift* ... "Building Cost Data" which includes the cost of labor, materials and installed components.

Alternatively, another source would be current prices taken from Bureau of Labor Statistics, Consumer Price Index (CPI) or Producer Price Index (PPI) information assuming (pro rata?) inflation or deflation over the period of time involved.

Other possibilities might include (1) recent prices paid for comparable buildings and/or paid for the installation of various building systems, (2) purchases made by the dealership/taxpayer, (3) purchase price information available from other comparable sources with respect to other transactions and (4) cost segregation studies.

Cost segregation studies may provide useful information if they permit reasonable allocations of original cost to the building and its structural components and systems. These might be studies (1) previously prepared cost segregation studies, (2) prepared at a time reasonably close to when the building, etc., (unit of property) was placed in service, (3) prepared at a time not necessarily reasonably close to when the building, etc., (unit of property) was placed in service, and (4) currently prepared cost segregation studies - prepared at this time to "look back" to determine reasonable allocations to building components and to building systems.

See Supplementary Information pages 58-59 for more details on the mechanics involved with the Form 3115 filing for CAM #177 for *The "Roof Replacement" - Dispositions of Building Components - Scenario.*

PROCEDURES FOR FILING FORM 3115 & SECTION 481(a) ADJUSTMENTS

The original Form 3115 is to be filed with the taxpayer's income tax return for the year of change. A signed copy of the completed Form 3115 must be filed with the IRS at Ogden, Utah. Note: this signed copy should not be filed with the National Office of the IRS in Washington, DC.

The copy of Form 3115 filed with the IRS in Ogden, Utah must be filed "no earlier than the first day of the year of change and no later than the date the taxpayer files the original Form 3115 with its Federal income tax return for the year of change."

Be careful with the required duplicate copy. Letter Ruling 201237003 is a reminder to be careful about timely filing copies of Forms 3115 and to comply with ***all*** of the filing requirements.

This LTR 201237003 involved a taxpayer who had engaged an accounting firm to prepare a Form 3115, *Application for Change in Method of Accounting*, to be filed under Rev. Proc. 2011-14.

The ***original*** Form 3115 was timely filed. However, due to a miscommunication between the taxpayer's tax department and the accounting firm, the ***copy*** of the Form 3115 was not timely mailed to the Ogden Office. Subsequently, the accounting firm learned that the copy of the Form 3115 had not been timely filed.

The accounting firm promptly advised the taxpayer of this fact and after evaluating various options, the taxpayer engaged the accounting firm to prepare a request for an extension of time to file the duplicate of Form 3115 with the Ogden Office.

A taxpayer's request for relief (i.e., in the form of an extension of time to file the copy of the Form 3115) will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith,

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and that granting relief will not prejudice the interests of the Government. (Reg. Sec. 301.9100-3)

The information provided and representations made by the taxpayer established that it had acted reasonably and in good faith with its request.

Accordingly, the IRS granted an extension of time of 30 days from the date of the Ruling to allow the taxpayer to file the necessary signed copy of the Form 3115 with the Ogden Office. However, this result was not obtained without the expenditure of considerable time, effort and money (filing fees) which otherwise could have been avoided

Section 481(a) adjustment computations and limitations. In only a few instances, CAMs may be made using the cut-off method (i.e., only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting). No Section 481(a) adjustment is required when the cut-off method is used.

In some instances ... basically involving fixed asset depreciation CAMs ..., a ***modified*** Section 481(a) adjustment is permitted. (I.e., the unadjusted depreciable basis and the depreciation reserve of the asset as of the beginning of the year of change are accounted for using the new method of accounting. In other words, there is no recomputation of depreciation under the new method with respect to the years preceding the year of change.)

In the majority of situations, a "full" Section 481(a) adjustment is required (i.e., the taxpayer must compute the effect of applying the new method of accounting to transactions in years prior to the year of change). The Section 481(a) adjustment is computed even though the statute of limitations may have closed on the years in which the events giving rise to the need for an adjustment occurred.

Accordingly, a Section 481(a) adjustment will be either a positive or a negative amount.

If the taxpayer has a ***positive*** Section 481(a) adjustment, that amount is taken into income over 4 years (unless the amount is less than $25,000 - in which case the taxpayer may elect to take the entire amount in income in one year).

If the taxpayer has a ***negative*** Section 481(a) adjustment, that amount is taken into income entirely in the year of change.

In connection with CAMs under Rev. Proc. 2012-20, if a Section 481(a) adjustment involves more than one asset in the same year, if one or more of the changes in a single Form 3115 generate a negative Section 481(a) adjustment and other changes in that same Form 3115 generate a positive Section 481(a) adjustment, the taxpayer may provide a ***single negative Section 481(a) adjustment*** for all such changes (i.e., changes that are included in that Form 3115 generating such negative adjustment) and a ***single positive Section 481(a) adjustment*** for all the changes that are included in that Form 3115 generating such positive adjustment.

In some instances, the computation of the Section 481(a) adjustment may be relatively easy because only one - or a few - transactions are involved. In other instances, the computation may involve a significant number of transactions ... in some cases, numerous transactions ... in years prior to the year of change.

The practical problem will be in calculating the amount of the Section 481(a) adjustment. That problem will arise because ***the Regulations prohibit the use of judgmental sampling***.

The Regulations do not provide for the use of extrapolation procedures (such as those that are provided under Reg. Sec. 1.263A-7 ... i.e., "3-year averaging technique"). Instead, taxpayers will be required to follow the extremely complex statistical sampling procedures and requirements that are set forth in Revenue Procedure 2011-42.

In this regard, the following standard language describing Section 481(a) adjustments is used in both Rev. Procs. 2012-19 and 2012-20 ... "By following the sampling procedures provided in Rev. Proc. 2011-42 (2011-37 I.R.B. 318), a taxpayer changing its method of accounting under [... this Section ...] may use statistical sampling in determining the Section 481(a) adjustment. ***Sampling methodologies not described in Rev. Proc. 2011-42 are not permitted.***"

Discussion of Rev. Proc. 2011-42 is beyond the scope of this article. However, the information on pages 60-64 will give you an idea of how difficult it will be to comply with the provisions of this Revenue Procedure.

PRACTITIONERS' CONCERNS OVER THE NEW T-REGS.

Although only a few practitioners attended or spoke at the public hearing on the Regulations in May, there has been no shortage of written criticism of these Regulations. Here are a few examples...

- The rules are too complex and burdensome administratively.
- The Regulations retain, in many cases, most of the facts and circumstances determinations despite appearing to offer more specific or concrete examples of how the rules are intended to be implemented.

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 (Continued from page 41)

- The Regulations do not provide an objective standard by which *"materiality"* is either defined or may be determined.
- The *de minimis* rule is unfair, too complicated, unrealistic and causes problems because a business has no way of knowing at the beginning of the year what its *de minimis* amount will be for the year.
- The *de minimis* amount is only determined after the end of the year by reference to (1) taxable gross receipts for the year and (2) the total amount of depreciation and amortization deducted on the books for the year.

Many businesses, especially larger businesses, do not have a single account through which all amounts expensed under their capitalization policies are tracked. Often, these businesses do not even maintain information (purchase invoices, etc.) regarding the items that were purchased and expensed under these policies.

Also, there seems to be some confusion over whether a business becomes entitled to expense any amount if the "ceiling" is exceeded for the year. In other words, if the total amount of a business' expenditures subject to the *de minimis* rule exceeds the ***larger*** amount in the ceiling computation (i.e., the 0.1% of total receipts or 2% of book depreciation and amortization), ...

Other related questions include (1) is there a "cliff effect" - meaning the business gets not deduction for any *de minimis* amount? ... *or* ... (2) is the business permitted to expense an amount up to the computed *de minimis* ceiling amount?

The AFS requirement. The requirement that a business must have an AFS (Applicable Financial Statement) unfairly discriminates against many dealerships and other businesses that have no need for audited financial statements. The requirement that the AFS be a "certified audited financial statement" is unduly restrictive. The AICPA suggests that the definition of an AFS be expanded to include "reviewed" financial statements. According to some, it would be even more reasonable to expand the definition of an AFS to include "compiled" financial statements.

The Regulations are essentially retroactive in the sense that adjustments are required under Section 481(a) in connection with many changes in accounting method that may be made. Section 481(a) adjustments will be difficult to compute in many cases because (prior year) information may not be available, and the Regulations do not provide for the use of extrapolation procedures for purposes of estimating these amounts.

Informally, as well as in Notice 2012-73, the IRS has acknowledged that some of these concerns may be addressed when these Regulations are finalized.

Perhaps this suggests that it might be wise to wait until the Regulations are finalized before filing Forms 3115 to make changes in accounting methods, unless the changes are relatively straight-forward and do not reflect practices that involve large dollar amounts over a lengthy span of years.

CONSIDERATIONS, OPPORTUNITIES & STRATEGIES FOR 2012

Until November 20th of this year, taxpayers and practitioners alike were extremely concerned over the requirement that the new Regulations were to become effective January 1, 2012.

Just about every seminar or presentation on these Regulations concluded with suggestions, to-do lists and/or checklists of activities that should be considered before year-end (which would have been December 31, 2012).

