New Vehicle Dealership Audit Technique Guide 2004

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New Automobile Dealership
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Chapter 1
General Focus, Procedure and Getting Started

INTRODUCTION

In preplanning an examination of an automobile dealership, a review of the return, as is customary, could pose interesting questions to begin the audit. An agent knows there are a variety of internal research tools with which to start. By securing information from the Integrated Data Retrieval System (IDRS), an agent may be able to perform a preliminary comparative analysis of the income and deduction items as well as the balance sheet which would provide initial information useful to the agent.

Many dealerships have begun conducting business transactions utilizing e-commerce, or the Internet. Using a search engine to look at a dealership's website may provide some background information on a specific dealership.

The return may be a consolidation of two or more entities created for the benefit of the automobile dealer. The separate entities provide the dealership the ability to clarify operations and distinguish activities. If the return is a large consolidated operation, flow-through schedules or other accompanying statements are disclosed on the return identifying these activities.

New automobile dealerships maintain good internal controls and prepare complete books and records. Dealerships as franchisees, properly book sales activities to conform to the financial statement requirements imposed in the form of the manufacturers statements by the franchiser, the factory. Once the income is booked, some dealerships may incorrectly treat or classify them for tax purposes. This may occur through shifting of business activities to related entities.

An entity chart is helpful in visualizing the organizational structure. It is important that all related returns are gathered. One entity may own the land where the dealership operations are and rent is paid to the shareholder. Another entity may be an insurance company formed to facilitate the paper flow of extended service contract sales or a management company is formed to receive management fees. All three are related entities and related party transactions should be examined. An understanding of each entity's activities, business purpose and tax implications would be required.

GETTING STARTED

The key to a quick and competent closure of any new vehicle dealership examination hinges on narrowing the scope of the examination to items that may prove productive. This section addresses tools necessary to frame the scope of the examination and to transition from planning to the start of the examination of the books and records.

In order to determine the examination's focus, request copies of the following before the initial interview. These documents form the cornerstone of any auto dealership examination:

Pre-Interview Documents to request:
1. Unadjusted Trial Balance and Adjusting Journal Entries
2. Tax Classification Work Papers
3. Manufacturer's Statement

Audit Techniques:
1. An agent obtaining this information before the initial appointment will be able to accomplish two objectives.
    a. First, the agent will be able to reconcile the trial balance to the tax return.
    b. Second, the agent will be able to ask more pointed questions during the initial interview.

Reconciliation
Regarding the reconciliation, it is recommended the agent do a full reconciliation of the trial balance and the adjusting journal entries to the tax return. By doing a little work up front the agent should have a specific understanding of the underlying transactions that make up the return. This is elaborated further in the next section.

Often in a dealership examination, the liability accounts have special significance. If the dealership is thinly capitalized, there may be an issue.. The recommended reconciliation will enable the agent to analyze liability accounts to determine if any issues exist regarding loans or inter-company transfers. When the initial interview is held, the agents' questioning may be more specific regarding liabilities or any transaction analysis made possible through the reconciliation.

Tax Classification Work papers (Tax Accountant's/Preparer's Grouping Sheets)
The agent has requested the tax classification work papers. It is difficult to envision a return at the level of a new vehicle dealership to be prepared without the assistance of such work papers. When received, most of the reconciliation is completed and the agent has saved the up front time previously scheduled.

Manufacturer's Statement:
In order to open and maintain a franchise, the auto dealership is required to furnish financial statements with the manufacturer on a regular basis, usually monthly. These manufacturer's statements are usually reliable, as shareholders in automobile dealerships do not want to risk losing their franchise rights and the manufacturer audits the dealerships frequently. For this reason, manufacturer's statements can be utilized to establish confidence in the taxpayer's books early and quickly in the examination process. The tax return filed by the dealership should be similar to the manufacturer's statements. For example, gross receipts should tie in to the tax return and any differences scrutinized. Any differences between the manufacturer's statements and the tax return that are large or unusual should be questioned. The use of different

documents to verify return items, given this reliable resource, is inefficient and should be avoided where circumstances warrant. Manufacturer statements are generally more reliable than in other industries since the dealer is required to file the statement with the manufacturer monthly. However, when looking at a monthly manufacturer statement, it may not include al adjustments that the 13th month statement includes.

Initial Interview:
Regarding the initial interview, the objective is to acquire up-front information about the dealership's normal operations and dealings with all other entities, shareholders and customers. Traditionally, the best way to do this was to require that the majority shareholder be present at the interview. However, the shareholder may not be available during the time frame designated by the agent to begin the examination.

Regardless of the availability of the principal shareholder, the agent should not delay the start of the examination due to the unavailability of any party. The agent can begin the examination and interview the designated representative. If the agent feels the questioning is not productive, an interview should be scheduled with the principal shareholder as soon as possible, but continue with the examination. The designated representative can give the agent sufficient information and documents to begin, and in many cases get deep into, the examination. If possible, schedule the initial interview after the 7th or 10th day of the month, following the month-end closing if you want to have the accounting manager attend.

Information Document Requests:
Requests for information work best when a separate Information Document Request (IDR) is issued for each item (for a particular issue) requested. This is especially true if many items have been requested. When a specific request is not timely filed, reissue the original request. For example, all information for the package audit such as related entities will be on a separate form, the payroll returns, Forms 941 and 940 and state returns (as applicable) would be listed on the same form.

Related Entities:
An important source of information the agent could garner at the onset of the examination concerns related entities. The agents' IDR should ask the dealership to list all related entities including the employer identification number, EIN. The IDR should go one step further and ask the dealership to prepare a flow chart laying out all related entities and their purpose and relationship to the principal shareholder. Often the reconciliation will reveal related entities to the agent through inter-company loans or transfers.

Relative to related entities, an agent should consider reviewing our IRS internal documentation in the context of related return analysis. Initially, prior and subsequent return information should be secured to determine if the taxpayer is:

1. Reporting losses every year,
2. Conforming to the market place (high profit in a recognized good year).

Review the taxpayer's Forms 941 to see at what level dealership activity responded to the general peaks and surges of the industry.

In addition, check filing documents on the dealer, a process crucial to the beginning of future pertinent questions. A search of IRS files for other businesses using a similar name or address of the taxpayer may also reveal related entities.

Concurrent with the request for information regarding related entities, the agent should request copies of all related returns for all years of relevance. The key is to obtain verifiable information regarding the shareholder's equity interests in these related entities.

Changes in Accounting Methods:
See the general retail guide for general change of accounting information.
Revenue Procedure 2001-23
Revenue Procedure 2001-23 is provided for used car dealerships that sell used automobiles or used light-duty trucks and provide an alternate accounting methodology by electing to use the Used Vehicle Alternative LIFO method. This is addressed in the Used Car Dealership Audit Technique Guide.

Revenue Procedure 2002-28
Smaller dealerships can now elect to use Rev. Proc. 2002-28, with regard to use of the cash method. The procedure relieves broad categories of taxpayers with gross receipts of up to $10 million from the general requirement to accrue income from the sale of goods. In general:

1. Eligible taxpayers are permitted to elect to report income from routine receivables from the sale of goods on the cash basis: that is, as payment is received, or constructively received.
2. Other transactions would be covered by the rules applicable to non inventory sales.
3. The cost of the goods themselves must be capitalized but taxpayers may elect to exclude them from formal inventory accounting and treat them as "materials and supplies."
4. Prior to this procedure was a December 2001 release of Notice 2001-76.
    a. While the procedure was included with the notice and in proposed form, taxpayers had been permitted to rely upon it for taxable years beginning with calendar year 2001, pending further guidance.
    b. The final procedure likewise is effective for taxable years ending December 31, 2001, or later.
    c. Moreover the procedure will not disturb accounting methods used in earlier years to the extent that their use would have been permitted under the procedure.
5. Rev. Proc. 2002-28 does not simplify the law; it adds another step to the existing analysis.
6. It does not supersede Rev. Proc. 2001-10; an earlier relief provision confined to taxpayers with revenues under $1 million.

7. Current law continues to apply to taxpayers not electing to apply the procedure.
8. Moreover, some taxpayers — notably contractors — will be able to argue, based on recent case law, that they are not selling merchandise in the first place, and therefore need not abide by the restrictions the procedure imposes on use of the cash method. Nevertheless, many small businesses will appreciate the increased flexibility that the new procedure offers. [1]
9. The flow chart of the application of Rev. Proc. 2002-28 explains the requirements of an eligible small business at the end of this chapter.

The agent's familiarity with Package Audit requirements and audit standards relative to these requirements would make a detailed discussion redundant. We, therefore, would like to stress certain points pertinent to automobile dealerships.

When sending out the initial IDR, the agent should request information sufficient to complete the Package Audit phase of the examination during the first few days at the audit site. This will ensure the agent's time at the dealership is productive and will put him or her in a position to work on more material items as the examination progresses. Eliminating down time will ensure timely closure of the case.

Audit Techniques- Initial Review of Assigned Tax Return

1. Upon initial review of the assigned tax return, look for missing statements or schedules, changes in accounting methods, and any special notes, elections, or disclosures.

2. Review the case file for Service Center/District Information, prior audit information, Department of Motor Vehicle transcripts, and tax transcripts.

3. Order and analyze this information as necessary. Remember the necessary Taxpayers' Bill of Rights II (TBOR II) requirements on Third Party Contacts as required by code section §7602(c).

4. Utilize the Integrated Data Retrieval System (IDRS) as necessary. In addition to internal documents, the agent should consider pulling other reconciliatory information such as payroll, payer and payee master file information, documents relative to ownership entities.

5. A search can be made for related entities by name and/or TIN. Find out if there are any open tax audits and what the status of the case, i.e.: location of cases.

6. Start a list of possible third party resources, which may be tapped into, should necessity dictate. Consider the manufacturer, the Department of Motor Vehicles, used car wholesalers, etc.

[1] James E. Salles, Esq., Caplin & Drysdale; 2002 TNT 109-74; 21 May 2002; Washington

7. Real estate information showing real property in the names of the audit principles can be pulled from a service such as "Data Quick," "Choicepoint Public Sector" or "Experian Information Solutions" where the Service subscribes to it.

8. Consideration needs to be made whether dealership Gross Income can be accepted with minimal testing where the amounts showing on the manufacturer's statement match per return amounts.

9. A complete reconciliation of payroll returns is usually a verification item. The agent may consider an assumption of correctness after "confidence in books" has been established in other areas. The agent should ask the practitioner to perform the reconciliation and to provide copies of the work papers in the initial Package Audit Information Document Requests.

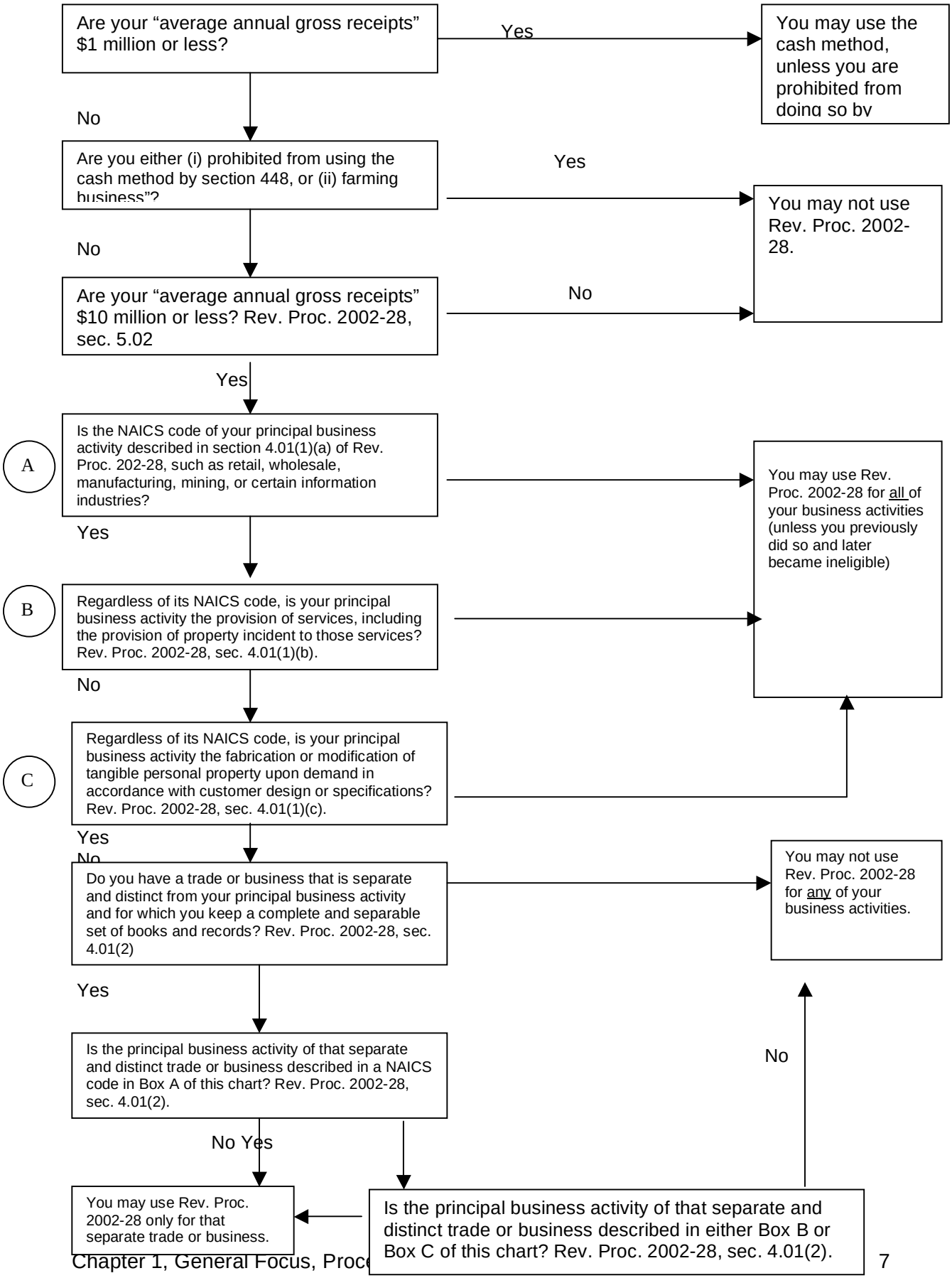
10. It is recommended that officer compensation be verified as being included on the payroll returns and that any large, unusual, and questionable items are further analyzed.

11. Compare prior and subsequent years operations of this and related entities. This one-year, one entity look is the beginning point of the examination and merely provides a window for the agent to see into the taxpayer's operations. The overall picture of how the taxpayer is handling the whole concern for all relevant periods is at issue with the examination.

Summary

If this initial analysis does not result in indications of unreported income, the scope of the examination may be limited to technical issues. This determination made in conjunction with applicable IRM cites, Revenue procedure changes in accounting method compliance and Package Audit requirement compliance could lead to strict classification of the scope auditing standard, whether there is a large, unusual, questionable or related party transaction that requires analysis.