With the issuance of Notice 2012-73, almost everything is seen in a different light. Now, these suggestions, to-do lists and/or checklists have been slightly revised to indicate that these activities should be considered before the Regulations are finalized and become effective.

See the facing page for a list of opportunities and strategies to consider.

The postponement of the effective date of the Regulations to January 1, 2014 (after the Regulations are finalized) suggests the advisability of adopting a "wait and see" attitude toward immediately making changes in method under the new Regulations.

Perhaps with the exceptions of making changes in method that involve roof (or other building component) replacement scenarios ... or changes that are relatively straight-forward ... many taxpayers and their advisors are probably going to "wait-and-see" what is in the final Regulations before filing Forms 3115 to make changes under the new Tangibles Regulations.

Tangibles Regulations	*CONSIDERATIONS, OPPORTUNITIES & STRATEGIES FOR 2012*
Studies to Be Conducted	• Certain areas of a dealership's operations should be reviewed to determine if there are any existing business practices that will be prevented after the Regulations become finalized. The proposed Regulations already provide some indication of changes that may have to be made. • Analyze prior year additions to building accounts to determine if there were any expenditures that now may be deducted under the new T-Regs. via CAM #177. • Analyze prior year minimum capitalization levels and expense accounts to determine if amounts were written off that should have been capitalized or if existing practices will have to be changed. • Analyze depreciation and/or amortization deductions with respect to leasehold improvements to determine whether they are being written-off over the proper useful lives (39 years or 15 years for certain leasehold improvements) ... CAM #175. • Possible differences in treatments under Federal vs. state income tax laws ... States might not allow the same tax treatments that the Regulations either require or permit. • The adequacy of the accounting records to support/substantiate deductions and/or computations of amounts, especially with respect to acquisition or disposition transactions involving buildings and components.
Should Some Elections Be Made in 2012 Tax Returns?	• Consider the advisability of making elections in connection with finalizing tax returns for 2012. • These elections can be made on an item-by-item basis and/or on a year-by-year basis. ◆ The treatment may differ for different items and/or for the same type of item from year to year. ◆ In other words, these elections are not considered to be methods of accounting. ◆ If the taxpayer is considering capitalizing (and depreciating) large dollar amounts related to the purchases of materials and supplies and/or other assets, special depreciation allowances and/or Section 179 first-year depreciation may be available, but in some cases, these provisions have limitations of their own which need to be considered. • Elections to consider include... ◆ Election to capitalize and depreciate materials and supplies ... Either for ***all*** - or more ***selectively***. ◆ Election to deduct materials and supplies under the *de minimis* rule in Reg. Sec. 1.263(a)-2T(g). ◆ Election to capitalize and depreciate property acquisition costs, rather than take a deduction, under the *de minimis* rule in Reg. Sec. 1.263(a)-2T(g). ◆ Election to determine the amount of gain or loss on a disposition of property of an entire unit or a structural component of a unit, or the entire unit (including the last unit from a General Asset Account). ◆ Election to use General Asset Accounts ... This election is made by checking the appropriate box on Form 4562 (*Depreciation, etc.*) and including it as part of the original timely-filed income tax return.
Speculating on Increased Tax Rates for 2013	• Consideration should be given to whether 2012 or 2013 would be the better year of change from a tax standpoint if the use of net operating losses or other switches in effective tax rates might be involved. • If beneficial CAMs will result in significantly large dollar amounts of ***negative*** Section 481(a) adjustments, then ***if*** Congress were to increase tax rates for 2013, might it be more beneficial to postpone the deduction until 2013 when tax rates are higher? ◆ In other words, if the CAM will result in a large negative Section 481(a) adjustment (i.e., a deduction in the current year of change for the taxpayer), it may be more beneficial to postpone the effective date of the CAM to Jan. 1, 2013 - if Congress enacts (significantly) higher income tax rates which become effective after the end of 2012. ◆ However, many still believe "a bird in the hand is worth 2 in the bush."
Will the Final Regulations Really Simplify Compliance?	• Notice 2012-73 has hinted that when finalized, the Regulations may reflect changes - some significant, and some favorable to taxpayers. • For example, it is not clear whether exactly the same definitions that are used in determining unit of property (UOP) definitions for building systems and components (under Reg. Sec. 1.263(a)-3T) will be applied to dispositions/retirements of building systems and components (under Reg. Sec. 1.168(i)-8T). • The final Regulations may provide some clarification as to what methods or approaches the IRS will accept in making "reasonable allocations" to determine/estimate asset cost when a building or building component is retired. For example, might the IRS accept extrapolations back in time based upon ... ◆ Current CPI or PPI indexes assuming inflation or deflation in prior years as determined by the Bureau of Labor Statistics? ◆ Current price indexes as published in construction industry guides? ◆ Recent prices paid for comparable buildings and building components?

Executive Summary

THE NEW "TANGIBLES" REGULATIONS - IMPACT ON AUTO DEALERSHIPS

CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES ... IMPROVEMENTS VS. REPAIRS

Willard J. De Filipps, CPA ... December 2012

- The new "Tangibles" Regulations include nine different sets of Regulations which clarify and expand the standards for proper capitalization of specific expenditures associated with tangible property.
- The new "Tangibles" Regulations, which affect ***all*** taxpayers, were issued on December 27, 2011.
  - Originally, these ***Proposed*** Regulations were stated to be effective January 1, 2012.
  - However, IRS Notice 2012-73 has announced a delay in the effective date of the Tangibles Regulations.
  - Taxpayers will not be required to apply the ***Final*** Regulation rules to years before 2014. This is because the Treasury anticipates finalizing the Regulations sometime during 2013.
  - However, taxpayers will be permitted (i.e., may elect) to apply the rules in the ***Temporary*** Regulations to their 2012 and/or 2013 tax years - i.e., to tax years starting on or after January 1, 2012 and before the applicability date of the ***Final*** Regulations.
  - The Notice says that the Treasury expects the ***Final*** Regulations will affect - and in certain cases, simplify - the implementation of (1) the *de minimis* rules, (2) the safe harbor rules for routine maintenance, and (3) the rules under Sec. 168 for dispositions of depreciable property.
- The Regulations emphasize the need to make a proper determination based upon ***all of the facts and circumstances.*** The IRS acknowledges the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs and the difficulties encountered in applying these standards in actual practice.
- Practitioners and taxpayers should approach the interpretation of the new Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless there are unusually favorable (extenuating) "facts and circumstances" that override the detailed rules.
  - *Bottom line* ... "facts and circumstances" determinations trump everything else.
  - The Regulations contain frequent references to the need to consider the rules of Section 263A along with the rules set forth in the Regulations.
- Because Regulations enunciate new standards and changes from pre-Regulation case law, the apparently more precise rules set forth are illuminated by numerous examples. These examples must be studied in an attempt to determine what the IRS actually will permit. In many instances, there is no indication as to which facts given in an example may be (more or less) essential to the conclusion that is stated.
- Practitioners will have to become not only familiar, but proficient, with the statistical sampling procedures and requirements set forth in Rev. Proc. 2011-42. This will be necessary because the IRS will not permit taxpayers to use judgment sampling in applying the rules in the new "Tangibles" Regulations.
- The new Regulations include important correlative revisions to the fixed asset tax accounting rules for depreciation and disposition when a replacement of a major component or substantial structural part of a building occurs.
  - This includes the revision (expansion) of the definition of a "disposition" ... so that taxpayers may treat the retirements of structural components of buildings as "dispositions" of property.
  - This will allow taxpayers to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building.
  - Accordingly, taxpayers will not have to continue to depreciate amounts allocable to structural components that are no longer in service. In other words, taxpayers will not be required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.
- ***If a taxpayer elects to apply the rules in the Temporary Regulations to 2012, some of the elections to be made in 2012 income tax returns*** can be accomplished by simply reflecting the properly computed amounts in the tax return being filed. In other words, no affirmative election statements are required. In other instances, specific forms must be completed and included in the income tax return in order to make the election.

THE NEW "TANGIBLES" REGULATIONS - IMPACT ON AUTO DEALERSHIPS

CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES ... IMPROVEMENTS VS. REPAIRS

Willard J. De Filipps, CPA ... December 2012

- ***"Reg. -3T."*** The principles for determining whether activities and expenditures relating to buildings should be capitalized or expensed are found in the general rules for ***"improvements,"*** under Reg. Sec. 1.263(a)-3T.
  - In applying these Regulations, it is critical to determine what constitutes a ***unit of property***. For a building, the "unit of property" consists of the building ***and*** its structural components ***and*** building systems. All three elements are considered together and collectively as a single "unit of property."
  - This specific Regulation includes detailed (and, in many places, subjective) rules for determining whether the expenditures are incurred for (1) a *"betterment,"* (2) a *"restoration"* to the building, building structure and/or the building systems, or (3) an *"adaptation"* of the building (including the structure and/or any of the building systems) to a new or different use.
  - This Regulation is divided into seventeen (17) Subsections which are lettered (a) through (q) and includes eighty-eight (88) fairly detailed examples.
  - ***Automobile dealerships.*** An *Automotive Alert* issued by the IRS Motor Vehicle Technical Advisor (Feb. 2012) identified three examples as likely to be relating to the current dealership activity involving facility upgrades and improvements. These are *Examples #6, #7* and *#8*, which are included among the 19 examples under Reg. Sec. 1.263(a)-3T(h)(4).
    - These three examples are not specific to auto dealerships. Upon close analysis, these examples provide little helpful insight except to create the expectation that significant amounts usually will have to be capitalized when all of the facts and circumstances are taken into consideration.
- ***Changes in accounting methods (CAMs).*** In conforming existing practices to comply with the new Regulations, taxpayers will be required to make changes in methods of accounting.
  - Revenue Procedures 2012-19 and 2012-20 provide specific guidance for making CAMs under the new T-Regs.
  - Most of these changes will be "automatic" and will require the computation of Section 481(a) adjustments.
  - Under the limitations currently included in the Regulations, in many situations, it may be extremely difficult - if not impossible - to make proper computations of the required Sec. 481(a) adjustments because taxpayers may only use the results of computations derived from the application of the statistical sampling procedures that are sanctioned by Rev. Proc. 2011-42.
  - Unless the changes in accounting methods under consideration are relatively straight-forward and do not reflect practices that involve large dollar amounts over a lengthy span of years ... taxpayers may prefer to wait until these new Regulations are finalized before they file Forms 3115 to make some of these changes.
- ***"Risk management" vs. ignoring the new Regulations.*** Many practitioners are of the opinion that ... as a matter of proper "risk management" by a dealership/taxpayer ... the adverse effect of reporting manufacturer payments for facility upgrades as income when received can be mitigated (to some extent) by complying with provisions in the new Tangibles Regulations.
  - However, practitioners should approach the interpretation of the new Tangibles Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless unusually favorable extenuating "facts and circumstances" override the detailed rules.
  - ***Schedule UTP (Uncertain Tax Positions) and other concerns.*** Failure to comply with the new Regulations to years after they become effective may constitute negligence and raise corresponding concerns over potential penalty assertions by the IRS.

Source: *"The New Tangibles Regulations: Part III ... Impact on Auto Dealerships"*
presented by Willard J. De Filipps, CPA for De Filipps University on October 16, 2012.
(with modifications to reflect subsequent issuance of IRS Notice 2012-73 on Nov. 20, 2012)

<table>
<tr><th>T-Regs
Timeline
(2004-2014)</th><th>TIMELINE FOR THE NEW TANGIBLE PROPERTY REGULATIONS
IMPROVEMENTS VS. REPAIRS
CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES
Page 1 of 2</th></tr>
<tr><td>January 2004</td><td>• The IRS and the Treasury Department published Notice 2004-6 (2004-3 IRB 308) announcing an intention to propose Regulations providing guidance in the area of standards for applying Section 263(a), case law and administrative guidance previously issued by the IRS.
◆ This notice identified issues under consideration by the IRS and the Treasury Department and invited public comment on whether these or other issues should be addressed in the Regulations and, if so, what specific rules and principles should be provided.</td></tr>
<tr><td>August 2006</td><td>• First Proposed Regulations.
• The IRS and the Treasury Department proposed amendments to the Regulations under Section 263(a) (i.e., now referred to as the "2006 proposed Regulations") relating to amounts paid to acquire, produce, or improve tangible property.
◆ Taxpayers and practitioners submitted written comments on the 2006 proposed Regulations.
◆ The IRS held a public hearing on these (2006) Regulations in December 2006.</td></tr>
<tr><td>March 2008</td><td>• Re-proposed Regulations.
• After consideration of the comment letters and the statements at the public hearing (in Dec. 2006 on the 2006 proposed Regulations), the IRS and the Treasury Department withdrew the 2006 proposed Regulations.
• Simultaneously, the IRS and the Treasury Department proposed new Regulations (i.e., now referred to as the "2008 proposed Regulations") under Sections 162(a) (relating to the deduction for ordinary and necessary trade or business expenses) and Section 263(a) (relating to the capitalization requirement).
◆ Numerous written comments were submitted on the 2008 proposed Regulations.
◆ The IRS held a public hearing on these (2008) Regulations in June 2008.</td></tr>
<tr><td>November 2010</td><td>• IRS Audit Technique Guide (ATG) ... Guidance for IRS auditors examining cost cap issues.
• Currently, the primary use of this ATG is to ...
◆ Document the approaches taken by the IRS in the years before the new T-Regs. became effective (i.e., 2011 and prior years).
◆ Provide a useful reference summarizing case law and IRS guidance through the end of 2010.</td></tr>
<tr><td>December 2011</td><td>• In Dec. 2011, after considering the comment letters and the statements at the public hearing (in June 2008 on the 2008 proposed Regulations), the IRS and the Treasury Department withdrew the 2008 proposed Regulations.
• To replace the 2008 proposed Regulations, the IRS and Treasury proposed new Regulations, to be effective January 1, 2012, that incorporated (to some extent) the text of the 2008 Regulations.
• Accordingly, in Treasury Decision (T.D.) 9564, on December 27, 2011, the IRS published temporary Regulations that provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property.
◆ These Regulations became effective January 1, 2012.</td></tr>
<tr><td>January 2012</td><td>• In January 2012, the IRS issued two Revenue Procedures which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations.
◆ These CAMs are for taxable years beginning on or after January 1, 2012.
◆ If timely made, these CAMs can be made as automatic CAMs, not requiring prior IRS consent.
• Rev. Proc. 2012-19 is for CAMs involving ...
◆ Materials and supplies ... [Reg. Secs. 1.162-3T & -4T]
◆ Capital expenditures in general ... [Reg. Sec. 1.263(a)-1T]
◆ Transaction costs ... [Reg. Sec. 1.263(a)-2T]
◆ Improvements ... [Reg. Sec. 1.263(a)-3T]
• Rev. Proc. 2012-20 is for CAMs involving ...
◆ Leased property ... [Reg. Sec. 1.167(a)-4T]
◆ General asset accounts and accounting ... [Reg. Sec., 1.168(i)-1T]
◆ MACRS (Modified Accelerated Cost Recovery System) property ... [Reg. Sec., 1.168(i)-7T]
◆ Dispositions of MACRS property ... [Reg. Sec. 1.168(i)-8T]</td></tr>
<tr><td>February 2012</td><td>• IRS issues Automotive Alert entitled "IRS Issues New Regulations ... Deduction and Capitalization of Expenditures Related to Tangible Property." This includes an Addendum entitled "Regulation Examples #6,-7 and -8 re: Store Remodels and Refreshes."</td></tr>
</table>

T-Regs Timeline (2004-2014)	***TIMELINE FOR THE NEW TANGIBLE PROPERTY REGULATIONS*** ***IMPROVEMENTS VS. REPAIRS*** ***CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES*** **Page 2 of 2**
February 2012	• 2012 NADA Convention *Dealer Tax Issues* Workshop includes significant discussion by panelists of manufacturer assistance payments to dealerships for facility improvements. • Consensus of panelists ... These payments received by dealerships would be includable (i.e., taxable as ordinary income) upon receipt. However, this adverse tax impact could be significantly minimized by the consideration and appropriate use of several techniques adapted from the new T-Regs ... ◆ Treatment of appropriate expenditures as repair expenses (rather than as capitalizable expenditures) under the Section 263(a) tangibles Regulations and examples. ◆ Change in accounting method to reflect new definition of a "disposition" ... so that taxpayers may treat the retirements of structural components of buildings as "dispositions" of property. ▪ This will allow taxpayers to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building. ▪ Accordingly, taxpayers will not have to continue to depreciate amounts allocable to structural components that are no longer in service. In other words, taxpayers will not be required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.
March 2012	• On March 15, 2012, the LB&I (Large Business & International) Directive stated that for taxpayers who had adopted a method of accounting (change) relating to the conversion of capitalized assets to repair expense under Section 263(a), examining agents should discontinue any current exam activity with regard to these issues and not begin any new exam activity with regard to these issues. • Also, if the taxpayer under exam files a Form 3115 with regard to these issues on or after December 23, 2011, the examining "should risk assess the Form 3115 and determine (in consultation with the *Change in Accounting Method Issue Practice Group*)" whether to examine the Form 3115. ◆ In effect, this is a "moratorium" or a "stand-down order" for 2 years.
March 2012	• The IRS revised the Instructions for Form 3115 (to be used with the Dec. 2009 revision of Form 3115). • This revision of the Form 3115 Instructions lists all of the changes in accounting methods that might be made in connection with the new Tangibles Regulations. ◆ These changes in accounting method may be made under Rev. Procs. 2012-19 or 2012-20.
May 2012	• On May 9, 2012, the IRS held a public hearing at which interested parties presented comments on the Temporary and Proposed Regulations regarding deduction and capitalization of expenditures related to tangible property. ◆ Criticisms of these Regulations were varied and extensive.
November 2012	• ***Delay in effective date of Tangibles Regulations*** ... IRS Notice 2012-73 (Nov. 20, 2012) ◆ Taxpayers will not be required to apply the ***Final*** Regulation rules to years before 2014. ◆ This is because the Treasury anticipates finalizing the Regulations sometime during 2013. ◆ However, taxpayers will be permitted to apply the rules in the ***Temporary*** Regulations to their 2012 and/or 2013 tax years (i.e., to tax years starting on or after January 1, 2012 and before the applicability date of the ***Final*** Regulations). ◆ The Notice says that the Treasury expects the ***Final*** Regulations will affect - and in certain cases, simplify - the implementation of (1) the *de minimis* rules, (2) the safe harbor rules for routine maintenance, and (3) the rules under Sec. 168 for dispositions of depreciable property.
2013	• For tax returns filed for 2012 during 2013, taxpayers may elect to ... but are not required to ... comply with the Temporary Regulations issued Dec. 27, 2011. • The Treasury anticipates finalizing the Regulations sometime during 2013. • LB&I moratorium requiring IRS agents "stand down" on raising T-Reg. issues continues through Dec. 31, 2013.
2014	• As of January 1, 2014, expiration of LB&I moratorium requiring IRS agents "stand down" on raising T-Reg. issues.