APPLICATION OF REV. PROC. 2002-28



Yes

Flow chart – Application of Revenue Procedure 2002-28

Chapter 2
Books and Records

Characteristics

The books and records of an automobile dealership whose efforts are concentrated on the sale of new vehicles have several features the examining agent should keep in mind before and during the audit process:

1. Voluminous Records

With literally hundreds of books, thousands of accounts, and millions of entries, new automobile dealerships may have the most "full" set of books and records of any non-regulated, non-traded company. Chart of Accounts, source codes, grouping papers, and the manufacturer's accounting manual are the key to not getting lost and conducting an effective audit. These books are almost exclusively in an electronic format with subtotals carried forward throughout the course of the year.

2. Overwhelming

Voluminous records, in conjunction with experienced taxpayers and representatives, make the agent's job difficult at first. A well-planned and organized audit will help the examiner focus the examination, mitigating the "overwhelming" factors.

3. Financial Statements

One of the most important tools is the manufacturer's statement, which is prepared regularly (usually monthly) and sent to the manufacturer, who keeps well abreast of the dealership's business operations. These statements are standardized per the factory manual and can be reconciled to tax items. This process can establish confidence in the books in order to curtail reconciliatory and verification activities.

4. Accounting Manual

Each factory has its own accounting manual, typically 500 pages or so of format and procedure. This is a must for the examining agent and should be obtained for use at the beginning of the audit. The manual should be used as a tool throughout the examination.

5. Similarities and Differences

The books and records are different from dealership to dealership, but given the control imposed by the factory manual, any dissimilarity is made to conform to the same final form. As such, it is important to determine those characteristics that account for differences between dealership entities, as tax consequences may relate to the different methods.

6. Traditional Books

An automobile dealership has all the traditional books with significant detail as well as a large set of subsidiary ledgers.

a. General Ledger
b. Journals – The traditional books
    1) General
    2) Sales
    3) Purchases
    4) Cash Disbursements Journal
    5) Cash Receipts Journal
    6) Payroll
c. Journal Sources: Auto dealerships journalize these five traditional books into many sub-journals using source codes to identify a particular transaction and the particular source book it is journalized to. These sub-journals, which include the traditional books, may number as many as fifteen.
d. Subsidiary Ledgers

7. Starting the examination

The audit should start and proceed from the accountant's (preparer's) work papers and the general ledger in order to determine focus and familiarize the agent with the specifics of the books. A recommended process is:

Reconcile

a. General Ledger to working papers.
b. Group - Use accountant’s papers to group accounts into return items.
c. Reconcile - Beginning Trial Balance and Adjusting Journal Entries to the tax return.
d. Reconcile - Beginning Trial Balance to General Ledger.

8. Structure of the General Ledger

The General Ledger (GL) is prepared monthly and is cumulative, summarizing entries made to each account by the journals. Being computerized, source codes are used to post summaries of monthly journal entries to the General Ledger accounts. Without a key of the source codes, one does not know from where an amount originated.

9. Journal Voucher Entries

The Journal Voucher book contains items which alter the General Ledger to correct errors, account for standard recurring items, and make tax adjustments.

a. Standard Entries

Items such as Amortization and Prepaid expenses, which are periodically being adjusted, are done through Journal Voucher entries.

b. Errors

The correction of errors, which posted to the General Ledger, the Journals, or the subsidiary ledgers, is also done through the Journal Voucher.

c. 13th Month Entries

At the end of the taxable year, and prior to the preparation of the Trial Balance, several entries are made which constitute corrections to previously recorded errors and adjustments in yearend account balances for federal tax purposes. These 13th month entries generally address accruals, writedowns, the LIFO reserve and elimination of book reserves, to name a few. These entries are prevalent in the auto industry and are usually identifiable by a unique source code in the General Ledger.

10. Schedules

In addition to the typical books and records, auto dealers also maintain a number of various subsidiary ledgers that may assist in the examination. Examples of such subsidiaries include:

a. Accounts Receivable: List of customers and account balances.
b. Accounts Payable: List of vendors and account balances.
c. New Vehicles: Stock number, cost, amount floored (short-term loan from bank for automobiles purchased), etc;
d. Perpetual versus physical inventory listings.

11. Separate Folders

Certain items, which do not require a living ledger, are kept track of by the typical dealership. Examples include:

a. Fixed Assets
b. Prepaid Expenses

12. Other Dealership records to be aware of

a. Report of Sales Book: In California, it is required that all sales be reported to the Department of Motor Vehicles within 5 days of sale in order to register the vehicles. Analysis of this record will ensure the sales cutoff is proper at the beginning of the year and at yearend. Agents should foot a sample to assure all sales are recorded in the general ledger.
b. Car Jackets: A separate folder for each new vehicle sold which contains documentation pertaining to this particular transaction.

Remember, each dealership is different and, therefore, it is paramount the examining agent require someone truly familiar with the books and the business to detail the operations and the accounting system at the initial interview.

Books and Records General Ledger Audit Example

Picture a General Ledger of about 10,000 pages for the year with only numeric reference points to various transactions. In order to effectively sample items, a

connection to source documents is necessary. It is common where new car auto dealerships are concerned to break down the 5 traditional journals, (i.e., Sales, Purchases, Cash Disbursements, Cash Receipts, Payroll), into 15 different journal sources, with 15 applicable source codes to represent and include these traditional books. Such a journal source setup could look like the following, this is an example of one of the computer vendors used by auto dealerships:

Source Code	Description
1	New Vehicle Sales
2	Used Vehicle Sales
3	Repair Order Sales
4	Parts Sales
5	Cash Receipts
6	Cash Disbursements
7	New Vehicles Purchases
8	Used Vehicle Purchases
9	General Purchases
10	Dealer Trades
11	General Adjustments
12	Prior Year Adjustments (13th month adjustments)
13	Standard Entries
14	Warranty Credits
24	Payroll

Each Source Code representing a source journal is typically divided into monthly books, for example:

Source Code – 7 New Vehicle Purchases
a. January 1
b. February 2
c. March 3
d. April 4
etc…
Using our scenario above, where we have 15 source codes and a different book for each quarter, it would not be inconceivable to have 60 journal source books for one tax period.

These concepts can become a little muddled where these journal source books are straddled around a fiscal yearend with quarters that do not conform to what are considered "traditional quarters," or the dealership maintains a separate set of source books for each manufacturing line sold (i.e., one set of journal sources for manufacturer A and a separate set for manufacturer B). There would be 120 journal source books for one tax period using the criteria set forth above.)

Where the agent wishes to sample an item from the General Ledger, the source code should be secured and then the source journal should be referenced corresponding to the quarter of posting. Then descriptions become more revealing and appropriate source documents can be requested. The typical item posted to a General Ledger using this journal source method would resemble the following:

General Ledger

11/0X	7	$1,000

What does this entry mean? Remember these postings represent a summary of monthly activity occurring in that particular journal source posted to the general ledger. This particular entry indicates the month of November 200X had activity of $1,000 that was summarized and posted to the General Ledger emanating from Journal Source book 7. Reviewing our journal source codes we find that Journal Source 7 represents New Vehicle Purchases. To find this particular entry we would go to that particular Journal Source 7 book which incorporates the summaries for November 200X. Inspection of that book reveals entries that would resemble the following:

7 New Vehicle Purchases

Date	Invoice #	Description	Amount
11/1/0X	111111	New Car	$100.00
11/2/0X	222222	New Car	$200.00
11/3/0X	333333	New Car	$300.00
11/4/0X	444444	New Car	$400.00

Journal 7 New Vehicle Purchases Total $1,000.00

The agent may now request specific invoices or flooring statements pertaining to the entry originally noted in the General Ledger, as necessary.

Each journal will have its own unique source documents:

Source Code	Description	Probable Source Documents
1	New Vehicle Sales	Car Jacket
2	Used Vehicle Sales	Car Jacket or aggregated files
3	Repair Order Sales	Folders or invoices
4	Parts Sales	Invoices
5	Cash Receipts	Bank Statements (by bundle #)
6	Cash Disbursements	Bank Statements (Checks by bundle #)
7	New Vehicle Purchases	Flooring Statements, invoices
8	Used Vehicle Purchases	Car Jackets, Cash Disbursements
9	General Purchases	Usual substantiation documentation
10	Dealer Trades	Invoices
11	General Adjustments	Dealership Internal accountant's work papers and journal entry sheets

12	Prior Year Adjustment	Work papers and individual AJEs
13	Standard Entries	Usual substantiation
14	Warranty Credits	Car jackets, transaction statements
24	Payroll	Payroll company books and records

Electronic Records Requirement for Dealer Software

Automobile dealerships utilize computer software specifically designed for a particular dealership or from the manufacturer for use at the dealership. Revenue Procedure 98-25 sets guidelines for the requirement of a dealership to retain electronic records.

This revenue procedure specifies the basic requirements for the establishment, maintenance and retention of a taxpayer's records are maintained within an Automatic Data Processing (ADP) recordkeeping system. The requirements of this procedure are applicable to all Internal Revenue Code provisions that have unique or specific recordkeeping requirements. Rev. Proc. 91-59, 1991-2 CB 841, was modified and superseded for machine-sensible records relating to tax years beginning after December 31, 1997. However, taxpayers that comply with this procedure for tax years beginning prior to that date will be treated as having complied with Rev. Proc. 91-59 for those years.

With regard to a dealership's information system:

- The manufacturers and distributors mandate the specifications of dealership accounting systems.
- Dealerships have a limited number of hardware and software vendors from which to choose.
- The transfer of data from one vendor's product to another is difficult or impossible.
- Information systems are typically relatively small and do not store information from prior cycles.
- Back up tapes might be made but typically are not retained for an extended period.
- If back up information is available; it generally cannot be loaded back onto the dealer's system without removal of the current activity.
- Information systems contain proprietary software that usually cannot be accessed by a Computer Audit Specialist.
- Dealers communicate with manufacturers through a Dealer Communication System (DCS) that generally allows a dealership to order vehicles and parts, submit warranty claims, and send other communications to the factory.
- Dealerships increasingly use the Internet and e-mail to communicate with customers, manufacturers, and other partners.
- Some dealers have entire departments devoted to providing e-mail responses to prospective clients.

Conclusion

Although intimidating at first, the books and records of an automobile dealership are usually very complete. However, a structured audit plan and the knowledge of the accounting procedures employed by the dealership will provide the necessary tools to do a thorough examination. Therefore, it is crucial that some understanding of the records exist prior to the issuance of even the first IDR. Given this comprehension, the auditor should have all the necessary information to get started.

Chapter 3
Balance Sheet

Generally, Balance Sheets are necessary where a corporation or partnership is the business organization of choice. Most new vehicle auto dealerships are corporations or partnerships. Balance sheet examinations can save time and ensure a thorough examination.

Entries made to many, if not most, balance sheet accounts have corresponding entries to the income statement. Audit planning which considers this duplication of entries will save time and effort. Remember that partnership return balance sheets entries shown on Form 1065 are sometimes, but not always reported at Fair Market Value.

Balance sheet accounts are "real" accounts. These accounts represent things the dealership owns or owes. Their balances are carried forward from year to year. This differs from income statement accounts, which are closed out at yearend and only reflect business operations within a specified cycle. These operating accounts are closed to retained earnings and result in net income or loss to the business.

Material fluctuations or changes to these real accounts may signify activities requiring examination. These fluctuations and changes signify a change to things the dealership owns or owes. These differences require effort on the part of the dealer when assets or liabilities are accumulated or dispersed. If these changes are not correctly accounted for in the books and records, assets or liabilities may be accumulated or disbursed without ever being reflected in income. As a general statement, income is taxable, unless a proper Schedule M-1 adjustment is made. The propriety of Schedule M-1 adjustments is addressed later.

A 3-year comparative analysis at the beginning of an auto dealership examination allows us to identify such changes and fluctuations that may require examination in the audit planning stages.

Tax classification of balance sheet accounts, performed when the books are reconciled to the return, is paramount to a successful balance sheet audit. This classification gives us the ability to spot curious relationships that may occur with these accounts. As an example, loans to shareholders are often grouped in the other current liability account. If the balance sheet does not specifically list this loan, its existence may never be discovered. This audit tool assists in the determination of the examination scope.

Frequently, adjustments to balance sheet accounts result in an increase to taxable income. Remember that all income statement accounts are run through the balance sheet, but not all balance sheet accounts are run through the income statement. An example of entries in balance sheet accounts not affecting the income statement could be a loan to the shareholder eliminated through retained earnings.

An example of an entry involving a corporation is:

Debit Retained Earnings
Credit Loan to Shareholder

Retained Earnings is an Equity account and Loans to Shareholder is an Asset account. If the Loan to Shareholder account is being increased as a result of a loan being made to shareholder, the account should be debited rather than credited to reflect an increase in the account's balance. The cash account should be credited to reflect the decrease or payment of cash in that situation. If an examiner observes the above entry, further inquiry is necessary.

The manufacturer's statement should be secured in order to establish confidence in the taxpayer's balance sheet accounts.

Schedules M-1 and M-2 have definite balance sheet implications and should be reconciled and looked to for help in identifying what the taxpayer is doing. Differences between book and tax treatment of items should be questioned and taxpayers should be asked to submit their authority for any differences that do not appear to be compatible with generally accepted accounting or tax principles. This is also where deviations from reliable manufacturer statements may occur.

Below are Balance Sheet items related to the auto industry.

1. Cash
2. Accounts Receivable
3. Inventory
4. Loans to/from Shareholders
5. Fixed Assets - Real Estate- Building & Equipment
6. Accounts Payable, Other Current Liabilities and Other Liabilities
7. Capital Stock/Capital Account
8. Retained Earnings

1. *<u>Cash</u>*

One of the objectives in analyzing the cash account is to determine if cash equivalents and balances are properly classified on the balance sheet. Dealerships may put an asset into the cash portion of the balance sheet in order to make financial statements look more attractive. Contracts in Transit are one example of this. Although much like a receivable, some auto dealerships may treat these as a cash item.

A Contract in Transit is the amount of the automobile's sale price, which is going to come from the financing company that has not yet arrived. The dealer justifies a cash treatment of these contracts as they typically deal with one or two institutions on an ongoing basis, collection is close to certain, and turn around is fast (about a week). The financing institution "makes the loan," the proceeds are forwarded to the dealer who then acts on the note executed by the buyer. The entries that should be made are:

DR Contracts in Transit (a receivable)
CR Sales
(When the sale is made)

DR Cash in Bank
CR Contracts in Transit
(When cash is received)

Sources of cash verification and substantiation items include:

a. Bank Statements
b. General Ledger and subsidiary journals
c. Statement of Cash Flows
d. Financial statement footnotes
e. Loan applications and credit line and flooring limits
f. Non-trade in used car acquisitions
g. Non-inventoried durable goods purchases
h. Other entities

Issues

- Is all income reported?
- Has Form 8300 been filed as required?

Audit Techniques - Cash

These techniques can be utilized to determine potential areas of non-compliance affecting the tax return by:

A. Tracing the outstanding checks at yearend to determine payment of a liability in the next period.
B. Accounting for and questioning all material related to company transfers.
C. Reviewing Adjusting Journal Entries, standard entries, and Journal Vouchers affecting the cash accounts.

Form 8300 – Documents to Request

Form 8300 for currency transactions over $10,000 should be requested. The review of these forms should be conducted in conjunction with the audit of the cash accounts.