Capitalization Concepts ... -3T(e)	***UNIT OF PROPERTY (UOP) DETERMINATIONS ... BUILDINGS, BUILDING COMPONENTS & BUILDING SYSTEMS*** **Page 1 of 3**
General Rules	• In the case of a building, each building and its structural components is a single unit of property (building). • An amount is paid for an improvement to a building if the amount paid results in an improvement to the building structure ***or*** any of the structural components defined as "building systems." • Each building system, including the components thereof, ◆ Is separate from the building structure, and ◆ Must be the subject of the separate application of the improvement rules.
Building Structure	
Building Structure	• A building structure consists of the building and its structural components other than the structural components designated as buildings systems. • Building structure includes all Section 1250 property components, including... ◆ Foundation ◆ Walls ◆ Finishes ◆ Windows and doors ◆ Roofs
Building Systems	
HVAC	• ***Heating, ventilation, and air conditioning ("HVAC") systems*** include ... ◆ Motors ◆ Chillers ◆ Compressors ◆ Pipes ◆ Boilers ◆ Ducts ◆ Furnace ◆ Radiators
Plumbing Systems	• ***Plumbing systems*** include ... ◆ Pipes ◆ Sinks ◆ Drains ◆ Bathtubs ◆ Valves ◆ Toilets ◆ Water and sanitary sewer collection equipment ◆ Site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures
Electrical Systems	• ***Electrical systems*** include ... ◆ Wiring ◆ Outlets ◆ Junction boxes ◆ Lighting fixtures and associated connectors ◆ Site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures
Escalators	• Includes all escalators in the building.
Elevators	• Includes all elevators in the building.
Fire Protection & Alarm Systems	• ***Fire-protection and alarm systems*** include ... ◆ Sensing devices ◆ Pumps ◆ Computer controls ◆ Visual and audible alarms ◆ Sprinkler heads ◆ Alarm control panels ◆ Sprinkler mains ◆ Heat and smoke detection devices ◆ Associated piping or plumbing ◆ Fire escapes & fire doors ◆ Emergency exit lighting and signage ◆ Firefighting equipment, such as extinguishers and hoses

Capitalization Concepts ... -3T(e)	***UNIT OF PROPERTY (UOP) DETERMINATIONS ...*** ***BUILDINGS, BUILDING COMPONENTS & BUILDING SYSTEMS***
Building Systems *(continued...)*	
Security Systems	• ***Security systems for the protection of the building and its occupants*** include ... ◆ Window and door locks ◆ Security cameras ◆ Recorders ◆ Monitors ◆ Motion detectors ◆ Security lighting ◆ Alarm systems ◆ Entry and access systems ◆ Related junction boxes ◆ Associated wiring and conduit
Gas Distribution System	• ***Gas distribution system*** includes ... ◆ Associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures
Other	• ***Other structural components*** ... These are, or will be, identified as such in published guidance.
Building Systems Examples ... Reg. Sec. 1.263(a)-3T(e)(6)	
Example 1 ***Building Systems***	• X owns an office building that contains a HVAC system. • The HVAC system incorporates ten roof-mounted units that service different parts of the building. ◆ The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. • X pays an amount for labor and materials for work performed on the roof-mounted units. • X must treat the building and its structural components as a single unit of property. [See -(e)(2)(i)] • An amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. [See -(e)(2)(ii)] • The entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. [See -(e)(2)(ii)(B)(1)] • Therefore, if an amount paid by X for work on the roof-mounted units results in an improvement (for example, a betterment) to the HVAC system, ***X must treat this amount as an improvement to the building***. [See -(e)(2)(ii)]
Example 2 ***Building Systems***	• X owns a building that it uses in its retail business. • The building contains two elevator banks in different locations in its building. • Each elevator bank contains three elevators. • X pays an amount for labor and materials for work performed on the elevators. • X must treat the building and its structural components as a single unit of property. [See -(e)(2)(i)] • An amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. [See -(e)(2)(ii)] • All of the elevators, including all their components, comprise a building system. [See -(e)(2)(ii)(B)(5)] • Therefore, if an amount paid by X for work on the elevators results in an improvement (for example, a betterment) to the entire elevator system, ***X must treat these amounts as an improvement to the building***. [See -(e)(2)(ii)]

UNIT OF PROPERTY (UOP) DETERMINATIONS ... BUILDINGS, BUILDING COMPONENTS & BUILDING SYSTEMS

Building Systems Examples ... Reg. Sec. 1.263(a)-3T(e)(6) *(continued...)*

Example 4 ***Building Structure & Systems ... Property Other Than Buildings***	• X, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for X's employees that manage and administer X's manufacturing operations. ◆ The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. ◆ X pays an amount to add an extension to the office building. • X must treat the building and its structural components as a single unit of property. [See -(e)(2)(i)] • An amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. [See -(e)(2)(ii)] • Therefore, if an amount paid by X for the addition of an extension to the office building results in an improvement (for example, a betterment) to the building structure, X must treat this amount as an improvement to the building. [See -(e)(2)(ii)] • In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under the general rule in -(e)(3)(i) ... and are comprised of the groups of components that are functionally interdependent.
Example 15 ***Improvement Property***	***Part (i)*** • X is a retailer of consumer products. • In Year 1, X purchases a building from Y, which X intends to use as a retail sales facility. • X must treat the building and its structural components as a single unit of property. [See -(e)(2)(i)] • An amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. [See -(e)(2)(ii)] ***Part (ii)*** • In Year 2, X pays an amount to construct an extension to the building to be used for additional warehouse space. • Assumptions ◆ The extension involves the addition of walls, floors, roof, and doors, but does not include the addition or extension of any building systems described in -(e)(2)(ii)(B). ◆ The amount paid to build the extension results in a betterment to the building structure under paragraph (h) of this Section, and is therefore treated as an amount paid for an improvement to the entire building under -(e)(2)(ii). • Accordingly, X capitalizes the amount paid as an improvement to the building under paragraph (d) of this Section. • The extension is not a unit of property separate from the building, the unit of property improved. [See -(e)(4)] • Thus, to determine whether any future expenditure constitutes an improvement to the building under -(e)(2)(ii), X must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or any of the designated building systems.

Capitalization Concepts

IMPROVEMENTS OVERVIEW
BETTERMENTS, RESTORATIONS & ADAPTATIONS

Overview ... Requirement to Capitalize Amounts Paid for Improvements

- A taxpayer generally must capitalize the aggregate of related amounts paid to improve a unit of property owned by the taxpayer. (Note: Special rules and treatments are provided for amounts paid to improve leased property.)
- A unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer...
  - Result in a betterment to the unit of property,
  - Restore the unit of property, ***or***
  - Adapt the unit of property to a new or different use.
- In general, if the words "improvement" or "improvements" are used in the Regulations, they signify that the expenditures involved are required to be capitalized.
- In other words, *betterments*, *restorations* and *adaptations* are ***improvements*** to buildings, and they are required to be capitalized in accordance with the rules at Reg. Sec. -3T(h) ... -3T(i) and ... -3T(j), respectively.
- Costs incurred during an improvement that are required to be capitalized ...
  - All the direct costs of an improvement.
  - All the indirect costs (including, for example, otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under Section 263A.
    - Therefore, indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under Section 263(a), regardless of whether they are made at the same time as an improvement.
  - The aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year.
  - Whether amounts are related to the same improvement depends on
    - The facts and circumstances of the activities being performed and
    - Whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.
- ***Improvements to property*** ... An improvement to a unit of property (other than a lessee improvement) is not a unit of property separate from the unit of property improved. The unit of property for lessee improvements is discussed elsewhere.
- ***Changes in accounting methods***
  - It may be necessary to make multiple changes in accounting methods in order to either comply with or to derive benefits from the provisions in Sections 1.263(a)-3T(h), (i) and (j) of the new Regulations.
  - Procedures for changes in accounting method under the rules for capitalizing improvements - involving Form 3115 filings - are set forth in Revenue Procedure 2012-19.

IMPROVEMENTS OVERVIEW
BETTERMENTS, RESTORATIONS & ADAPTATIONS

Three Classes of Improvements

#1 Betterments	• ***An amount paid results in the betterment of a unit of property only if it ...*** ◆ ***Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition*** of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production, ◆ ***Results in a material addition*** (including a physical enlargement, expansion, or extension) to the unit of property, ***or*** ◆ ***Results in a material increase in capacity*** (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.
#2 Restorations	• ***An amount is paid to restore a unit of property only if it ...*** ◆ Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. Sec. 1.165-7), ◆ Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component, ◆ Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165, ◆ Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use, ◆ Results in the rebuilding of the unit of property to a like-new condition after the end of its class life, ***or*** ◆ ***Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (see paragraph (i)(4) of this section).***
#3 Adaptations to a New or Different Use	• In general, amounts are considered to be paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time when the unit of property was originally placed in service by the taxpayer. • In the case of a building, an amount is considered to be paid to adapt the unit of property to a new or different use if it adapts to a new or different use the building, the building structure, ***or*** any of the building systems.
Caution	• Even if activities and expenditures involved do not meet the criteria listed for each of the three major categories, it is still possible that the expenditures may have to be capitalized. • This is because under Section 263A, if costs are incurred by reason of some larger project, then those costs incurred would have to be capitalized. • Possibly, this is why the result in Example 8 under Reg. Sec. -3(h)(4) requires capitalization of all expenditures, even those incurred under Example 6 and 7, which otherwise might have been deductible.

Example 6
Costs Deductible

BUILDING REFRESH ... NOT A BETTERMENT
REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 6

Facts & Assumptions (i)

- X owns a nationwide chain of retail stores that sell a wide variety of items.
- To remain competitive in the industry and increase customer traffic and sales volume, X periodically ***refreshes*** the appearance and layout of its stores.
- To make the stores more attractive and the merchandise more accessible to customers, the work that X performs to refresh a store consists of ...
  - Cosmetic and layout changes to the store's interiors and
  - General repairs and maintenance to the store building.
- The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors.
- The display tables and the racks all constitute Section 1245 property.
- X pays amounts to refresh 50 stores during the taxable year.
- In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period.
- ***Assumptions ...***
  - Each Section 1245 property within each store is a separate unit of property.
  - The work does not ameliorate any material conditions or defects that existed when X acquired the store buildings.
  - The work does not result in any material additions to the store buildings.

Analysis (ii)

- If an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. [-3T(e)(2)(ii)]
- ***Considering the facts and circumstances*** [as required under -3T(h)(3)(i)], including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, ***the amounts paid for the refresh of each building do not result in material increases*** in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh.
- ...The work performed ***keeps*** X's store buildings' structures and buildings' systems ***in the ordinary efficient operating condition*** that is necessary for X to continue to attract customers to its stores.

Conclusions

- X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments. [-3T(h)(1)(iii)].
- X is required to capitalize the amounts paid to acquire and install each Section 1245 property. [-2T(d)(1)]

Comments

- *Remember ... "Betterment" = Improvement = Expenditures required to be capitalized*
- *Activities that constitute a "refresh" fall one level below activities that collectively would constitute a "betterment." The Regulations do not explicitly state this; but it appears to be a "logical" conclusion from everything else in the Regulations.*
- Example 6 *reflects a situation where the activities resulted in no material improvements, nor any corrections of material defects or conditions. In other words,* Example 6 *reflects a "refresh" activity that keeps the building in ordinary efficient operating condition.*
  - *Therefore, the taxpayer is permitted to expense (i.e., deduct) the expenditures related to the "refresh" ... but the taxpayer cannot expense the costs of the Section 1245 property that it acquired.*
- *The Regulations include specific definitions - broad, comprehensive definitions - for nine different potential building systems ... including heating and ventilation (HVAC), plumbing, electrical, fire protection and alarm, security system.*
  - *Those are all separate building systems. None of the activities/work described in* Example 6 *affected these components. (If they had, the result would have been different.)*

Example 7 Costs Partially Deductible	***Building Refresh, But with Limited Improvement*** ***Reg. Sec. 1.263(a)-3T(h)(4) ... Example 7***
Facts & Assumptions	• This *Example* assumes the same facts as in *Example 6*, and adds additional facts. • The additional facts in *Example 7* are that, ◆ In the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (i.e., the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom facilities. ◆ As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures.
Analysis	• If ***any*** of the amounts paid result in ***betterments*** to the building structure or any building system, X must treat the amounts as an improvement to the building. [-3T(e)(2)(ii)] • The plumbing system in each of X's store buildings, including the plumbing fixtures, is a building system. [-3T(e)(2)(ii)(B)(2)] • X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a ***betterment*** because they result in a material increase in the quality of each plumbing system. [-3T(h)(1)(iii)] • X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. [-3T(f)(3)] ◆ Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized. [-3T(f)(3)]
Conclusions	• ***Capitalize ...*** X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate [-3T(e)(2)(ii)], and must capitalize the amounts. [-3T(d)(1)] • ***Deduct ...*** However, X ***is not required*** to capitalize the costs described in *Example 6* to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. [-3T(f)(3)] ◆ Accordingly, X is not required to capitalize [under -3T(f)(3)] any costs specified in *Example 6* for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.
Comments	• *Remember ... "Betterment" = Improvement = Expenditures required to be capitalized* • *Whenever the Regulation uses the word "improvement," that should be a signal that some of the activities and/or expenditures will be required to be capitalized.* • Example 7 *involves (i.e., it assumes) the same fact pattern described in* Example 6 ... ***except*** *that the taxpayer also pays certain amounts to remove and replace certain elements in its plumbing ... and plumbing constitutes a "building system."* • *In* Example 7, *the taxpayer is required to capitalize all the costs associated with the betterment because they resulted in a material increase in the quality of each plumbing system ... and the plumbing system is just one of the several building systems which are integral to the overall building (unit of property).* • *The taxpayer is also required to capitalize all of the indirect costs that directly benefit or are incurred by reason of the betterment. However, within the context of this "limited" improvement, since these improvements were made "in addition to" those that were made to refresh the building, the taxpayer would be permitted to deduct the expenses related to the refreshment aspect of the overall remodeling activity.* • ***Bottom line...*** Example 7 *reflects a greater degree of involvement. It involves a refresh that also includes an improvement to a building system. Within that fact pattern, the taxpayer is still permitted to deduct the expenditures related to the refreshment activity. But note that is only the portion of the expenditure relating to the refreshment activity. All of the other expenditures (relating to the improvement activity or aspect) are required to be capitalized.*

Example 8 All Costs Capitalizable	***BETTERMENT (i.e., AN IMPROVEMENT) ... BUILDING REMODEL REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 8***

Facts & Assumptions (i)

- This *Example* assumes the same facts as in *Example 6*, and adds even more additional facts.
- The additional facts in *Example 8* are that...
  - ◆ The work performed to refresh the stores directly benefits or was incurred by reason of a ***substantial remodel*** to X's store buildings.
  - ◆ X performs significant additional work to alter the appearance and layout of its stores to increase customer traffic and sales volume. This work was "in addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in *Example 6*."
- As part of the significant additional work to alter the appearance and layout, X pays amounts to ***upgrade the buildings' structures*** (as defined under -3T(e)(2)(ii)(A)). This work includes...
  - ◆ Removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores,
  - ◆ Replacing ceilings with acoustical tiles (to reduce noise and create a more pleasant shopping environment),
  - ◆ Rebuilding the interior and exterior facades around the main doors (to create a more appealing entrance),
  - ◆ Replacing conventional doors with automatic doors, and
  - ◆ Replacing carpet with ceramic flooring of different textures and styles (to delineate departments and direct customer traffic).
- In addition, X pays amounts for ***work on the electrical systems***, which are building systems (as defined under -3T(e)(2)(ii)(B)(3)). Specifically, this work ...
  - ◆ Upgraded the wiring in the buildings so that X could add video monitors and an expanded electronics department, and
  - ◆ Removed and replaced the recessed lighting throughout the buildings with more efficient and brighter lighting.
- The work performed on the buildings' structures and on the electrical systems (as described above) also included the removal and replacement of [fixed assets that were] both Section 1250 and Section 1245 property.
- In its applicable financial statement, X capitalized all the costs incurred over a 10-year period.
  - ◆ X anticipates that it will have to remodel the store buildings again after another 10 years.

Analysis (ii)

- If any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. [-3T(e)(2)(ii)]
- Considering the facts and circumstances (as required by-3T(h)(3)(i)), the amounts that X pays for the remodeling of its stores result in ***betterments*** to the buildings' structures and electrical systems. [-3T(h)].
  - ◆ The "facts and circumstances" considered include...
    - ▪ The purpose of the expenditure,
    - ▪ The physical nature of the work performed,
    - ▪ The effect of the work on the buildings' structures and buildings' systems, and
    - ▪ The treatment of the work on X's applicable financial statements.
- Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores ***materially increase*** the productivity, efficiency, and quality of X's stores' electrical systems. [-3T(h)(1)(iii)]
- Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring ***materially increase*** the productivity, efficiency, and quality of X's store buildings' structures. [-3T(h)(1)(iii)]
- In addition, the amounts paid for the refresh of the store buildings described in *Example 6* also must be capitalized (under -3T(f)(3)(i)) because these expenditures directly benefitted or were incurred by reason of the improvements to X's store buildings' structures and electrical systems.