A. Ask taxpayer to provide an analysis of cash receipts and copies of the Forms 8300's that were filed.
B. Request to review cash receipts vouchers (generally maintained by the dealers in bundles in numerical sequence) and make a determination as to whether or not there are any delinquent Form 8300's outstanding.

2. *Accounts Receivable*

Receivables for an Auto dealer are typically divided into:

- New Vehicle Sales
- Used Vehicle Sales
- Warranty Repairs
- Other Repairs
- Extended Service Contracts (ESC)
- Holdbacks
- Finance Receivables
- Other
  - Driver education receivables (paid by Mfg.)
  - Manufacturer rebates (paid by Mfg.)
  - Other claims
- Non-Trade Receivables

a. **Sales**

Only portions of these receivables actually deal with vehicle sales. Extended Service Contracts (ESC's) are usually receivables from auto buyers, but since most dealers sell to individuals, and most individuals either pay cash or obtain their own financing, sales receivables only occur when the dealership chooses to finance an arrangement.

Potential Issues

- Unreported sales and proper year of inclusion.
- In addition, a related party, or series of related party transactions could be occurring which may raise an arm's length transaction question under IRC section 482.

Audit Techniques

- Test sales recorded in opening days of subsequent year to determine whether said sales are includible in year under examination.
- Confirm tested sales against Car Jackets, Sales Journal and the Car Stock Book, etc.

b. Dealership financing

If the dealer is financing the customer, there must be a note, which should be booked at face value. As payments are earned by the

dealership, the note is reduced by the amount of the principal payment and interest income is recorded.

Audit Techniques

- The terms of the note must be reasonable. In this category of the balance sheet, the note should call for payback to occur within a 1 to 5 year window. If the principal balance remains unchanged for a long period of time or if the stated or (unstated) interest rate is not at least equal to the Applicable Federal Rate (AFR). IRC §483, look to see if it is an arm-length transaction.

c. Note Transfers

Scrutinize any trend of dispositions of notes, either gains or losses, as related or unreported transactions could be occurring.

The note carried by the dealership is sold to a financial institution, the terms of sale become important. The note is sold either "without recourse" or "with recourse." A note is sold "without recourse" when the dealership is in financial duress or when the prospects of collecting are poor. If the customer defaults the bank CAN NOT look to the dealer for payment. Notes sold "without recourse" can be discounted to a significant degree. A note sold "with recourse" means that if the customer defaults, the bank CAN force the dealership to pay.

Receivables transferred "without recourse" should be recorded as a sale because (1) ownership risks and benefits are transferred and (2) the net cash flow effect of the transfer is known at the date of the transfer.

When receivables are transferred "with recourse," the transferor agrees to make good any receivables that are not collectible. Even though ownership risks and benefits are not shifted completely, the transfer should be recorded as a sale if the net cash flow effect of the transfer can be reasonably estimated; otherwise the transfer of receivables is a borrowing and a liability should be recorded. FASB Statement of Financial Accounting Standards No. 125 (superceding FASB No. 77) sets forth conditions, all of which must be met, in order for the transferor to record a sale. These include:

1. The transferred assets have been isolated from the transfer or—put beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (1) each transferee obtains the right—free of conditions that restrict it from taking advantage of that right—to pledge or

exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
3. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. For additional information, refer to the Chapter 16, Related Financing Companies.

d. **Financing**

A Finance Receivable occurs when the dealership negotiates a customer's loan for them. The amount of finance income is dependent on two factors: the interest rate on the contract and the market rate. The dealership may earn a commission on the market rate and the entire difference between the market rate and the rate on the contract. This should be booked to Finance Sales when the customer signs the note.

When a dealership has a significant amount of "recourse" notes, the main financing institution will often establish a reserve, which corresponds to a chargeback account on the dealership's books (contra-asset receivable).

Audit Techniques – Finance Receivable

- It is recommended that these credits be reviewed to determine the correctness of any connected write-offs through a Bad Debts account.
- (In order to take a bad debts expense, the direct write off method must be used). See the Finance Reserves the Miscellaneous Chapter, Chapter 16.

e. Leased Car Receivables

FASB Statement of Financial Accounting Standards No. 13 provides classification criteria to account for a lease as either a capital lease (sale) or as an operating lease (rental). Most dealerships involved with leasing have operating leases.

Vehicles placed in the leasing business within the dealership operation should be transferred at inventory value, excluding holdback, and not recorded as vehicle sales. The vehicle remains on the books of the dealership as property leased to a lessee and is depreciated over its useful life. The dealership records the lease payments as lease income. Units

retired from leasing service should be transferred to the used vehicle inventory for disposal. It is at this time that a valuation issue may exist, whether the vehicle should be transferred at its net book value or at wholesale value, less estimated reconditioning charges. Remember, for tax purposes, the adjusted basis and resulting gain or loss, and treatment of reconditioning expenses differs from how it is recorded on the books.
If under the terms of the lease, the ownership risk and benefits are transferred to the lessee, the lessee has purchased the vehicle and the dealer is merely financing the purchase for the lessee. Also, vehicles sold to a separate leasing entity, independent or owned, should be recorded as sales.

f. Dealer Reserves

Dealers sell the majority of new vehicles under some form of note that includes the unpaid balance of the vehicle, plus finance charges. These contracts are sold or endorsed to a finance company. This transaction normally creates the "dealer's reserve." See Financing above.

If the note is transferred in a non-recourse transaction (the note is not always non-recourse), the finance company owns any cars, which are repossessed. The dealer receives the purchase price of the automobile and a finance commission.

Obligations of purchasers for deferred payments on installment sales are discounted or sold by dealers to finance companies. These finance companies pay the dealers most of the amounts in cash, but credit to each dealer, in a "reserve account," a small percentage thereof, which is retained by the finance company to secure performance of the dealer's obligations under his guarantees or endorsements. The amounts thus credited to the dealers in "reserve accounts" on the books of the finance companies must be reported as income accrued during the tax years in which they are credited to such reserve accounts.

Law:

In *Commissioner vs. Hansen,* 360 U.S. 446 (1959), the Supreme Court held that amounts credited to an automobile dealership in a reserve account on the books of the finance company must be reported as income during the tax year in which the amounts are credited to the reserve accounts.

Dealers must include in income all amounts placed in the reserve account and all deposits into the account regardless of use. *Resale Mobile Homes, Inc.,* 965 F.2d 818 (10th Circuit, 1992)

g. **Related Party Receivables**

Non-trade receivables should be examined for possible related party issues. Accounts receivable that are due from related individuals should be closely scrutinized.

Issue:

Constructive dividend to shareholder

Documents to Request:

a. Secure analysis of items comprising other receivables and segregate between related and non-related trade receivables.

Audit Techniques:

a. Review and analyze non-trade receivables
b. Review all substantial credit balances and trace to source.
c. Analyze the composition of the account balance.
d. Trace the source of repayments
e. Determine whether or not a loan was made and if a bona fide debtor-creditor relationship exists.
f. If there is a loan, secure copies of notes or evidence of indebtedness.
g. Determine that the terms of note are being followed such as interest is being accrued as income.

3. *Inventory*

Inventory includes items that are used to produce income and are not period expenses, such as:

a. New vehicles
b. Used vehicles
c. Remanufactured core
d. Parts and Accessories
e. IRC section 263A
f. LIFO reserve
g. Demonstrators
h. Body shop materials
i. Sublet repairs
j. Labor-in-process

Taken on an individual basis, these sectors of the inventory account can be analyzed by looking at the LIFO calculations, the accountant's work papers on the 263A allocation, and the used vehicle valuation sheets. See LIFO, 263A chapters.

a. New Vehicles

Many dealerships use LIFO to value new car and truck inventories. LIFO is discussed in a separate chapter due to its complexity.

b. Used Vehicles

Effective for tax years after December 31, 2000 an Alternative LIFO method for Used Cars is available as prescribed by ***Revenue Procedure 2001-23***. . Taxpayers must follow the automatic consent procedures of ***Revenue Procedure 2002-9, (Revenue Procedure 99-49 superceded)*** to use this method. Upon election, all previous write-down or parts inventory (if LIFO is elected for Parts Inventory) must be recaptured. Refer to the Used Car LIFO chapter.

Dealers are to value the automobiles based on the lower of:

1) Cost: What the dealer actually pays for a vehicle (cash outlay) in an arm's length transaction or its actual cash value.

Or

2) Market: Treas. Reg. section 1.471-4(a) provides that for normal goods, market is the aggregate of the current bid prices prevailing at the date of inventory. *Thor Power Tools*, 439 U.S. 522 (1979) defines current bid price as replacement cost based on the normal quantity and quality of the inventory item in the market in which the taxpayer normally *purchases* its goods. Subsequent selling price does not necessarily equate to replacement cost.

Reconditioning expenses are inventoriable and added to the cost of the applicable vehicle. Rev. Rul. 67-107 recognized industry practice of carrying into inventory the cost figure until the end of the year. The inventory value is then adjusted to conform to the average wholesale price at that time. The ruling then refers to Section 471 of the Code as well as the above regulations so inventory valuation methodology is one that clearly reflects income. Accordingly, it allows only used vehicles taken in trade to be valued using an official used car guide. It does not require the use of a specific publisher, but the regulations do require consistent treatment. To any used vehicle valuation guide, additions and/or subtractions may be necessary according to options and mileage, and according to the condition of each vehicle. Certain vehicles, such as antiques or classics, may have a value that cannot be ascertained from the usual official guides.

c. Remanufactured Cores

- If your dealer is engaged in servicing vehicles for repairs and/or warranty work and even reconditioning, he or she may purchase remanufactured parts (for example, carburetor, alternator). Generally, the price of the remanufactured part includes a charge for the "core." This is an amount that will be refunded to the dealer once the old part is returned. If the dealer has any cores on hand at yearend, they should be inventoried. For example, a part may cost $100 divided into two costs: $70 for the cost of rebuilding the part and a $30 core

charge. The $70 may be an inventoriable cost if part of reconditioning a vehicle or a current expense for repairs or warranty work. The $30 is inventoriable separately with other parts until the core is returned for credit. Although it is improper, the dealer may expense the entire $100 when the part is purchased and include the $30 core charge as income only when the core is returned.

Remanufactured Cores and Revenue Procedure 2003-20

- Beginning with taxable years ending on or after December 31, 2002, Revenue Procedure 2003-20 allows a safe harbor method of accounting (the "Core Alternative Valuation" (CAV) for remanufacturers and rebuilders of motor vehicle parts ("remanufacturers") and resellers of remanufactured and rebuilt motor vehicle parts ("resellers") that use the lower of cost or market (LCM) inventory valuation method to value their inventory of cores held for remanufacturing or sale. This revenue procedure also provides a procedure for qualifying remanufacturers and resellers currently using the LCM method to obtain automatic consent of the Commissioner to change to the CAV method. Moreover, this revenue procedure provides a procedure for qualifying remanufactures and resellers not currently using an LCM method to obtain automatic consent to change to an LCM method in conjunction with a change to the CAV method.

- Section 2 Background:
  .01 In General.
  (1) Remanufacturers acquire inventories of used motor vehicle parts (e.g., wiper motors, engines, transmissions, and alternators for automobiles, trucks, buses, etc.) for use in remanufacturing. These used parts are frequently referred to within the remanufacturing industry as "cores." Remanufacturers rebuild motor vehicle parts from cores through use of new and used component parts and sell the resulting products as remanufactured replacement parts. Resellers acquire cores in conjunction with their resale activity and sell the cores to a remanufacturer or another reseller in the distribution chain.
  (2) Remanufacturers and resellers acquire cores from customers ("customer cores") who purchase remanufactured replacement parts. To encourage a customer to return the core, remanufacturers and resellers generally offer the customer a credit (offset against the purchase price). Remanufacturers and resellers also acquire cores from third-party suppliers of cores (businesses that specialize in supplying cores to meet specific needs, referred to within the industry as "core suppliers" or "core brokers") and occasionally acquire cores directly from other sources.
  (3) Controversy exists as to the proper market valuation of cores under the LCM method. See Consolidated Manufacturing, Inc. v. Commissioner, 249 F.3d 1231 (10th Cir. 2001), rev'g in part, 111 T.C. 1 (1998). In order to reduce controversy and minimize disputes, the Service has determined that it is

appropriate to provide a safe harbor procedure for the LCM valuation of cores in inventory.

.02 Law: §471: treatment of inventories: it must conform as nearly as may be to the best accounting practice in the trade or business; and it must clearly reflect income. Regs. §1.471-2(c) provides that the bases of valuation most commonly used by business concerns and which meet the requirements of § 471 are (1) cost and (2) cost or market, whichever is lower. Section 1.471-2(c) also provides that any goods in an inventory that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, but in no case shall such value be less than the scrap value.

.03 Section 1.471-3(b) defines the cost of merchandise purchased since the beginning of the taxable year as the invoice price less trade or other discounts, § 1.471-3(c) defines cost as (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to, and necessary for, the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

.04 Section 1.471-4(a) provides “market” means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacturer, and finished manufactured goods on hand.

.05 Section 1.471-4(c) provides inventory valuation for market value of each article when using cost or market.

.06 Section 1.471-2(f) provides deducting from inventory a reserve for price changes is not in accord with regulations underlying §471.

.07 Section 472(b) and §1.472-2 require taxpayers using the last-in, first-out (LIFO) method to inventory their goods at cost.

.08 Section 446(e) and §1.446-1(e)(2)(i) require that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for income tax purposes.

Section 3. Scope
.01 *Applicability*: This revenue procedure applies to remanufacturers and resellers that want to change to the CAV method described in section 4 of this revenue procedure to value inventories of cores. For purposes of this “cores” include electrical, mechanical, hydraulic, and other operating motor vehicle parts, including parts of automobiles, trucks, buses, motorcycles, boats, construction equipment, farm machinery, and other on- and off-road motorized equipment. The CAV method applies only to cores held in inventory for

remanufacturing or, in the case of a reseller, held for sale to a remanufacturer or another entity in the distribution chain. The CAV method only applies to cores valued under the LCM method.

.02 *Inapplicability.* This revenue procedure does not apply to a taxpayer that values its inventory of cores at cost (including a taxpayer using the LIFO method) unless the taxpayer concurrently changes (under section 6.02 of this revenue procedure) from cost to the LCM method for its cores (including labor and overhead related to the cores in raw materials, work-in-process and finished goods). A taxpayer that wants to concurrently change from cost to the LCM method must: (a) not be otherwise prohibited from using the LCM method; (b) comply with the general rules relating to inventories under § 471 and the regulations thereunder; and (c) in the case of taxpayers using the LIFO method, use the LCM method and a permitted method for identification as determined and defined in section 10.01(1)(b) of the APPENDIX of Rev. Proc. 2002-9, 2002-3 I.R.B. 327, 368-69.

SECTION 4. THE CORE ALTERNATIVE VALUATION METHOD

.01 *In General.*

(1) A taxpayer using the CAV method values its inventory of cores at LCM, determines cost in accordance with section 4.02 of this revenue procedure, and determines market in accordance with section 4.03 of this revenue procedure.

(2) The CAV method will be a permissible method of accounting provided the taxpayer follows the rules and computational methodology described in sections 4.02 through 4.05 of this revenue procedure and, if the taxpayer is changing from another method to the CAV method, the provisions of section 6 of this revenue procedure regarding changes in method of accounting. All computations under the CAV method, however, are subject to verification upon examination of the taxpayer's income tax returns.