Conclusions

- X must treat the costs of improving the buildings' structures and systems, ***including the costs to refresh***, as improvements to X's retail buildings [under -3T(e)(2)(ii)], and X must capitalize the amounts paid for these improvements [under -3T(d)(1)].
- In addition, X is required to capitalize the amounts paid to acquire and install each Section 1245 property. [Reg. Sec. 1.263(a)-2T(d)(1)]

SELECTED CAMs MORE GENERALLY APPLICABLE TO DEALERSHIPS UNDER THE NEW TANGIBLES REGULATIONS

Instructions for Form 3115

Department of the Treasury
Internal Revenue Service

(Rev. March 2012)

(Use with the December 2009 revision of Form 3115)

Application for Change in Accounting Method

- The filer/applicant must be within the scope of, and comply with, all of the applicable provisions of the published guidance that authorizes each listed change.
- Taxpayers must file a signed copy of its completed Form 3115 with the IRS in ***Ogden, UT (Ogden copy)***, in lieu of filing the National Office copy, no earlier than the first day of the year of change and no later than the date the taxpayer files the original Form 3115 with its Federal income tax return for the year of change.
- ***All of the changes below are to be made in accordance with Revenue Procedures 2012-19 and/or 2012-20.***

Automatic CAM #	Description of Change
#162 ***Deducting Repair & Maintenance Costs***	• Applicable Code Section is Section 162. • For an applicant changing from capitalizing under Section 263(a) amounts paid or incurred for tangible property ***to*** deducting these amounts as repair and maintenance costs under Section 162 and Reg. Sec. 1.162-4T. • Also for an applicant changing its units of property under Reg. Sec. 1.263(a)-3T(e) solely for purposes of determining whether amounts paid or incurred improve a unit of property under Reg. Sec. 1.263(a)-3T. • Section 481(a) adjustment is required. • Statistical sampling under R.P. 2011-42 may be used in determining Sec. 481(a) adjustment. • Full discussion of CAM #162 is in Section 4.02(1) of Rev. Proc. 2012-19. • Adds new Section 3.10 to the *Appendix* to Rev. Proc. 2011-14.
#164 ***Deducting Non-Incidental Materials & Supplies When Used or Consumed***	• Applicable code Section is Section 162. • For an applicant changing its method of accounting for non-incidental materials and supplies to the method of deducting such amounts in the taxable year in which they are actually used or consumed, consistent with Regulations Section 1.162-3T. • This change applies only to the amounts paid or incurred in taxable years beginning on or after January 1, 2012. • Cut-off method is required ... i.e., no Section 481(a) adjustment is required for this change. • Statistical sampling under R.P. 2011-42 may be used in determining applicable amounts. • Full discussion of CAM #164 is in Section 4.02(3) of Rev. Proc. 2012-19. • Adds new Section 3.12 to the *Appendix* to Rev. Proc. 2011-14.
#165 ***Deducting Incidental Materials & Supplies When Paid or Incurred***	• Applicable code Section is Section 162. • For an applicant that wants to change its method of accounting for incidental materials and supplies to the method of deducting such amounts in the taxable year in which they are paid or incurred, consistent with Regulations Section 1.162-3T. • This change applies only to amounts paid or incurred in taxable years beginning on or after January 1, 2012. • Cut-off method is required ... i.e., no Section 481(a) adjustment is required for this change. • Statistical sampling under R.P. 2011-42 may be used in determining applicable amounts. • Full discussion of CAM #165 is in Section 4.02(4) of Rev. Proc. 2012-19. • Adds new Section 3.13 to the *Appendix* to Rev. Proc. 2011-14.

Selected CAMs More Generally Applicable to Dealerships Under the New Tangibles Regulations

#169 ***Deducting*** **de minimis** ***Amounts***	• Applicable Code Section is Section 263(a). • For an applicant changing its method of accounting for amounts paid or incurred to acquire ... (including any amounts paid or incurred to facilitate the acquisition ...) a unit of property ***to*** the method of applying the *de minimis* rule under Reg. Secs. 1.263(a)-2T(g) and 1.263A-1T(b)(14) to such amounts, consistent with Reg. Sec. 1.263(a)-2T. • This change applies only to amounts paid or incurred in taxable years beginning on or after January 1, 2012. • Cut-off method is required ... i.e., no Section 481(a) adjustment is required for this change. • Statistical sampling is not mentioned in connection with making this change. • Full discussion of CAM #169 is in Section 4.02(8) of Rev. Proc. 2012-19. • Adds new Section 3.17 to the *Appendix* to Rev. Proc. 2011-14.
#173 ***Capitalizing Acquisition or Production Costs***	• Applicable Code Section is Section 263(a). • For an applicant changing its method of accounting to capitalizing amounts paid or incurred to acquire or produce property under Regulations Section 1.263(a)-2T and, if depreciable, to depreciating such property under Section 168. • Section 481(a) adjustment is required. • Statistical sampling under R.P. 2011-42 may be used in determining Sec. 481(a) adjustment. • Full discussion of CAM #173 is in Section 4.02(12) of Rev. Proc. 2012-19. • Adds new Section 10.09 to the *Appendix* to Rev. Proc. 2011-14.
#174 ***Capitalizing Improvements to Tangible Property***	• Applicable Code Section is Section 263(a). • For an applicant changing its method of accounting ***to*** capitalizing amounts paid or incurred for improvements to units of property consistent with Reg. Secs. 1.263(a)-1T and 1.263(a)-3T and, if depreciable, to depreciating such improvements under Section 168. • Section 481(a) adjustment is required. ◆ *A taxpayer making this change must attach to its Form 3115 a schedule for the Section 481(a) adjustment listing the adjustment amounts for each property classification (i.e., 5-year property, 7-year property, or nonresidential real property).* • Statistical sampling under R.P. 2011-42 may be used in determining Sec. 481(a) adjustment. • Full discussion of CAM #174 is in Section 4.02(13) of Rev. Proc. 2012-19. • Adds new Section 10.10 to the *Appendix* to Rev. Proc. 2011-14.

#175
 Depreciation of Leasehold Improvements
	• Applicable Code Sections are Sections 167, 168 & 197.
	• For taxpayers with depreciable interests in leasehold improvements at the beginning of the year of change.
	• CAMs covered are for changing methods ***from*** improperly depreciating or amortizing leasehold improvements over the term of the lease (including renewals, if applicable) ***to*** properly depreciating or amortizing these leasehold improvements under Sec. 167(f)(1), 168, or 197.
	• Schedule E of Form 3115 must be completed in connection with this change.
	• This change applies only to taxable years beginning on or after January 1, 2012.
	• Section 481(a) adjustment is required ... Where more than one asset is involved...
	  ◆ A taxpayer that wants to make this change for more than one asset for the same year of change should file a single Form 3115 for all such assets and provide a single net Section 481(a) adjustment for all the changes included in that Form 3115.
	  ◆ If one or more of the changes in that single Form 3115 generate a negative Section 481(a) adjustment and other changes in that same Form 3115 generate a positive Section 481(a) adjustment, the taxpayer may provide a ***single negative Section 481(a) adjustment*** for all such changes (i.e., changes that are included in that Form 3115 generating such adjustment) and a ***single positive Section 481(a) adjustment*** for all the changes that are included in that Form 3115 generating such positive adjustment.
	• Statistical sampling is not mentioned in connection with making these changes.
	• Full discussion of CAM #175 is in Section 5.03(1) of Rev. Proc. 2012-20.
	• Adds new Section 6.27 to the *Appendix* to Rev. Proc. 2011-14.

#177	• ***Dispositions of a Building or of a Structural Component*** • See separate discussion of automatic CAM #177 on the following pages.

CAM #177	***DISPOSITIONS OF BUILDING COMPONENTS THE "ROOF REPLACEMENT SCENARIO"***

CAM #177 ... Dispositions of a Building or a Structural Component

In General	• Applicable Code Section is Section 168. • CAMs under #177 may concern several possible situations involving buildings or structural components of buildings that are not in General Asset Accounts. *[Sec. 6.29(3)]*. • This change applies only to taxable years beginning on or after January 1, 2012. • The scope limitations do not apply to a taxpayer that makes this change for its first or second taxable year beginning after December 31, 2011. • Full discussion of CAM #177 is in Section 5.03(3) of Rev. Proc. 2012-20. • Adds new Section 6.29 to the *Appendix* to Rev. Proc. 2011-14.

CAM #177 ... Description of Changes

Identification of Asset Disposed of ***Sec. 6.29(3)(a)***	• For purposes of determining/identifying the "asset" disposed of, a change in method ***to*** an asset that is permissible under Reg. Sec. 1.168(i)-8T(c)(4) for determining what building, [...] or structural components has been disposed of. *[Sec. 6.29(3)(a)]*. ◆ ***No ruling on asset.*** The consent granted to make this change is not a determination by the Commissioner that the taxpayer is using the appropriate asset for determining what asset is disposed of by the taxpayer and does not create any presumption that the proposed asset is permissible. The Director will ascertain whether the taxpayer's determination of its asset is permissible.
Sec. 6.29(3)(b)	• If the taxpayer makes the change specified above, and if the taxpayer disposed of the "asset" in a taxable year ***prior to the year of change***, but continues to deduct depreciation for such disposed asset under the taxpayer's present method of accounting, a change from depreciating the disposed asset to recognizing gain or loss upon disposition. • ***Comment*** *... A CAM under this Section (i.e., -(3)(b)) would be appropriate in situations where the dealership had to make an* ***estimate*** *of the actual cost and of the accumulated depreciation of the component being disposed of.* ◆ *This* ***estimate*** *would need to be made because at the time of filing the CAM, the dealership was not treating building components as separate assets, and therefore, at the time when the CAM was being made, the dealership had to use a* ***reasonable method that is consistently applied to the larger asset for purposes of determining the unadjusted depreciable basis of the asset (component) being disposed of.***
Sec. 6.29(3)(c)	• If the taxpayer's present method of accounting is in accord with Reg. Sec. 1.168(i)-8T(c)(4)(ii)(C) [among others], and if the taxpayer disposed of a building ... or a structural component, or an improvement or addition thereto in a taxable year prior to the year of change but continues to deduct depreciation for such disposed asset under the taxpayer's present method of accounting, a change ***from*** depreciating the disposed asset ***to*** recognizing gain or loss upon disposition. • ***Comment*** *... It seems that a CAM under this Section (i.e., -(3)(c)) would only apply if (1) the dealership already had/was treating building components as separate assets, and (2) therefore, at the time when the CAM was being made, it was able to determine with accuracy the actual cost and the accumulated depreciation of the component being disposed of.*
Sec. 6.29(3)(d)	• For buildings, ... structural components, or improvements or additions thereto accounted for in multiple asset accounts, a change in the method of identifying which assets have been disposed of ***from*** an impermissible method of accounting [i.e., a method not specified in Reg. Sec. 1.168(i)-8T(f)(1) or (2)(i), (ii), or (iii) ***to*** a permissible method of accounting [i.e., a method specified in those citations]. ◆ The Last-In, First-Out (LIFO) method of accounting is an impermissible method for determining which assets were disposed of out of a multiple asset account. • ***Comment*** *... Generally, a CAM under this Section (i.e., -(3)(d)) will not be applicable to a dealership unless the asset disposed of was accounted for in a multiple asset account.*
Other Ramifications	• These changes ***also will affect*** ... ◆ The determination of gain or loss from the disposition of the building, [...] or the structural component, and ◆ ***May affect*** whether the applicant must capitalize amounts paid to restore a unit of property.

DISPOSITIONS OF BUILDING COMPONENTS
THE "ROOF REPLACEMENT SCENARIO"

CAM #177 ... Dispositions of a Building or a Structural Component *(continued...)*

Required Attachment (Statement) to Form 3115	• A taxpayer making this change must attach to its Form 3115 a statement with the following... ◆ A description of the assets to which this change applies; ◆ If the taxpayer is making a change specified in Section 6.29(3)(a), a description of the asset disposed of under the taxpayer's present and proposed methods of accounting; ◆ If the taxpayer is making the change specified in Section 6.29(3)(d), a description of the method of identifying which assets have been disposed of under the taxpayer's present and proposed methods of accounting; [generally not applicable in dealership situations] and ◆ If any asset is public utility property ... *[text deleted]*.
Ogden Copy of Form 3115	• *Ogden copy of Form 3115 required in lieu of National Office copy.* • A taxpayer making this change (i.e., #177) in its method(s) of accounting must file a signed copy of its completed Form 3115 with the IRS in Ogden, UT (Ogden copy), ***in lieu of*** filing the copy with the National Office of the IRS in Washington, DC. • The *Ogden copy of Form 3115* must be filed... ◆ No earlier than the first day of the year of change, ***and*** ◆ No later than the date the taxpayer files the original Form 3115 with its Federal income tax return for the year of change.

CAM #177 ... Two Examples in Section 6.29(4) Interpret These Changes

Example 1 ***Sec. 6.29(4)***	• Taxpayer X acquired and placed in service a building and its structural components in 1990. • X depreciates this building and its structural components under Section 168. • In 2000, X replaced the entire roof of the building. • X did not recognize a loss on the retirement of the original roof and continues to depreciate the original roof. • X also capitalized the cost of the replacement roof and has been depreciating this roof under Section 168 since 2000. • X may file a Form 3115 to change to (1) treating the building as an asset and (2) [treating] each structural component of the building as a separate asset and also (3) to change from depreciating the original roof to recognizing a loss upon its retirement.
Example 2 ***Sec. 6.29(4)***	• Taxpayer Y acquired and placed in service a building and its structural components in 2000. • In 2005, Y constructed and placed in service an addition to this building. • Y depreciates the building, the addition, and their structural components under Section 168. • Y may file a Form 3115 to change to treating (1) the original building as an asset, (2) the addition to the building as a separate asset, and (3) each structural component of the original building and the addition as a separate asset.

CAM #177 ... Section 481(a) Adjustment is Required

Section 481(a) Adjustment Is Required	• Where more than one asset is involved (i.e., concurrent changes)... ◆ A taxpayer that wants to make this change for more than one asset for the same year of change should file a single Form 3115 for all such assets and provide a single net Section 481(a) adjustment for all the changes included in that Form 3115. • If one or more of the changes in that single Form 3115 generate a negative Section 481(a) adjustment and other changes in that same Form 3115 generate a positive Section 481(a) adjustment, the taxpayer may provide a ***single negative Section 481(a) adjustment*** for all such changes (i.e., changes that are included in that Form 3115 generating such negative adjustment) and a ***single positive Section 481(a) adjustment*** for all the changes that are included in that Form 3115 generating such positive adjustment. • ***Comment*** *... The spread period for a positive Section 481(a) adjustment is 4 years. The spread period for a negative Section 481(a) adjustment is 1 year - the year of change. This means that it is not necessary to net the positive and the negative adjustment; instead, each component of the Section 481(a) adjustment has its own spread period.* • ***Comment*** *... Although statistical sampling under R.P. 2011-42 may be used in determining applicable amounts of the Section 481(a) adjustment, ordinarily, that will not be necessary.*

Rev. Proc. 2011-42 Overview

Statistical Sampling Procedures & Requirements ... Revenue Procedure 2011-42

Rev. Proc. 2011-42 ... General Guidance on Sampling Procedures

- In August 2011, the IRS issued Revenue Procedure 2011-42 (2011-37 I.R.B. 318). Like its Field Directive predecessor, this Revenue Procedure is also intended to "provide taxpayers with guidance regarding the use and evaluation of statistical samples and sampling estimates." However, this Revenue Procedure may be cited as having precedential authority in negotiations with the IRS, so it carries a higher level of precedential value than the Field Directive.
- Rev. Proc. 2011-42 almost exactly matches the 2009 Field Directive word-for-word ... except that the references to LIFO applications in the Field Directive do not appear in the Revenue Procedure. It also includes three *Appendices.*

The New Tangibles Regulations & Related CAMs ... Effective January 1, 2012

- In effecting changes in accounting method (CAMs), in all instances where the computations to determine the amount of the Section 481(a) adjustment are so numerous that sampling must be used to estimate the effect on the population, Section 481(a) adjustments will be difficult to compute in many cases because (current and/or prior year) information may not be available.
- Unfortunately, the Regulations do not provide for the use of extrapolation procedures for purposes of estimating these amounts. They specifically prohibit the use of judgmental sampling.
- Rev. Procs. 2012-19 and 2012-20 employ the following standard language in describing Section 481(a) adjustments ...

  "*Section 481(a) adjustment.* By following the sampling procedures provided in Rev. Proc. 2011-42 (2011-37 I.R.B. 318), a taxpayer changing its method of accounting under [... this Section ...] may use statistical sampling in determining the Section 481(a) adjustment. ***Sampling methodologies not described in Rev. Proc. 2011-42 are not permitted.***"

- Therefore, in making CAMs under the new Regulations where exact amounts are not known, taxpayers must follow the (complex) statistical sampling procedures and requirements in Rev. Proc. 2011-42.

Analysis of Rev. Proc. 2011-42

* *Text omitted*

Source (Pages 60-64)

De Filipps University, *"New Tangibles Regulations: Section 263(a) & Others ... Part II."* Audio Seminar, October 10, 2012.

Standards for Sampling Plan & Sampling Documentation Rev. Proc. 2011-42 ... Appendix A & B

Appendix A ... Sampling Plan Standards

Taxpayers are required to have a written sampling plan prior to the execution of a sample.

The plan must include the following items...

(1) The objective of the plan including a description of what value is being estimated and for which tax year(s) the estimate is applicable,

(2) Population definition and reconciliation of the population to the tax return,

(3) Definition of the sampling frame,

(4) Definition of the sampling unit,

(5) Source of the random numbers, the starting point or seed, and the method used in selecting them,

(6) Sample size, along with supporting factors in the determination,

(7) Method used to associate random numbers to the frame,

(8) Steps to be taken to insure that the serialization of the frame is carried out independent of the drawing of random numbers,

(9) Steps to be taken in evaluating the sampling unit, and

(10) The appraisal method(s) to be used in appraising the sample.

Appendix B ... Sampling Documentation Standards ... Sample Execution Documentation

Taxpayers must retain adequate documentation to support the statistical application, sample unit findings, and all aspects of the sample plan and execution.

The execution of the sample must be documented and include information for each of the following...