.02 *Determination of Cost.*

(1) *In general.* Under the CAV method, the taxpayer is required to use as the cost of each core in ending inventory the invoice price adjusted, as appropriate, for discounts, freight costs, and other direct and indirect costs properly allocable to the cores as described in §§ 1.471-3 and 1.263A-1. If the core was acquired from a core supplier or broker, the invoice price is the amount paid to the core supplier or broker. If the core was acquired from a customer, the invoice price is the sum of any credit allowed to the customer and any amount paid to the customer.

(2) *Service may redetermine appropriate cost.* As a general rule, the taxpayer must follow the form that the taxpayer used for the transaction. *See*, for example, *In re Steen*, 509 F.2d 1398, 1402 n. 4 (9th Cir. 1975) and *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967). If the Service

determines, however, that the taxpayer's use of the credit amount as the invoice price does not clearly reflect income (for example, because the taxpayer artificially inflated both the price of the remanufactured core and the credit amount solely to manipulate gross receipts for tax avoidance), the Service may examine the substance of the transaction to determine the appropriate cost for a core. *See*, for example, *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

.03 *Determination of Market Value.*

(1) *In general.* Under the CAV method, the market value under § 1.471-4 of each core in ending inventory is the "allowable supplier price" adjusted, as appropriate, for other direct and indirect costs properly allocable to the core as described in §§ 1.471-4 and 1.263A-1. The allowable supplier price will be considered to be the replacement cost for purposes of §§ 1.471-4 and 1.263A-1.

(2) *Allowable supplier price.* For purposes of this revenue procedure the "allowable supplier price" is the amount the taxpayer would pay in an arm's length transaction to acquire a particular core from a core supplier or core broker, plus the related transportation cost that would be incurred to acquire possession of the core from the core broker or supplier at year-end. If the taxpayer has purchased a particular type of core from several core suppliers or core brokers during the tax year, the allowable supplier price for that core type will be deemed to be the weighted-average price, including transportation cost, the taxpayer would have to pay in an arm's length transaction to acquire the particular core type at year-end from the core suppliers or core brokers from whom the cores were purchased during the tax year. If the taxpayer has not purchased a particular core type from a core supplier or core broker during the tax year, the taxpayer must identify its largest (in dollar terms) supplier of cores during the current tax year that also sells the particular core type in the ordinary course of its business; the allowable supplier price will be the arm's length price from that supplier for the core type at year-end plus the transportation cost that would be incurred to acquire the core type from that supplier. If none of the taxpayer's suppliers sell the particular core type, the taxpayer must reasonably determine the allowable supplier price based on the arm's length price for the core type at year-end, plus the transportation cost, in the geographical area or market in which the taxpayer regularly participates. In any case, no further adjustments will be allowed in determination of allowable supplier price.

(3) ***Example of allowable supplier price calculation using weighted-average price****.* Taxpayer, a remanufacturer, had 4 units of Part X customer cores in inventory at year-end. Taxpayer acquired these customer cores from customers in transactions in which taxpayer sold to the customers remanufactured parts and received cores from the customers in exchange for credits toward the purchase price of the remanufactured parts. During the tax year, Taxpayer purchased 8 units of Part X cores from suppliers (2 units of Part X from Core Supplier A and 6 units of Part X

from Core Supplier B). Therefore, Taxpayer purchased 25% (2 of 8 units) of the total number of Part X acquired for the year from Core Supplier A and 75% (6 of 8 units) of the total number of Part X acquired for the year from Core Supplier B. At the end of the taxable year, the price Taxpayer would have to pay in an arm's length transaction to acquire Part X, including transportation cost, was $20 from Core Supplier A and $16 from Core Supplier B. Taxpayer would determine the allowable supplier price for Part X customer cores under the CAV method as follows:

	# of Units Purchased During Year	% of Total Units Purchased During Year	End of Year Price
Core Supplier A	2	25%	$20
Core Supplier B	6	75%	$16
Total	8		

CAV Core Supplier Price for Part X Customer Cores = (25% x $20) + (75% x 16) = $17.

.04 *Comparison of Cost and Market.* Under the CAV method, the market value of each core in ending inventory, as determined under section 4.03 of this revenue procedure, shall be compared with the cost of each core in ending inventory, as determined under section 4.02 of this revenue procedure, and the lower of such values shall be the inventory value of the core. This analysis must be performed on a part-by-part basis.

.05 *Write-down of Defective Cores.* Under the CAV method, a taxpayer may not reduce the value of a defective core under § 1.471-2(c) until the taxpayer discovers that the core is subnormal and scraps the core or offers the core for sale at a bona fide selling price that is less than cost. In no case may a taxpayer value a core at less than the scrap value. A taxpayer may not reduce the value of cores based on anticipated defect percentages or historical defect experience rates. If a taxpayer complies with the requirements of this revenue procedure, the Service will not disallow a write-down of a defective core in the year it is scrapped on the grounds that the decline in the value of the core actually occurred in a preceding taxable year.

SECTION 5. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE SAFE HARBOR METHOD

If a taxpayer within the scope of this revenue procedure was consistently using the CAV method provided in section 4 of this revenue procedure before February 10, 2003, the taxpayer's use of the CAV method will not be raised by the Service as an issue in a taxable year that ends before February 10, 2003. Moreover, if such taxpayer's use of the CAV method has already been raised as an issue in examination, appeals, or before the Tax Court in a taxable year that ends before February 10, 2003, the issue will not be further pursued by the Service.

A. SECTION 6. CHANGES IN METHOD OF ACCOUNTING

.01 *In General.* A change in the treatment of customer cores in inventory to the CAV method provided by this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Therefore, a taxpayer within the scope of this revenue procedure that wishes to change to the CAV method for a taxable year ending on or after December 31, 2002, must file a Form 3115, Application for Change in Accounting Method.

.02 *Automatic Change for Taxpayers Within the Scope of this Revenue Procedure.*

(1) *Automatic change to the CAV method*. A taxpayer within the scope of this revenue procedure that wants to change to the CAV method must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9, as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, Announcement 2002-17, 2002-8 I.R.B. 561, and Rev. Proc. 2002-54, 2002-35 I.R.B. 432, with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change to the CAV method for its first taxable year ending on or after December 31, 2002, provided the taxpayer's method of accounting for cores is not an issue under consideration in examination (within the meaning of section 3.09 of Rev. Proc. 2002-9) at the time the Form 3115 is filed with the national office;

(b) In lieu of the label required by section 6.02(4) of Rev. Proc. 2002-9, taxpayers are instructed to write “Filed under Rev. Proc. 2003-20” at the top of the form; and

(c) Taxpayers making concurrent changes under subsections (2) or (3) of this section should include the concurrent change with the change to the CAV method in a single application.

(2) *Change from cost to LCM.* An automatic change in method of accounting to the CAV method under this revenue procedure also includes, where applicable, a concurrent change from the cost method to the LCM method.

(3) *Change from LIFO.* An automatic change in method of accounting to the CAV method under this revenue procedure also includes a concurrent change from the LIFO method to a permitted method for identification as determined and defined in section 10.01(1)(b) of the APPENDIX of Rev. Proc. 2002-9. A taxpayer that desires to discontinue LIFO to use the CAV method must make a concurrent change from its cost method to the LCM method.

SECTION 7. RECORD KEEPING

Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The books or records required by § 6001 must be kept at all times available for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. § 1.6001-1(e). In order to satisfy the record keeping requirements of § 6001 and the regulations thereunder, a taxpayer that uses the CAV method should maintain records supporting all aspects of its inventory valuation including but not limited to cost of supplier cores.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in section 9 of the APPENDIX.

d. Parts Inventory

Revenue Procedure 2002-17 describes a safe harbor method of accounting for vehicle parts inventory that allows automobile dealers to approximate the cost of their parts inventory using the replacement cost of the parts. The revenue procedure also includes procedures for dealers to receive automatic consent to change to the replacement cost method.

Discussion

Automobile dealerships normally carry a significant inventory of parts for use in the dealership service department and for retail sales. Dealers are generally required by their franchiser manufacturer/distributor) to value their parts inventory at replacement cost rather than at the historical purchase cost of each part. To assist dealers in valuing parts at replacement cost, the manufacturer or other parts supplier provides the dealer with periodic price updates. Once the dealership processes the price updates, the historical purchase price of the parts is not maintained by the computer system.

The method described in Revenue Procedure 2002-17 applies to a specific group of taxpayers. To qualify, a taxpayer must be engaged in the trade or business of selling vehicle parts at retail and must be authorized by one or more manufacturers or distributors to sell new automobiles or light, medium or heavy trucks. The replacement cost method may be used in conjunction with either the First-in, First-out (FIFO) inventory method or the Last-in, First-out (LIFO) method.

The method authorizes a qualifying taxpayer to "determine the cost of vehicle parts in inventory by reference to the replacement cost of the part[s]…" Replacement cost is defined as the amount provided in a "standard price list" on the date of the dealer's inventory. The price list must be one that is widely recognized, used for business purposes in the industry, and used by the dealer to purchase vehicle parts. In addition, a dealership that elects the Replacement Cost Method must satisfy the conformity requirement and use the method for financial reports and tax.

Changing to the Method

Qualifying dealers that are using the replacement cost method described in Revenue Procedure 2002-17 on March 12, 2002 may continue to use the safe harbor method without filing a Form 3115, Application for Change in Method of Accounting. The revenue procedure also provides audit protection for years ending before December 31, 2001. If the dealer is under examination and the issue is currently under consideration, the revenue procedure mandates that the issue will not be pursued.

Dealers that are not using the replacement cost method on March 12, 2002 must follow the automatic change provisions of Revenue Procedure 2002-9 with certain modifications. Modifications include making the change on a cut-off basis, i.e. without a §481(a) adjustment. Dealers that comply with the election requirements will receive

audit protection, with respect to the method of determining the cost of parts, for any tax year prior to the year of change.

In addition to normal recordkeeping requirements supporting all aspects of its inventory valuation, dealers electing the Replacement Cost Method must maintain copies of the price lists used in the applying the method.

Conclusion

The Replacement Cost Method provided in Revenue Procedure 2002-17 provides clear guidance for franchised automobile dealers and resolves a long-standing issue in the industry without imposing significant additional burden on the dealerships.

Parts inventory should include properly valued cores and "obsolete" parts in which the taxpayer retains dominion and control, but has written down or written off. If the dealership writes down used car or parts inventories year after year, a further examination of the yearend inventory sheet is required. Yearend write-downs are subject to compliance with Treas. Reg. sections 1.471-2 and 1.471-4 and the *Thor Power Tool* case.

Issue:
Valuation of Parts, Valuation of CORES inventory

Documents to Request:

1. Form 3115
2. Parts Price List
3. Schedule of Obsolete and Cores inventory
4. Request Supplier List of CORES
5. Invoice price adjusted, as appropriate, for discounts, freight costs, and other direct and indirect costs properly allocable to the cores.
6. If the core was acquired from a core supplier or broker, the invoice price is the amount paid to the core supplier or broker.
7. If the core was acquired from a customer, the invoice price is the sum of any credit allowed to the customer and any amount paid to the customer.

Audit Techniques

1. Review Form 3115 for conformity to Rev. Proc. 2002-17
2. Review the procedures for Coordinated Issue on CORES
   See LMSB website:
   http://lmsb.irs.gov/hq/pftg/motor_vehicle/coordinated_issues.htm
3. Review Form 3115 for conformity to Revenue Proc 2003-10
   (item #3 is effective for tax years after 12/31/2002).

4. ***Loans to and from Shareholders***

Refer to the MSSP Guide Shareholder Loans on the website address:
http://ftp.fedworld.gov/pub/irs-mssp/a8shloan.pdf

The corporate balance sheet should be reviewed for the existence of loan accounts either to or from the shareholder. However, when balance sheet for shareholder loan accounts has no entry this does not mean there are no outstanding loan balances. In several cases, it was noted the shareholder loans were included in asset and liability (primarily other current liabilities) accounts other then the normal loans to and from shareholder account. This is why tax classification is so important. Thus, during the initial interview the agent should inquire as to the existence of loans and the taxpayer's policies with respect to the loan, repayments, interest rates, and collateral.

Once the existence of a shareholder loan is established, the concern is whether the loans are arms length transactions (i.e. length of loan, interest rate, etc.). The shareholder could be receiving an interest free loan or they may be taking money out of the company tax free, through forgiveness of the loans by the corporation at a later date. Therefore, the agent should request copies of the loan documents. If loan documents exist, they will show the terms, which the agent can then validate. If loan documents are not available, the agent should review the corporate minutes for a possible mention of and the details of the loans.

In regard to interest generated by a loan from shareholder, the agent must inspect the payables accounts and interest expense account for a possible deduction of the interest owed by the corporation of which the shareholder has not been paid. IRC section 267(a)(2) states the corporation and the shareholder (who holds a greater than 50 percent interest in the company either directly or by attribution) will be put on the same basis of accounting, usually cash basis, to determine when a deduction is allowed, even though one is an accrual basis taxpayer and the other is cash basis. In simpler terms, the corporation will be allowed a deduction when the interest is paid, not when it is accrued. However if the corporation has accrued the expense, inspect the Schedule M-1 to determine whether the amount has been backed out for tax purposes. To illustrate this point consider the following example:

> A corporate taxpayer has a tax year ending in June. The corporation accrued and deducted $125,000 as interest expense, which was related to a shareholder loan. The corporation had only paid $75,000 before its yearend and paid the remaining $50,000 in December. Even though the shareholder is required to include the full $125,000 in his calendar tax year, the corporation is not allowed a deduction for the accrual of $50,000 until such time as it is paid. Timing adjustments, such as this, should be considered and made.

a. Demand Loans

Often times, the loans between the taxpayer and its shareholder will be demand loans in lieu of formal loans with a stated rate of interest and repayment

period. In the case of demand loans, special rules apply under IRC section 7872. IRC section 7872(f)(5) defines a demand loan as "any loan which is payable in full at any time on the demand of the lender" and is not necessarily "in lieu of formal loans." The foregone interest on such below-market interest rate loans is treated as transferred from the lender to the borrower as of the last day of the calendar year and re-transferred immediately from the borrower to the lender as interest. There is a $10,000 *de minimis* exception for compensation-related and corporate-shareholder loans that do not have tax avoidance as one of the principal purposes. See IRC section 7872(c)(3).

When a corporation makes interest free (or low interest) loans to its shareholders, the shareholders' family members, or other related parties the constructive ownership rules of IRC section 267(c) apply per Treas. Reg. section 1.7872-4(d)(2)(ii).

1) The shareholder has received a constructive dividend in the amount of the foregone interest to the extent of earnings and profits.
2) The corporation is treated as having received a like amount of interest income.
3) After the 1990 year, the shareholder will be allowed a deduction for the interest deemed paid to the corporation only if the shareholder can demonstrate the expense is other than a personal expense.