(1) The seed or starting point of the random numbers,

(2) The pairing of random numbers to the frame along with supporting information to retrace the process,

(3) List of the sampling units selected and the results of the evaluation of each unit,

(4) Supporting documentation which support the conclusion reached about each sample item. This would include such items as notes, invoices, purchase orders, project descriptions, etc.,

(5) The calculation of the projected estimate(s) to the population, including the computation of the standard error of the estimate(s),

(6) A statement as to any slips or blemishes* in the execution of the sampling procedure and any pertinent decision rules, and

(7) Computation of all associated adjustments.

- An example of an associated adjustment would be the amount of depreciation allowable based on a probability determination of an amount capitalized.

**Comment:* *The term "slips or blemishes" is not defined ... It would seem to correspond with "unusual factors or complications."*

APPENDIX C

Technical Formulas

UNSTRATIFIED (SIMPLE RANDOM SAMPLE) MEAN ESTIMATOR	STRATIFIED MEAN ESTIMATOR

Sample Mean of Audited Amounts

$$\bar{x} = \frac{\sum x_j}{n}$$

Estimate of Total Audited Amount

$$\hat{X}_M = N\bar{x} \qquad \hat{X}_{Ms} = \Sigma(N_i \bar{x}_i)$$

Estimated Standard Deviation of the Audited Amount

$$S_x = \sqrt{\frac{[\Sigma(x_j^2)] - n(\bar{x}^2)}{n-1}}$$

Estimated Standard Error of the Total Audited Amount

$$\hat{\sigma}(\hat{X}_M) = \frac{NS_x\sqrt{1-n/N}}{\sqrt{n}} \qquad \hat{\sigma}(\hat{X}_{Ms}) = \sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{xi}^2}{n_i}\right]}$$

Achieved Precision of the Total Audited Amount

$$A'_M = \frac{NU_R S_x\sqrt{1-n/N}}{\sqrt{n}} \qquad A'_{Ms} = U_R\sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{xi}^2}{n_i}\right]}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE) DIFFERENCE ESTIMATOR	STRATIFIED DIFFERENCE ESTIMATOR

Estimate of Total Difference

$$\hat{D} = N\bar{d} \qquad \hat{D}_S = \Sigma(N_i \bar{d}_i)$$

Estimate of Total Audited Amount

$$\hat{X}_D = Y + \hat{D} \qquad \hat{X}_{Ds} = Y + \hat{D}_s$$

Estimated Standard Deviation of the Difference Amount

$$S_D = \sqrt{\frac{[\Sigma(d_j^2)] - n(\bar{d}^2)}{n-1}}$$

Estimated Standard Error of the Difference Amount

$$\hat{\sigma}(\hat{D}) = \frac{NS_D\sqrt{1-n/N}}{\sqrt{n}} \qquad \hat{\sigma}(\hat{D}_S) = \sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Di}^2}{n_i}\right]}$$

Achieved Precision of the Difference Amount

$$A'_D = \frac{NU_R S_D\sqrt{1-n/N}}{\sqrt{n}} \qquad A'_{Ds} = U_R\sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Di}^2}{n_i}\right]}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE) RATIO ESTIMATOR	STRATIFIED COMBINED RATIO ESTIMATOR

Estimated Ratio of Audited Amount to Recorded Amount

$$R = \frac{\Sigma x_j}{\Sigma y_j} = 1 + \frac{\Sigma d_j}{\Sigma y_j} \qquad \hat{R}_C = \frac{\Sigma(N_i \bar{x}_i)}{\Sigma(N_i \bar{y}_i)} = 1 + \frac{\Sigma(N_i \bar{d}_i)}{\Sigma(N_i \bar{y}_i)}$$

Estimate of Total Audited Amount

$$\hat{X}_R = Y\hat{R} \qquad \hat{X}_{Rc} = Y\hat{R}_C$$

Estimated Standard Deviation of the Ratio

$$S_R = \sqrt{\frac{\Sigma(x_j^2) + \hat{R}^2\Sigma(y_j^2) - 2\hat{R}\Sigma(x_j y_j)}{n-1}}$$

Estimated Standard Deviation of the Ratio in i^{th} Stratum

$$S_{Rc_i} = \sqrt{\frac{[(\Sigma x_{ij}^2 - (\Sigma x_{ij})^2/n_i)] + [\hat{R}_C^2(\Sigma y_{ij}^2 - (\Sigma y_{ij})^2/n_i)] - [2\hat{R}_C(\Sigma x_{ij}y_{ij} - n_i\bar{x}_i\bar{y}_i)]}{n_i - 1}}$$

Estimated Standard Error of the Ratio Amounts

$$\hat{\sigma}(\hat{X}_R) = \frac{NS_R\sqrt{1 - n/N}}{\sqrt{n}} \qquad \hat{\sigma}(\hat{X}_{Rc}) = \sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Rc_i}^2}{n_i}\right]}$$

Achieved Precision of the Ratio Amounts

$$A'_R = \frac{NU_R S_R\sqrt{1 - n/N}}{\sqrt{n}} \qquad A'_{Rc} = U_R\sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Rc_i}^2}{n_i}\right]}$$

UNSTRATIFIED (SIMPLE RANDOM SAMPLE) REGRESSION ESTIMATOR	STRATIFIED COMBINED REGRESSION ESTIMATOR

Estimated Regression Coefficient

$$b = \frac{[\Sigma(x_j y_j)] - n\overline{xy}}{[\Sigma(y_j^2)] - n(\bar{y}^2)} = 1 + \frac{[\Sigma(d_j y_j)] - n\overline{dy}}{[\Sigma(y_j^2)] - n(\bar{y}^2)} \qquad b_c = \frac{\Sigma N_i(N_i - n_i)S_{XYi}/n_i}{\Sigma N_i(N_i - n_i)S_{Yi}^2/n_i} = 1 + \frac{\Sigma N_i(N_i - n_i)S_{DYi}/n_i}{\Sigma N_i(N_i - n_i)S_{Yi}^2/n_i}$$

Estimate of Total Audited Amount

$$\hat{X}_G = N\bar{x} + b(Y - N\bar{y}) \qquad \hat{X}_{Gc} = \Sigma(N_i\bar{x}_i) + b_C[Y - \Sigma(N_i\bar{y}_i)]$$

Estimated Standard Deviation of the Regression Amounts

$$S_G = \sqrt{\frac{1}{n-2}\left[[\Sigma(x_j^2)] - n(\bar{x}^2) - \frac{(\Sigma(x_j y_j) - n\overline{xy})^2}{\Sigma(y_j^2) - n(\bar{y}^2)}\right]}$$

Estimated Covariance between the Audited and Recorded Amounts in i^{th} Stratum

$$S_{xy_i} = \frac{[\Sigma(x_{ij}y_{ij})] - n_i\bar{x}_i\bar{y}_i}{n_i - 1}$$

Estimated Standard Deviation between the Audited and Recorded Amounts in i^{th} Stratum

$$S_{Gc_i} = \sqrt{S_{X_i}^2 - 2b_C S_{XY_i} + b_C^2 S_{Y_i}^2}$$

Estimated Standard Error of the Audited and Recorded Amounts

$$\hat{\sigma}(\hat{X}_G) = \frac{NS_G\sqrt{1 - n/N}}{\sqrt{n}} \qquad \hat{\sigma}(\hat{X}_{Gc}) = \sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Gc_i}^2}{n_i}\right]}$$

Achieved Precision of the Audited and Recorded Amounts

$$A'_G = \frac{NU_R S_G\sqrt{1 - n/N}}{\sqrt{n}} \qquad A'_{Gc} = U_R\sqrt{\Sigma\left[N_i(N_i - n_i)\frac{S_{Gc_i}^2}{n_i}\right]}$$

Rev. Proc. 2011-42

Technical Formulas Acceptable for Statistical Sampling Rev. Proc. 2011-42 ... Appendix C

Appendix C - Technical Formulas ... Definition of Symbols

Term	Definition
n	• Sample Size
N	• Population Size
x	• The value of the sampling unit that is being used as the primary variable of interest. • In audit sampling, this would be the audited (or revised) value of the transaction.
y	• The value of the sampling unit that is being used as the "paired" variable that is related to the variable of interest. • In audit sampling, this would be the reported (or original) value of the transaction.
d	• The value of the sampling unit that is the difference between "paired" variable (y) and the variable of interest (x). That is, $d = x - y$. • In audit sampling, this would be the difference (or the change) of each transaction's value.
X	• The total value of the primary variable of interest. • In audit sampling, this would be the estimated total audited value of the population. ◆ Typically, this value is not known for the entire population and is estimated based on the statistical sample selected.
Y	• The total value of the variable that is paired with variable of interest. • In audit sampling, this would be the total reported value of the population. ◆ Typically, this value is known for the entire population and may be estimated based on the statistical sample selected.
D	• The total value of the difference between the "paired" variable and the variable of interest. • In audit sampling, this would be the estimated total difference of the population. ◆ Typically, this value is not known for the entire population and is estimated based on the statistical sample selected.
U_R	• The confidence coefficient which is based on either the Student's t-distribution or the normal distribution. ◆ For example, a 95% one-sided confidence coefficient based on the normal distribution is 1.645. ◆ This term is often referred to as the t-value and the z-value.

De Filipps' DEALER TAX WATCH

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