If the corporate loan is made to an employee, who is unrelated to the shareholder as discussed in IRC section 267(c), the scenario is similar except:

(a) The foregone interest is characterized as additional compensation to the employee.
(b) The corporation has deemed interest income in a like amount.
(c) The corporation can deduct the amount as compensation, subject to reasonable compensation limits. IRC section 7872(f)(9) specifically states that the amount of additional compensation flowing to an employee from a compensation-related below-market loan is not subject to income tax withholding. Such compensation is subject to FICA and FUTA employment taxes (Conference Committee Report on P.L. 98-369). Even though income tax withholding is not required, payments must be reported under the appropriate information provision.
(d) After the 1990 year, the employee will only be allowed a deduction

ii. for the interest deemed paid to the corporation if the employee can demonstrate the expense is not a personal expense.

Although the transfer of taxable income between parties may appear to be offsetting, there can be significant tax impact in the reallocation, depending on the relative tax brackets of the borrower and lender and the deductibility of the interest deemed paid.

The regulations contain detailed instructions for computing the interest imputed on interest free and below-market rate loans using published federal rates. A simplified method is available for use in imputing interest on loans of $250,000 or less. Rev. Rul. 86-17 provides for the use of a "blended annual rate" to simplify the computation of the amount of foregone interest. There is no threshold dollar amount.

Despite the fact the computation may seem somewhat tedious at first, adjustments can be substantial and are required by law.

5. ***Fixed Assets and Real Estate (Building & Equipment)***

In an auto dealership, it is common for the dealership to rent the land and building from a related entity. When this occurs, building and equipment will not be one of the larger balance sheet accounts. The main issue is if the amount of the rent paid for the property by the dealership to the related entity is at arms-length. Fair Rental Value must be considered to determine excessive rent on a potential constructive dividend issue.

Subsequent to a reconciliation of the building and equipment items, the agent may wish to further look at:

a. Large, unusual, or questionable items
b. Like-kind exchanges
c. Potentially personal items
d. "Imaging Payments"

Manufacturers may reimburse dealers for a portion of the costs to renovate and/or relocate their stores. Taxpayers may be excluding these "imaging payments" from income as a contribution to capital. In *John B. White, Inc.*, 458 F.2d 989 (1972), *aff'g* 55 T.C. 729 (1971), the court ruled that the payment was includable in income.

e. consider §469 when the dealership leases the building and land from the shareholder. The rent is recharacterized as Nonpassive, Regs. 1.469-2(f)(6). Review the Passive Activity Rules in the website: http://abusiveshelter.web.irs.gov/pal/selfrent.htm

6. ***Accounts Payable, Other Current Liabilities and Other Liabilities***

When auditing a payable account, the agent may wish to focus on the year-end balances. By doing so, the agent will be able to verify that the taxpayer has not expensed items not meeting the conditions of IRC section 461(h), Treas. Reg. section 1.461-1(a)(2), or IRC section 162:

a. The liability must exist
b. The liability can be reasonably determined
c. Economic performance has occurred
d. The expense is ordinary and necessary
e. Expense is directly related to business.

Audit Techniques:

1. Review balances due to officer's and shareholder's; ascertain business purpose, trace to the corporate minutes, if material.
2. Look for liability amounts owed to other related entities.
3. Customer deposits is one liability account that dealerships may show as either a contra account receivable or a payable. It represents cash advances received for sales where delivery of the vehicle(s) has not yet occurred.
4. Reserves: A dealership may establish reserves for many contingent and uncertain losses. These should be expensed for tax purposes only when economic performance occurs and not when estimated. For book purposes however, reserves may be proper for such things as service contract losses, repossession losses, and potential bad debts.
5. Transfer of funds. These are which the dealership collects but must send to governmental agencies such as sales tax, luxury tax, and Department of Motor Vehicle (DMV) fees.

7. ***Capital Stock/Capital Account***

It is common for auto dealerships to be controlled by family members. They tend to be family ventures that may pass from generation to generation and may expand to incorporate several dealerships in different areas. Possible issues include the transfer of ownership between family members. These transfers should be examined to ensure that gift tax or capital gain tax was properly reported.

Flow through entities should be analyzed with their related Forms 1040 to determine that Forms K-1 match ownership percentages and those individuals are not mistakenly considering active income as passive or visa versa.

Although a stock certificate book and corporate minutes are helpful in developing capital issues, the most important facts come from the related returns and interviews of the taxpayers involved.

8. *Retained Earnings*

Auto dealerships tend to expand and therefore issues such as Accumulated Earnings Tax (IRC section 531) are not usually applicable. If the balance sheet of the corporation leads an agent to consider this issue the agent should gather the information necessary for using the Bardahl formula early in the examination including:

a. Planned expansion
b. Operating ratios
c. Amount of liquid assets and retained earnings.

9. ***Conclusion***

A balance sheet audit is valuable and necessary, as it not only provides information for many possible issues, but also familiarizes the agent with the structure and nature of the taxpayer's books and records, which although somewhat standardized in the auto industry, always tends to differ from one taxpayer to the next. Reconciliation and scrutinization of large, unusual or questionable items is the key to an effective and efficient balance sheet audit.

Chapter 4
Inventory

Automobile dealerships have a great deal of discretion in what accounting methods they will employ for various classes of their inventoried items. Whatever method the taxpayer chooses, it must clearly reflect income. If there is confidence in the taxpayer's books and records, the scope of the inquiry into inventory can be narrowed, allowing the agent to dedicate audit resources to specific examination techniques:

1. Make sure everything that should be inventoried is included in an inventory account.
2. Verify that an allowable method is being used.
3. Scrutinize any adjustments made to inventory accounts.

Auto dealerships typically maintain distinct inventories and tend to account for them differently. Among the types of inventoried items are:

1. New vehicles
2. Used vehicles
3. Parts and Accessories

The methods used for valuing and accounting for these classes of items do differ from dealership to dealership but are generally directed by the size of the firm. We can look at inventory issues as falling into one of three categories:

Used Car Dealerships

The smaller "lots" usually do not wish to invest the time, energy, and financial resources into a complex inventory system. They tend to use Lower of Cost or Market (LCM) to value vehicles and do not maintain any other inventories. At yearend, a valuation guide may be used to value the automobiles on an individual basis using 100 percent of the average wholesale valuation quote. The dealership then determines an ending inventory adjustment for the year. (See Rev. Rul. 67-107 and Treas. Reg. section 1.471.4)

Smaller New Vehicle Dealerships

This middle class of dealerships may employ any range of inventory techniques with little consistency among them. The dealerships range from small low volume motorcycle shops to medium sized multi-vehicle type lots. Here it is important to make sure that all items that should be inventoried are being correctly accounted for. It is not uncommon for a dealer of this size to inventory vehicles and expense parts and accessories. In any case, the method of valuation should be determined and inventory physically observed. The agent should determine the actual physical inventory, compare it to the amount shown on the tax return and make an adjustment for the difference.

Large Multi-Entity Dealerships
For tax purposes, the large dealerships may use LIFO for new vehicles, used vehicles, and parts and accessories with profit center costing allocations. They often have related used car and truck ventures, usually resulting from trade-ins for new vehicles sold. These trade-ins may be accounted for under the LCM method discussed previously. Certain items are accounted for under the specific identification method due to rarity, such as repossessions. The lower of cost of market can be used for these items under the rules discussed for used vehicles. It is recommended that all inventories be scrutinized as they have a material impact on taxable income and could be valued incorrectly.

The various methods of inventory valuation and the authority for utilizing them are:

1. First-in, First-out (FIFO), Treas. Reg. section 1.471-2(d)(2)
2. Lower of Cost or Market (LCM), Treas. Reg. section 1.471-2(c)
3. Specific Identification, Treas. Reg. section 1.471-3
4. Last-in, First-out (LIFO), Treas. Reg. section 1.472

FIFO is only advantageous in a deflationary economy, and historically the United States economy has exhibited inflationary tendencies, therefore it is improbable an auto dealership would use the FIFO method of inventory valuation. LCM on the other hand, offers an attractive method for handling used vehicles since their value at the end of the year may be less. Most, if not all, dealerships use specific identification for the inventory value of new vehicles for book purposes. This is based on the actual flow of goods. FIFO is an assumed flow of goods and is different from specific identification (cost or LCM) or LIFO. They may not use FIFO for vehicle inventory since the vehicles can be identified with specific invoices.

Lastly, LIFO, given the inflationary nature of the United States economy, is attractive to auto dealers and is frequently the inventory valuation method of choice. Full consideration of this topic demands a working knowledge of the rules and procedures governing it.

LIFO Background
Overview of the Method
A large problem area concerning the examination of auto dealerships occurs where the LIFO method of inventory valuation is used. This has been a problem due to the technical complexity of the method coupled with the volumes of records that must be examined to determine whether there is compliance. Auto dealerships elect the LIFO method because the benefits offered outweigh the negative aspects of its use for most. During inflationary times taxes are deferred by changing the flow of costing inventory through a sequence of valuation steps.

The last costs incurred are placed into the cost of sales and the earliest costs are retained as inventory (layers). This means that units in ending inventory are

valued at the oldest unit costs available and units in cost of goods sold are valued at the newest unit costs available. Accordingly, the LIFO method of valuation reverses the normal (assumed) flow of costs reflected in the FIFO (cost) method. LIFO is merely removing inflation from ending inventory and expensing it as part of the cost of goods sold.

When comparing the flow of LIFO costs to the flow of FIFO costs, we see that FIFO charges the cost of inventory items to cost of sales in the order of their acquisition. The cost of the inventory on the balance sheet under the FIFO method more clearly reflects the replacement cost than does the LIFO method. Under the FIFO method, when inventory is sold and then replaced at a higher cost, the difference between the inventories' selling price and the replacement cost, causes recognition of a phantom profit and fails in an economic sense to provide the best matching of costs and revenues.

The LIFO approach attempts to match the most recent costs of purchases from the computation of inventory costs. Where LIFO is used, if prices increase, a deferral of taxes will result and profits are decreased. The later higher costs are charged to costs of sales and earlier lower costs remain in inventory. This means inventory costs are removed in the reverse order of their acquisition.

The difference between the LIFO and non-LIFO inventory values is called the LIFO Reserve. The LIFO reserve represents the inflation that has been deducted through increasing Cost of Goods Sold, which results in lower taxes. It is important to note that the reserve must be brought back into income at some future date. The reserve is only a temporary deferral, not a permanent one; a timing difference. To better understand LIFO concepts, see, *Amity Leather Products Co.* v. *Commissioner*, 82 T.C. 726 (1984), *Hamilton Industries, Inc., Successor of Mayline Company, Inc. and Subsidiary* v. *Commissioner*, 97 T.C. 120 (1991), and *Fox Chevrolet, Inc. (Maryland)* v. *Commissioner*, 76 T.C. 708 (1981).
LIFO has taken on complexity that may or may not have been intended. To appreciate the problems associated with the election by automobile dealers to value their inventories using this method, we may want to see where this complexity began and have an understanding of problems present today.

Origins of the Method
Prior to 1939, taxpayers were only allowed to use the specific identification and the FIFO methods of inventory valuation. Taxpayer litigation seeking permission to use a LIFO forerunner was fruitless to this point. See *Lucas* v. *Kansas City Structural Steel Company*, 281 U.S. 264 (1930).

The Revenue Act of 1939 extended the privilege to use the LIFO method to all taxpayers. Along with the privilege of using LIFO for tax purposes, the 1939 Act also instituted a strict financial reporting conformity requirement.

Regulations issued pursuant to the 1939 Act indicated that the use of LIFO would only be allowed to taxpayers with few basic fungible commodities that could be measured in terms of common units, such as tons, yards, barrels, etc. As a result of the limitations imposed, the "specific goods" or unit LIFO method was the only official method authorized.

Under the specific goods method, taxpayers with diverse and non-homogeneous inventories, such as motor vehicles, could not, as a practical matter, use the specific unit method. Taxpayers with such non-fungible inventories were, in effect, denied the use of the LIFO method of accounting.

The Revenue Act of 1942 made two major changes to the LIFO method of accounting. First, the reporting requirement mandated in the 1939 Act was burdensome. It applied to all financial reports. Congress relaxed the requirement by limiting its application to annual reports.

Second, prior to this Act, as stated above, the specific unit method was the only allowable LIFO method. At this time a concept was introduced using a method which measured changes in inventory investment pools by reference to standard base year dollars and inflation indices relating back to the base year dollars. This dollar value method introduced a significant concept, which is referred to as "pooling," which considers a grouping of items within a product line. The 1942 Act authorized limited application of the dollar value method. In 1949, the LIFO regulations were amended permitting all taxpayers to use the dollar value method. See T.D. 5756, 1949-2 C.B. 21.

In 1961, final dollar value regulations were issued. These remained virtually unchanged until 1981. In the Economic Recovery Act of 1981, Congress enacted a number of provisions designed to simplify the LIFO method and make it more accessible to small businesses. See IRC section 472(f), allowing use of certain external indices the producer price index (PPI) and the consumer price index (CPI); IRC section 474 providing a simplified dollar value LIFO method, also known as the IPI Method, applicable to certain small businesses.

A Short History of LIFO Applications: Auto Dealership LIFO and the IRS

LIFO gained widespread acceptance by automobile dealers in the early 1970s as a result of sharp increases in automobile prices. However, the complexities of the application of dollar value LIFO concepts to the inventories of auto dealerships proved to be difficult to work with not only for automobile dealers but also for practitioners and revenue agents for both technical and practical reasons.

Problems computing dollar value LIFO for the auto dealership industry revolved around two concepts, averaging within submodels and assigning inflation to new vehicles.

A method used by many dealerships defined an item of inventory as the "make," model or sub-model. As quality increased, less expensive vehicles were replaced with more expensive vehicle. By averaging within submodels, higher priced vehicles would be grouped with lower priced vehicle. Though these groupings entailed working within the same model group, this comparison of dissimilar submodels produces an index higher than that attainable by comparing the higher priced submodel vehicles to other like kind higher priced submodel vehicles and lower priced submodel vehicles to other like kind lower priced submodel vehicles.

The following example is offered to illustrate the preceding paragraph:

1. Averaging Within Submodels

Corolla	**1985**	**1986**	
1702	5,967	6,319	50,941 / 48,959= 1.041
1703	6,285	6,654	
1712	6,190	6,543	
1787	7,352	7,669	
1795	7,060	7,360	
1788	7,950	8,121	
1798	8,155	8,275	
		48,959	50,941

2. Correct Submodel Cost Extension

Corolla	**Unit End Inv**	**1985 Cost**	**1985 Extended 1986**	**1986 Cost**	**1986 Extended**	
1702	1	5,967	5,967	6,319	6,319	860,222 / 835,077
1703	2	6,285	12,570	6,654	13,308	= 1.030
1712	1	6,190	6,190	6,543	6,543	
1787	25	7,352	183,800	7,669	191,725	
1795	26	7,060	183,560	7,360	191,360	
1788	27	7,950	214,650	8,121	219,267	
1798	28	8,155	228,340	8,275	231,700	
	110		835,077		860,222	

Example 1. "Averaging Within Submodels" does not consider actual numbers of units in ending inventory, but only considers the average of specific submodel ranges. The "Correct Submodel Extension" example considers items in ending inventory.

Consider an ending inventory of $2 million. A dealership with only 200 vehicles in ending inventory with a value of $10,000 each would have a $2,000,000 inventory. The difference between application of an index of 1.04 and 1.03 to this inventory is $20,000. ($2,000,000 x 1.04 is 2,080,000; $2,000,000 x 1.03 is $2,060,000.) As an addition to the reserve, this would produce a deferral of the tax on $20,000. As a decrease to gross profit, this would produce a $20,000 cost

of goods sold deduction. This example was rather basic and involved only one sub model group. In practice, the results produced by averaging within many sub model groups becomes increasingly material with higher indices using this method.

Another area of concern was that some dealers were comparing newly introduced models to existing items. A new vehicle has no item that preceded it to which a comparison in measuring years could be made to determine inflation. Therefore, a new vehicle should receive no inflation or an index of 1.000. Another issue was that some dealers did not construct the cost of a new vehicle as required by the regulations.

In some instances new items entering inventory were receiving improper inflation through "reconstructions" of supposed like kind vehicles. In some cases, there was no vehicle that previously existed which could be compared to a new vehicle. Such comparisons known as "reconstructions” could produce higher indices, thus a higher deferral in the reserve and an increased annual cost of goods sold deduction.

There were other problems, including a lack of adequate record retention. Some dealers were not maintaining records, as mandated by the regulations, which would enable the Service to determine the level of dealership compliance.

An additional problem concerning the computation of option indices was encountered. The Link Chain Method envisions accounting for each item in ending inventory. Once the items in ending inventory are determined, each item needs to be priced and inflation assigned to it. LIFO contemplates two methods of costing or pricing items in ending inventory. One of these pricing methods would be elected on the dealers Form 970. Pricing entails going back 1 year under the Latest Acquisitions Method or 2 years under the Earliest Acquisitions Method.

Application of these methods of costing encompasses the following analysis. If there were 300 vehicles in ending inventory for a particular year, those invoices needed to be secured. It is not uncommon for a midsize dealership to have this volume in ending inventory. The invoices were scheduled and a determination was made that they represent the items in ending inventory. Once this was done, each vehicle was listed showing the current year price and the price for this same item in the preceding year or years, if it was in existence. Doing this with 300 vehicles was cumbersome, but workable. Such was not the case concerning options.

Some domestic vehicles listed almost everything as an option. It was not uncommon for the invoices associated with these domestic vehicles to have 10, or more, options per vehicle. Each option needed specific pricing for the necessary measuring years, just as the vehicles did. Foreign vehicles were

better, but not much. Invoices utilized for a particular manufacturer at this time showed about 5 options per vehicle.

The domestic vehicles and associated options for the ending inventory cited above would require individualized accounting and pricing for approximately 3,300 items for each year of the LIFO election using the Latest Acquisitions Method. The number of accounting and pricing requirements would double if the Earliest Acquisitions Method was used. The foreign vehicles cited above would require pricing for approximately 1,800 items under the Latest Acquisitions Method and 3,600 under the Earliest Acquisitions Method for each year of the LIFO election. Some of the cases being worked at this time had 10 years or more of LIFO indices that required individualized accounting and pricing of each item in those ending inventories.

Statistical sampling was contemplated, but deemed not appropriate for two reasons. First, the pure Link Chain Method contemplated actual pricing of each item in ending inventory. Second, the dealers would not allow the Service to perform a statistical sample, although many used one themselves. They wanted the Service to price every item if their indices were going to be challenged knowing this was very difficult, if not impractical.

A solution to this unseemly situation was developed. Working these cases, it was found that options involved "about 10 percent of the dollar value and 90 percent of the work." It was found that by determining the index on vehicles in ending inventory and applying this index to the dollar value of the options, in ending inventory, the differences between the actual option calculation and this simplified method was *de minimis*. If allowed to proceed with this method, 90 percent of the work could be eliminated and an accurate LIFO index could be computed. This simplified method proved to be quite effective where adequate records were maintained and workable where there were few or no records.

To address these complexities and to provide a workable system to compute automobile LIFO, Rev. Proc. 92-79, superceded by Rev. Proc. 97-36, was issued. This provided a methodology for computing Alternative LIFO for new cars and new light duty trucks. In 2001 Rev. Proc. 2001-23 was issued providing the industry with the Used Vehicle Alternative LIFO Method.

Rev. Proc. 97-36 allows the auto dealer to compute indices by using a simplified method. The computations were to be arrived at using base to base pricing, comparing vehicles to vehicles, and applying the resulting index to the dollar value of the full inventory. There is no requirement to provide a separate accounting and pricing for options. More on Rev. Proc. 97-36 later in this section.

The agent who is considering addressing auto dealership LIFO computations for dealers who have not elected Rev. Proc. 97-36, must be cognizant of the "Definition of an Item" coordinated issue which requires inflation analysis for

specific components of manufacturers option packages. A copy of this coordinated issue is included in the Appendix of this ATG.

Some dealerships may have filed a Form 3115 under Rev. Proc. 97-27 to change their computation method. Others may prefer to wait until they are examined and file a Form 3115 in the first 90 days of the examination.

Chapter 5
Computing LIFO: Pre Revenue Procedure 97-36

Introduction
The information that follows concerns dollar value LIFO computations using the conventional definition of an item, including full comparability of items. This section also applies to an auto dealership that was eligible to elect 97-36 and did not exercise that election. A separate section discussing "Alternative LIFO," as defined in Rev. Procs. 92-79, 97-36 and 2001-23 is found later in this ATG.

This information focuses on the application of LIFO to new vehicles in ending inventory. The application of LIFO to used cars and parts is similar.

The information that follows is an attempt to explain the basic concepts of LIFO. This compendium not only addresses the technical principles to apply, but provides an in-depth case study featuring precise computations and definitions of what is being computed. It is our wish to make the revenue agent comfortable with these concepts so they will have the necessary confidence to complete this issue that may arise during an auto dealership examination.

LIFO Concepts
This section is arranged in a question and answer format addressing issues most often encountered in this area.

1. Why do we need to compute LIFO indices?
   We need to compute LIFO indices to determine the annual reserve increment (or decrement) known as the LIFO layer. This amount is added to or subtracted from the reserve on an annual basis. The LIFO reserve is the difference between the LIFO valuation of ending inventory and its non-LIFO (i.e. first-in, first-out, specific identification or average cost) valuation. By computing the annual index we can determine this inflationary rate, which is added to the non-LIFO value. The result of inflation being added to ending inventory creates the layer that adds to the reserve balance and increases the current year cost of goods sold deduction. The reserve balance creates a tax deferral for the dealership.

2. How do we measure the value of LIFO inventories?
   There are two methods: the Unit Method (also known as the Specific Goods Method) and the Dollar Value Method.

   The unit method is used where an inventory consists of specific items or goods that may be considered fungible. This method measures inventory changes in quantity of items. The unit method is rarely used by the auto dealership industry.

   The dollar value method measures inventory changes in terms of dollars instead of in terms of changes in quantity of items. This method is properly used when measuring an inventory that contains similar specific items such as vehicles. This

method groups items into separate pools. See Treas. Reg. section 1.472-8. Most auto dealerships use the dollar value method.

3. What are the Dollar Value methods of pricing a LIFO inventory?
   Treas. Reg. section 1.472-8(e)(1) states there are four:
   - Double Extension Method
   - Link Chain Method
   - Index Method
   - Retail Method (not discussed at this time)

   Whatever method is used must consistently and clearly reflect the income of the taxpayer. See IRC section 446(b). The dollar value method of valuing LIFO inventories is a method of determining cost by using "base year" cost expressed in terms of total dollars rather than quantity and price of specific goods as a unit of measurement. See Treas. Reg. section 1.472-8.

   This Guide will primarily focus on the Link Chain Method and touch upon the Double Extension Method because these methods are more commonly elected by auto dealers to value their inventories. The index method has not been encountered in an auto dealership setting, but is mentioned because it is an acceptable method that may be used. The retail method is technically an acceptable method to use, but it would be unlikely to be encountered because it uses external indexes that may produce indices significantly lower than those the auto dealer can generate internally.

a. Double Extension Method

Under the double extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended (priced) at both base year unit cost and current year unit cost. (Pools are discussed below.) The respective extensions (pricing) of the two costs are each totaled. The first total gives the amount of such inventory in terms of current year costs. (See below, for a discussion of determining current year costs). The second total gives the amount of such inventory expressed in base year costs.

Under the double extension method, a base year cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base year unit cost of the entering item shall be the current year cost of that item, unless the taxpayer is able to reconstruct or otherwise establish a different cost.

The double extension index formula is as follows:

$$\text{Index} = \frac{\text{Current year quantity (CYQ) x Current year costs (CYC)}}{\text{Current year quantity (CYQ) x Base year costs (BYC)}}$$

b. Link Chain Method

The link chain method is a cumulative index that considers all annual indices dating back to the year of election. It is used to restate current year inventory to base year costs. This cumulative index is also used to value increments of base year cost when they occur.

This cumulative index is called the link chain method because it is derived by a multiplication process that involves the "linking" of annual indices back to base year. For example, if the year of the LIFO election is 1991, and the current year is 1993, the 1993 link chain index is computed as follows:

1991 index times 1992 index times 1993 index = 1993 cumulative link chain index.

c. Index Method

Under the index method, indices are developed by double extending a representative portion of inventory in a LIFO pool or by using other sound and consistent statistical methods. The formula for calculating the sample index is identical to the one used in the double extension method.

In order to determine total base year costs, total current year cost is divided by a weighted average index derived for the sample. This calculation technique is necessary because the index method does not double extend the entire current year inventory. This index is also used to value increments.

The dollar value indices determined under the double extension and index methods measure inflation from "day 1" of the LIFO election, through the current year.

The annual inflation index is determined according to this formula:

$$\text{Index} = \frac{\text{End of year quantity (EQ) x End of year costs (EC)}}{\text{End of year quantity (EQ) x Beginning of year cost (BC)}}$$

4. How does reconstruction of base year costs affect Dollar Value pricing?
   The double extension method is the "preferred method" to compute base year costs as stated in Treas. Reg. section 1.472-8(e)(1). However, in the auto dealership context, using the double extension method to reconstruct base year costs raises concerns and hence is more susceptible to error than other known methods.

   LIFO - Reconstruction of New Item Cost

   Treas. Reg. section 1.472-8(e)(2) states in part; "Double-extension method. —(i) Under the double-extension method the *quantity of each item* in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost (emphasis added)."

   Under the double-extension method a base-year unit cost must be ascertained for new items entering a pool for the first time. The base-year unit cost of the new item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost.

   If the new item is a product or raw material *not in existence* on the base date, its cost may be reconstructed, that is, the taxpayer *using reasonable means* may determine what the cost of the item would have been had it been in existence in the base-year. If the item was in existence on the base date but not stocked by the taxpayer, he or she may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he or she stocked the item.

   If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base-year, he or she may use the earliest cost which he or she does reconstruct or establish as the base-year unit cost.

   It is clear from the language used in the regulations that this issue is highly factual. The regulations state the taxpayer "using *reasonable means* may determine what the cost of an item would have been had it been in existence in the base year."

   The regulations place the burden of reconstruction on the taxpayer by creating a presumption that base-year cost equals current-year cost for new items unless the taxpayer can demonstrate otherwise. This burden should not be taken lightly. The Supreme Court, in *Burnet* v. *Houston*, 283 U.S. 223 (1931) stated, "The impossibility of proving a material fact upon which the

right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof."

A number of techniques have been developed to make reconstruction easier. One technique is to elect the link-chain method. This method, which has generally been permitted, substantially reduces the task of reconstruction. This is so, because reconstructed costs only have to be established as of the beginning of the current year and generally there will be fewer completely new items.

Another technique used is to broadly define the inventory item. If a car dealer treats all cars as one item, there would probably never be a new item in the car pool.

The technique probably used most often is to develop an index for comparable items and then use that index to determine the base-year cost (beginning of the year cost for a link-chain taxpayer) for new items. Whether or not this reconstruction technique is reasonable has been the subject of two recent private letter rulings.

Chief Counsel recently commented on retail automobile dealerships with essentially the same facts and arguments. Each dealership had reconstructed the beginning-of-the-year costs of new vehicles in ending inventory utilizing an index derived only from comparable vehicles. The dealers argued they had used a reasonable method of reconstruction because the cost increases for comparable vehicles should be used as a guide for the new vehicles. They stated that it would be reasonable to assume that non-comparables (new vehicles) would have increased in price at the same rate as other vehicles produced by that same manufacturer. The same administrative staff, raw material suppliers, union contracts, and depreciation schedules, etc., would influence the price of both comparables and non-comparables. One dealer argued that a new vehicle as a percentage of the total inventory was not material and therefore, it had double-extended a representative portion of its inventory. The facts showed that comparable vehicles represented anywhere from 73 to 100 percent of the value of the vehicles in the various pools and years.

The National Office defines "comparables" as items that exist in both beginning and ending inventory. Non-comparables are items that only exist in the ending inventory.

The National Office concluded that the reconstruction methods used by these dealers were not reasonable and provided the following reasons:

1. Comparable and non-comparable vehicles may vary in their characteristics and costs.
2. This method is not supported by the regulations. It is inappropriate to apply an index derived from one subset of items in a pool to another subset of items. An index computed that excludes new models does not clearly reflect income.
3. The method has the potential to produce distortions in the dollar-value computations. These inaccuracies would then cause distortions in computations in subsequent years due to the use of the link-chain method.
4. Even if a dealer could substantiate its claim that the effect of inflation on comparable vehicles is reflective of the effect on non-comparable vehicles, there is no reasonable assurance that this relationship would continue in the future.
5. A price index for a dollar-value LIFO pool must be computed based on all the items in ending inventory for that pool.

The National Office stated, "Whether a taxpayer's particular method is reasonable is a determination that should be left to the district director because such a determination requires a *facts-and-circumstances analysis* [emphasis added]."

In a PLR the National Office stated "A taxpayer's method of reconstruction should be considered reasonable if the taxpayer can demonstrate that the method used is an accurate measure of what the rate of inflation would have been had the new item been in existence in the prior year, or had the item been stocked by the taxpayer in the prior year. For example, had X used an index derived from a portion of its vehicles in ending inventory that X could demonstrate were comparable to a particular new model, application of that index to derive a reconstructed beginning-of-the-year cost for that new model should be acceptable."

If the taxpayer's method of reconstruction is an issue, develop the issue by first determining how the taxpayer computes its index for new items. Consider following these steps;

1. ınterview the individual(s) who did the LIFO computations and ask them how they handled new items. If the method used does not appear to be reasonable you need more information.
2. Submit an Information Document Request for either a list of the new items or an identification of the new items on the double-extension schedules or inventory records.

3. Request the taxpayer to identify new items that existed in the base year (beginning of the year for a link-chain method) but were not stocked. Start with the tax years under examination.
4. If items existed but not stocked, the taxpayer should be able to obtain a proper cost either from existing price sheets or from its suppliers. Ask the taxpayer to obtain the cost prices.
5. Give the taxpayer the opportunity to demonstrate that the index derived for an existing item is comparable to a particular new item.
6. For the remaining items that are completely new, ask the taxpayer to either reconstruct the cost using reasonable means or accept the current price as the base or beginning-of-the-year price.
7. Depending on the results of the revised computations for the current year(s) under examination, consider either applying the steps above to prior years or adjusting the prior years using error rates for the current year(s).

Keep in mind that the regulations place the burden of reconstruction squarely upon the taxpayer. It is not the examiner's responsibility to either do the reconstruction or even to do a statistical sample to establish whether or not the taxpayer's short cut method is accurate and reliable. The examiner only has to demonstrate with supporting workpapers using the taxpayer's records (double-extension schedules and inventory listings) that the comparable (existing items) and non-comparable items vary in their characteristics and cost.

Since this is a facts-and-circumstances issue and the taxpayer is allowed to use reasonable means to reconstruct, the examiner should make every effort to resolve this type of issue.

Another issue that has come up in this area is whether a taxpayer may retroactively reconstruct the cost of a new item where the current year cost was used for that item as the base-year cost when the returns were filed. In the particular case where this issue arose, the taxpayer proposed this and requested a large refund during the examination.
How an item is valued would appear to be a method of accounting and any change in how that item is valued would be a change in method of accounting. Treas. Reg. section 1.446-1(e)(2)(ii)(a) states in part, "* * * Changes in method of accounting include * * * a change involving the method or basis used in the valuation of inventories * * *."

A taxpayer in the business of manufacturing diamond rings reconstructed the base-year cost of new diamonds by comparing them to a higher quality diamond. The Service held that the correction of the base-year cost of an item constitutes a change in method of accounting that could only be done prospectively. See IRC section 446 and the corresponding regulations,

Hamilton Industry, Inc., Successor of Mayline Company, Inc. and Subsidiary v. *Commissioner*, 97 T.C. 120 (1991) and Rev. Rul. 90-38, 1990-1 C.B. 57.

5. For Dollar Value LIFO what is the definition of an item?

The next few paragraphs reference the Motor Vehicles Industry Specialization Program's coordinated issue paper "Dollar Value LIFO – Definition of an Item". For more detail please refer to the full text.

An item of inventory is defined, for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method as authorized by Treas. Reg. section 1.472-8, is defined by reference to a particular vehicle as to make, year, model, body style, standard equipment, options, and other factors.

Treas. Reg. section 1.472-8(e)(2)(i) provides that under the double-extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. Under the link-chain method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both the beginning-of-the-year unit cost and the end-of-the-year unit cost. Neither the Code nor the regulations define what constitutes an item.

The tax court in *Wendle Ford Sales, Inc.* v. *Commissioner*, 72 T.C. 447(1979), determined that 1975 Fords with solid-state ignitions and catalytic converters were not new items when compared to 1974 Fords that did not have solid-state ignitions and catalytic converters. The manufacturer determined whether or not a Ford had either of these features. Their cost was never separately stated on the dealer's invoice. The court decided that the entire car was the item and not the individual components or parts.

Vehicles on hand at the end of 2 different taxable year should be compared considering differences in make, year, model, body style, standard equipment, options, and other factors, appropriate adjustments should be made to the cost of the vehicles on hand at the end of the prior taxable year to account for as many of these factors as possible. The prices of all factory-installed options are readily available to distributors and dealers. For body style, standard equipment, options and other features that are available at one point and not another, the adjustment should be based on the stated or implied price when available and factored in as a percentage of the base vehicle cost.

Under full comparability LIFO when a vehicle cannot be compared to a similarly equipped vehicle in the prior year, beginning and ending cost are the same, resulting in an index of 1.00.

Reconstruction is a fundamental issue for all three methods. The base year cost of an item will be the current year cost of the item unless the taxpayer is able to reconstruct or otherwise establish a different cost to the satisfaction of the agent.

If the taxpayer originally elects on their Form 970 the double extension method, but applies the link chain method without requesting permission, the taxpayer has an unauthorized change in accounting method. The taxpayer should recalculate their LIFO by applying the double extension method as originally filed. If the taxpayer wishes to change their method, then a Form 3115 should be filed under the provisions of Rev. Proc. 97-27, 1997-1 C.B 680 (May 8, 1997).

6. How many ways are there to compute a dollar value index?
   There are two general classes of indices, the *internal* and the *external*. The *internal method* generates indexes from information derived and maintained by the dealership. The *external method* indices are taken from the Consumer Price Index (CPI) or the Producer Price Index (PPI).

   These classes of indices should not be confused with different LIFO methods previously discussed. Remember, an index is a subpart of an overall LIFO method tracking the inflation or deflation of a particular item (pool) in ending inventory at a certain yearend.

   The external indices are used with the Inventory Price Index (IPI) Method and are seldom used for two reasons. The Government generated indices are generally lower than those produced internally by the dealers. Second, a dealership or group with gross receipts over $5,000,000 does not qualify, under IRC section 474, and under the IPI method can only take 80 percent (100% after for tax years ending after 12/31/2001 per Treas. Reg. 1.472-8) of the annual change in IPI Method CPI or PPI for the index. The use of the external indices is an election made with the adoption of LIFO or if this represents a change in method, then a Form 3115 should be filed under the provisions of Rev. Proc. 97-27, 1997-1 C.B. 680 (May 8, 1997).

7. What methods can be used to determine the current-year costs that can be used in the index calculations to price units in the yearend inventory?
   The current-year costs that can be used in the index calculations are:

   1. Cost based on the most recent purchases.
   2. Cost based on the average cost of purchases during the year.
   3. Cost based on the earliest acquisitions during the year.

   Remember, each item in the inventory pool at yearend is priced at current-year cost. See Treas. Reg. section 1.472-(2)(i).

In addition to these three methods, the regulations authorize the use of any other proper method that, in the opinion of the Commissioner clearly reflects income. Whatever method is adopted, it must be adhered to in all subsequent years. See Treas. Reg. section 1.472-8(e).

We will focus our concentration on the Earliest Acquisitions Method and the Latest Acquisitions Method (most recent purchases) because these are the most prevalent in the auto dealership industry.

The earliest acquisitions method encompasses pricing the inventory items on hand at the yearend with the actual cost of goods purchased during the taxable year in the order of acquisition. This theoretical position assumes that pricing is being done in chronological order to the actual purchases.

Note, in dollar-value LIFO, the indices are used to ascertain the amount of the LIFO reserve. However, in using the earliest acquisitions method, not only is the index creating the reserve, in addition there is an amount created called a "Hidden Reserve." If we compare the result of the pricing of yearend inventory using the earliest acquisitions method to the general ledger amount of the inventory at yearend, the difference is this additional amount of "reserve." This difference is not obtained in using the most recent purchases method. An example of these comparisons follows:

Example 1
There are 40 units of X in ending inventory that are to be valued at their earliest acquisition cost. Purchases of X during the year were as follows:

Date	Quantity	Amount
1/21	10 @	$2.00
2/15	10 @	2.10
3/25	15 @	2.15
4/08	30 @	2.25
5/10	100 @	2.30
10/11	150 @	2.50
12/10	200 @	2.45

The current year cost of X computed according to the earliest acquisition cost method would be $84.50:

10 x	$2.00	=	$20.00
10 x	2.10	=	21.00
15 x	2.15	=	32.25
05 x	2.25	=	11.25
40			$84.50

In contrast the FIFO amount (cost) = 40 x 2.45 = $98.00

The difference between the current-year cost pricing of the inventory being $84.50 and the FIFO amount of $98 results in a difference of $13.50, which is the "Hidden Reserve" obtained in earliest acquisition without considering the indices. This is an example of the hidden reserve referred to earlier.

If we want to use the most recent purchases (latest acquisition), the current year pricing will equal the amount using the FIFO amount. Therefore, the hidden reserve is not present under this method. Forty units at $2.25 equals $98 which is equal to the FIFO amount.

If an inventory contains a large number of different items, such as with auto dealerships, the pricing procedure just described could involve quite a few calculations and most, if not all, taxpayers do not price all items in their inventory using the earliest acquisition method. For this reason, the theoretical method of pricing ending inventory quantities under LIFO is not used and the taxpayers who elect this method use a shortcut method to determine the earliest acquisition cost. The IRS has not approved any short cut method. See coordinated issue "Segment of Inventory Excluded from the Computation of the LIFO Index."

In practice, using example 1 above, some taxpayers apply the earliest acquisition method of pricing quantities by using the $2 purchase price on January 21 to price all 40 units of X in ending inventory. Current-year costs of X would, therefore, be $80 (40 x $2). Even under this shortcut method a hidden reserve would result in the amount of $18.

In periods of inflation, the earliest acquisition cost generally produces the lowest LIFO inventory value. Use of the latest acquisition cost usually results in the highest LIFO inventory value.

Pooling

Introduction

One of the central points of LIFO valuation is the requirement to compare only like kind items. A unique aspect of the dollar value method is pooling, allowing the dealer to combine like kind items into a group where inflation is computed on these like kind items. If non-comparable items were pooled together there would be a fundamental problem with the indices causing a material distortion of income.

Assuming the dealership elects LIFO for its inventory, under the full comparability LIFO method, a dealer may have a pool for:

- New cars
- New trucks
- Parts
- Used cars

- Used trucks
- Other items such as recreational vehicles

Proper pooling must be determined for each trade or business. Some of the factors Chief Counsel has relied upon are based upon the particular facts and circumstances of the dealership include the following:

1. The dealership is engaged in the same type of activities (i.e., those related to new and used vehicle sales and service).
2. Employees including upper-level management, accounting personnel and administrative personnel can work at other locations, for example, the same employee is the general manager of multiple locations that sell automobiles and the used car manager manages all used vehicle sales for all locations and purchases all used vehicles that are not acquired through trade-in sales.
3. The dealership only has one checking account out of which all payrolls and other expenses are paid. The dealership has one line of credit that is secured by all inventories, regardless of location or manufacturer.

Importance of Pooling

The first and probably the most important problem involved in the dollar-value method is determining the character of the inventory items which may be grouped into a pool. Two pools are required, one for cars and one for trucks. The reason this question is so important is that the goods grouped in one pool are treated as fungible under the dollar-value method. Hence, inventory decreases in one item may be offset by increases in another item contained in the same pool. Under the specific goods method, if you have a quantity increase in an item of inventory, that increase is valued at the cost prevailing for that item in the year of the increase, absolutely separate from any other item in the inventory. Each item retains its own unique history of cost.

Under the dollar-value method, quantity increases or decreases are determined looking at the pool as a whole with the unit of measure the dollar. Treas. Reg. section 1.472-8(a) states in part "* * * new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole." If there is a quantity increase, in terms of dollars, that increase is valued at the cost prevailing for the year of the increase considering all of the items in the pool. Under this concept, historical cost for items decreasing or disappearing can be substituted for the cost of items increasing in quantity or new items entering the pool. This is the major difference between the dollar-value method and the specific goods method. If the pooling requirements were such that a pool had to be established for each item in the inventory, the results under dollar-value would not be much different than under the specific goods method. The results would be more accurate in that historic costs attributable to items liquidated could not be substituted for other items.

The Tax Court in *Fox Chevrolet, Inc.* v. *Commissioner*, 76 T.C. 708 (1981) (a new car and truck dealer with one pool) stated where "* * * a pool of inventory is depleted because sales exceed purchases during the year, the LIFO reserve is invaded and older "historic" costs flow into costs of sales. It is self-evident that *the greater number of pools the greater the likelihood of such a liquidation occurring*. [Emphasis added]." In *Fox Chevrolet* the Service wanted a pool for each model line of new cars. The Court noted that model lines change very rapidly and consequently pools would be liquidated each time a model line was discontinued.

The Tax Court in *Richardson Investments, Inc. and Subsidiaries (Formally known as Rich Ford Sales, Inc.), a New Mexico Corporation* v. *Commissioner*, 76 T.C. 736 (1981) [a new car and truck dealer] stated "[the Service's] 24-pool method, [pools by model line], would, in substance, place petitioner on the specific goods LIFO method."

What is interesting in the Richardson Investment case are the reasons stated why a second pool was required for new trucks. The Court stated:

> [t] he use of two pools would not, as a practical matter, prevent petitioner from employing the dollar-value method. * * *; the two-pool approach succeeds in matching revenues from truck sales with the costs of producing such trucks, and revenues from the sale of cars with the costs of producing such cars. In addition, petitioner's income, for income tax purposes, would be clearly reflected because of this matching of revenues and costs. Thus, the objections found with respect to [the Service's] 24-pool approach and petitioner's 1-pool approach are not applicable to a 2-pool approach. To the contrary, the fundamental purposes of the dollar-value method are enhanced.

Rules for pooling that apply to dealers:

Wholesalers, Retailers, etc.
Treas. Reg. section 1.472-8(c) provides the rules for establishing pools for wholesalers, retailers, jobbers and distributors. Basically they must pool by major lines, types, or classes of goods. In determining such groupings customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. The regulations mention department stores as an example of the customary business classification.

Cases on this part of the law have involved new car and truck dealers, two of which have been noted above. The Tax Court's reasoning in the Richardson Investments, Inc. case brings another factor into the determination of the proper number of pools under this section of the regulations. Near the end of its opinion, the Court stated:

> The two-pool [one for new cars and one for new trucks] approach succeeds in matching revenues from truck sales with the costs of producing such trucks, and revenues from the sale of cars with the costs of producing such cars. In addition, petitioner's income, for income tax purposes, would be clearly reflected because of this matching of revenues and costs. Thus, the objections found with respect to [the Service's] 24-pool approach and petitioner's

> 1-pool approach are not applicable to a 2-pool approach. To the contrary, the *fundamental purposes of the dollar-value method are enhanced*. Therefore, notwithstanding our earlier determination that one pool for new cars and new trucks is the customary business classification, this factor *is outweighed by the clear reflection of income obtained by utilizing two pools.* [emphasis added] See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, (1979).

This passage illustrates why requiring pools for unlike items is appropriate where customary practices are not firmly established.

Inventory Price Index (IPI) Method

Be aware that there are special pooling rules for taxpayers electing to use the Consumer Price Index (CPI) or the Producer Price Index (PPI) method provided for by Treas. Reg. section 1.472-8(e)(3). If the CPI tables are used, pools may be established based on the 11 general categories of consumer goods described in the CPI detailed report. If the PPI tables are used pools may be established based on the 15 general categories of producer goods described in Table 6 of the Producer Prices and Price Indexes. See Rev. Proc. 84-57, superceded by TD 8975, for additional explanations of the pooling requirements for taxpayers who use this method.

Under this method a new car and new truck dealer could have one pool that would include both new cars and new trucks. "Transportation Equipment" is one of the 15 categories. However, not all of a car dealer's inventory falls into this one pool. Car radios, car batteries, metal stampings, tires, and engine components are some examples of dealer inventory that are in another PPI pool.

What constitutes a new item?

Another issue is that of a "new item." In *Wendle Ford Sales, Inc.* v. *Commissioner*, 72 T.C. 447 (1979), the judge alluded to perhaps classifying new vehicles as new items after a period of 5, 10, or 15 years. Auto dealers maintain that technological changes are frequent and revolutionary. A 1995 Ford Thunderbird does not even closely resemble a Thunderbird of the early sixties, for all practical purposes only the name remains the same.

There was a television commercial comparing a 1965 Mustang to a 1995 Mustang. The theme of the commercial stated these cars have the same name, but everything else is new. Therefore, in lieu of everything else, most new vehicle inventory should be reclassified as new items periodically. This reclassification assumes that dealers will not be able to reconstruct the base period cost of the items. This issue would be applicable no matter what LIFO method is used.

Reconstruction is available under both the double extension and link chain methods. For the double extension method, the reconstruction would be for a period from the current year back to the base year. The base year is the year of election. For the link chain method, the period would be from the current year to the prior year only.

The calculation of the current inflation is derived from comparisons within each pool. For the double extension and the index method, the current inflation is derived by dividing the Base Year Cost into the Current Cost and subtracting the cumulative index for the prior year. As for the link chain method the current inflation is derived by taking the Current Cost and dividing by the Beginning of Year Cost.

For a further discussion of the definition of an item, refer to the coordinated issue paper "Dollar Value LIFO-Definition of an Item".

Foundation Principles

IRC section 472(a), in substance, authorizes a taxpayer to elect the LIFO method, provided the method clearly reflects income. A method clearly reflects income only if the method conforms to the regulations prescribed by the Secretary of the Treasury. The LIFO regulations are legislative and carry the full force of law.

To further enhance our understanding, it would be useful to provide a general background of how the LIFO rules are arranged in the regulations. There are eight applicable subparagraphs:

Treas. Reg. section 1.472-1, authorizes the use of the LIFO method and provides general rules for the use of the specific goods method.

Treas. Reg. section 1.472-2, sets forth the requirements incident to the adoption and use of LIFO. A taxpayer adopting LIFO must file an application and specify with "particularity" the goods to which LIFO is to apply. The cost of goods in ending inventories over those in beginning inventories must be valued at a cost that is, at the option of the taxpayer, the most recent, average, or latest acquisition cost. Inventories valued at LIFO must be reported in the same manner for financial purposes. This last rule is frequently referred to as the "conformity requirement."

Treas. Reg. section 1.472-3 provides instructions on the time and manner of making the election. A taxpayer must attach a completed Form 970 or equivalent statement to the tax return for the first year LIFO is adopted. Form 970 provides the Service with detailed information about the LIFO method adopted by the taxpayer. The regulation states that the taxpayer's application to use LIFO is subject to the Commissioner's approval upon examination of the taxpayer's tax return. Audit adjustments are subject to the appellate process.

Treas. Reg. section 1.472-4 states that the taxpayer in electing LIFO agrees to any audit adjustments that the Commissioner might require in order to have the taxpayer's LIFO method clearly reflect income.

Treas. Reg. section 1.472-5 stipulates that the LIFO election is irrevocable unless written permission is secured from the Commissioner.

Treas. Reg. section 1.472-6 provides the inventory methodology a taxpayer must use if permission is received to discontinue the use of LIFO or if the IRS terminates the LIFO election for failure to conform with the LIFO regulations.

Treas. Reg. section 1.472-7 provides cross-references for valuing LIFO inventories of an acquiring corporation. The language in this regulation is identical to the language in Treas. Reg. section 1.471-9. Both of these regulations state that IRC section 381(c)(5) and the regulations thereunder prescribe the rules for valuing inventories acquired in certain corporate reorganizations.

Treas. Reg. section 1.472-8 contains the rules for the use of the dollar value method. These rules are relegated to eight subparagraphs in the regulations. Below is a summary of these eight subparagraphs:

- Paragraph (a) provides for the election of dollar value LIFO and then explains the conceptual basis underlying the method.
- Paragraph (b) contains the pooling rules for taxpayers engaged in manufacturing.
- Paragraph (c) contains the pooling rules for retailers and wholesalers.
- Paragraph (d) reserves for the Commissioner the right to determine the appropriate number and composition of the dollar value pools.
- Paragraph (e) describes and explains the various dollar value methods available to the taxpayer.
- Paragraph (f) prescribes the rules for changing from another LIFO method to dollar value (i.e., from specific goods to dollar value).
- Paragraph (g) sets forth the rules for combining or splitting up dollar value pools.

The LIFO Election

In adopting LIFO, an election must be made to use the method. Such election is not automatically granted. To make the election, the following must be done:

1. Form 970, "Application to Use LIFO Method," or its equivalent must be completed, signed and attached to the return filed for the year of election. Its equivalent means that if the taxpayer does not file a Form 970, but attaches a schedule supplying all the necessary information, the taxpayer will be deemed to be in compliance.
2. A 3-year inventory analysis must be made for any increase in inventory value. Restatement of any other inventory value being used to state actual cost must be disclosed.
3. A statement describing computations and calculation of the index must be made. If electing the Index method, or the use of the Link Chain method is employed, an additional statement with justification must be submitted.

A taxpayer adopting the LIFO method is bound by the election. An amended return cannot be filed to revoke the election. Terminating or modifying the use of an elected LIFO method requires the advance approval of the Commissioner although some changes are automatic under Rev. Proc. 88-15, 1988-1 C.B. 683. Form 3115 should be used to make such changes. A taxpayer terminating LIFO generally cannot re-elect the method for 5 taxable years following the termination. See Rev. Procs. 88-15, 1988-1 C.B. 683 (superceded by RP 97-37, RP 98-60, RP 99-49 and RP 2002-9) and 92-20, 1992-1 C.B. 685, section 9.03(1).

The adoption of LIFO on Form 970 is tentative and is subject to the Commissioners's approval upon audit. See Treas. Reg. section 1.472-3(d). Furthermore, the taxpayer agrees to any adjustments the Commissioner may deem necessary in order to have the elected method clearly reflect income. See Treas. Reg. section 1.472-4.

The LIFO election requires adherence to "conformity requirements" by the taxpayer to maintain its viability which are discussed as follows:

1. Situations that do not warrant termination, but which may cause problems. These situations usually contemplate problems such as computational errors or applications. If a taxpayer elects the double extension method, but applies the link chain method without filing a Form 3115, this does not constitute a termination. The LIFO computations must be recomputed from the time of the election under the double extension method as originally elected.

   There are two methods that a taxpayer can elect on the Form 970, the unit method and the dollar value method. If a taxpayer elects the dollar value method of computing LIFO and is using the unit method or visa versa, without filing a Form 3115, then the taxpayer should be placed on the elected method as reflected on Form 970 from the time of the election of LIFO. See Rev. Proc. 79-23, 1979-1 C.B. 564, 1979.

2. What are the conformity requirements?
   IRC section 472(c) states a taxpayer on the LIFO method for tax purposes must also use the same method for financial reporting. The application of this section primarily concerns statements affecting a full year's operation, whether the same as the taxable year or any other 12 month period.

   No violation occurs if the taxpayer issues non LIFO reports or credit statements covering a period of operations that is less than the whole of the taxable year and less than 12 months.

   If the interim report contains annual financial data, the report must be on LIFO basis. Where the taxpayer presented its fourth quarter report to its

shareholders on a FIFO basis and also included its results of operation for the entire 12-month period on a FIFO basis, the Service may terminate the use of LIFO. The conformity requirement will not be considered violated as long as the series of interim reports, when combined, do not present operating results for the year on a non LIFO basis.

A franchised automobile dealer that elected the LIFO inventory method for federal income tax purposes violates the LIFO conformity requirement of IRC section 472(c) or (e)(2) by providing to the credit subsidiary of its franchisor (an automobile manufacturer) an income statement for the taxable year that fails to reflect the LIFO inventory method in the computation of net income.

IRC section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

Section 1.472-2(e)(1) of the Income Tax Regulations provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

Treas. Reg. section 1.472-2(e)(1) generally provides exceptions to the LIFO conformity requirement. Under Treas. Reg. section 1.472-2(e)(1)(iv), a taxpayer is not at variance with the LIFO conformity requirement if it uses an inventory method other than LIFO in a report or statement covering a period of less than an entire taxable year. However, Treas. Reg. section 1.472-2(e)(6) provides that a series of credit statements or financial reports is considered a single statement or report covering an entire taxable year if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the entire taxable year. For this purpose a taxable year includes any 1-year period that both begins and ends in a taxable year for which the taxpayer used the LIFO inventory method. See Treas. Reg. section 1.472-2(e)(2). Thus, income statements prepared on the basis of a calendar year may be subject to the LIFO conformity requirement even though the taxpayer employs a fiscal year for federal income tax purposes.

Under Treas. Reg. section 1.472-2(e)(2)(vi), a taxpayer is not at variance with the LIFO conformity requirement if it uses costing methods or accounting methods to ascertain income, profit, or loss in financial statements for credit purposes if such methods are not inconsistent with the LIFO inventory method. The use of cost estimates is an example of a costing method that is not inconsistent with the LIFO inventory method. See Treas. Reg. section 1.472-2(e)(8)(ix).

A taxpayer subject to these conformity requirements may have the LIFO election terminated for a conformity violation. In determining whether there exists a LIFO conformity violation, it is important to examine the automobile dealer's financial statement disclosures to the manufacturer and to the entities (creditors) that "floor plan" the dealer's inventory, regardless of whether a particular creditor is an affiliate of the manufacturer or outside party. Refer to Rev. Proc. 79-23.

In Rev. Proc. 97-44, I.R.B. 1997-41, (September 25, 1997), the IRS provided relief for franchised automobile dealers that have violated the LIFO conformity requirement. This revenue procedure provides relief for automobile dealers that elected the last-in, first-out (LIFO) inventory method and violated the LIFO conformity requirement of section 472(c) or (e)(2) of the Internal Revenue Code by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method. See, e.g., Rev. Rul. 97-42, 1997-41 I.R.B. (Situation 3). Automobile dealers that comply with this revenue procedure will not be required to change from the LIFO inventory method to another inventory method as a result of such LIFO conformity violation. Taxpayers that elected this relief were required to make three catch up payments to avoid being terminated.

Revenue agents should at a minimum, inquire if the taxpayer elected the above relief. If the taxpayer did elect the above relief, verify the required three payments were made.

If the taxpayer did not elect the relief, the agent must check to see if the taxpayer is in violation of the LIFO conformity requirements under IRC section 472. Even if they did elect the relief, taxpayers are required to continue to comply with the requirements of the regulations.

Rev. Proc. 98-46 extended the relief in Rev. Proc. 97-44 to medium and heavy truck dealers.

3. What are the record keeping requirements?

A taxpayer electing LIFO agrees to maintain adequate records to comply with the regulations. Treas. Reg. section 1.472-2(h) requires a taxpayer electing LIFO to maintain records supporting the LIFO computations and compliance with the LIFO regulations. Treas. Reg. section 1.472-2(h) places a substantial responsibility on the taxpayer since, under the LIFO reverse order principle, the costs in ending inventories relate to years all the way back to the year of the initial LIFO election. A taxpayer may have the LIFO election terminated for non-compliance. See *H.E. Boecking, Jr. and Sally Boecking* v. *Commissioner*, T.C. Memo. 1993-497, CCH 49,362(M). See Treas. Reg. section 1.472-8(e)(1).

4. How do write-downs affect the LIFO election?
   LIFO is a cost method. Write-downs from cost are not permitted. A taxpayer as part of the election must restore to the base year inventories all cost write downs to items on hand. This means restoration must be made to the beginning inventory in the first year covered by the LIFO election.

   The write downs that must be restored (and that cannot be subsequently claimed as long as the LIFO election is in effect) include "lower of cost or market" write downs, Treas. Reg. section 1.471-4, as well as "subnormal goods" write-downs. See Treas. Reg. section 1.471-2, Rev. Rul. 76-282, and Rev. Proc. 76-28, 1976-2 C.B. 645.

   Under elections made prior to December 31, 1981, the restoration had to be made on an amended return for the tax year immediately preceding the year of the LIFO election. See Rev. Proc. 76-6. For elections made after December 31, 1981, IRC section 472(d) requires the restoration to be made pro rata over 3 tax years beginning with the year of the LIFO election. The 3-year analysis that is required to be attached to the Form 970 provides the information for the restoration.

   The use of the lower of LIFO or cost or market for financial statements is not a violation of the conformity requirement although the write-down must be restored for tax purposes. See TAM 8402015.

5. How can the LIFO election be terminated?
   The service can terminate the use of the LIFO method by a taxpayer who has adopted LIFO without filing Form 970. There may be an exception to this rule if the taxpayer includes all of the information on the tax return that is required on the Form 970. *Fischer Industries Inc. and Subsidiaries* v. *Commissioner*, 87 T.C. 116 (1986).

   The method may also be terminated if the financial reporting requirements are not complied with (see above), or adequate records are not maintained (see above).

The 1987 Revenue Act added IRC section 1363(d), which requires that a C-Corporation using the LIFO method who converts to an S-Corporation must recapture its LIFO reserve and pay the tax over a 4 year period. This provision was effective after December 17, 1987.

For more information, refer to Rev. Proc. 79-23, 1979-1 C.B. 564, 1979.

Computations

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The examination of an auto dealership's LIFO begins with a determination of the appropriateness of the taxpayer's indices. A complete examination of the taxpayer's computations would require a great deal of both the Government's and taxpayer's time and resources. The agent should determine if issues are likely to exist, before embarking upon a complete examination of these indices.

The first thing the agent needs to do is to secure the Form 970 and determine which Dollar Value method the taxpayer has elected to price its inventory. In the auto dealership context, there are three such pricing methods; the Double Extension Method, the Link Chain Method and the Index method. The Link Chain Method is the most prevalent in this industry and will be the focus of this discussion.

The LIFO years should be determined by reviewing the Form 970. From this form, the agent can ascertain the method the taxpayer has elected to determine current year costs of the units in ending inventory in order to compute the index. Recall many auto dealerships elect the Earliest Acquisitions Method, also known as the First Purchases Method or the Most Recent Purchases, also known as the Latest Acquisitions Method. Taxpayers may elect the most recent Purchases method but, in fact, may be using the specific identification method. This is not an unauthorized change in method of accounting if it has been consistently used from the date of election.

To compute the LIFO index, both the latest acquisition and earliest acquisition methods require comparison of each vehicle in the current year's ending inventory to a similarly equipped vehicle in the prior year. The difference between the two methods lies in which purchase cost is used in the computation.

Dealers that elect to use the latest acquisition method must determine the last purchase (latest acquisition), during the current year, of each vehicle in ending inventory. (For latest acquisition, generally the vehicle on hand at the end of the year is the latest acquisition.) The cost of the latest acquisition of the vehicle must be compared to the cost of the latest purchase in the prior year of a similarly equipped vehicle.

Dealers that elect to use the earliest acquisition method must determine the first purchase (earliest acquisition), during the current year, of each vehicle in ending

inventory. The earliest acquisition must be determined for a vehicle similarly equipped to the vehicle in ending inventory. The cost of the first purchase of the vehicle must then be compared to the cost of the first purchase of a similarly equipped vehicle in the prior year.

For example: the dealer has in ending inventory a fully loaded Dodge Intrepid. Review of purchase invoices indicates that the dealer first purchased a similarly equipped Intrepid in May of the current year. The cost of the May purchase is the current year cost for purposes of computing the LIFO index. The dealer must then analyze vehicle purchases for the prior tax year and determine the first purchase of a similarly equipped Dodge Intrepid. The cost of the first purchase in the prior year is the prior year cost for the purpose of the LIFO computation.

Regardless of which method is elected, if the vehicle is determined to be a new item for purposes of the LIFO computation, the prior year cost is the same as the current year cost, i.e. 1.00 index. (Current year cost is determined as noted above.)

From these invoices, the indices will be created. The agent needs to determine the manufacturer, model year and model type of the various distinct vehicles the dealership has in ending inventory, separated into two pools, cars and trucks. This is necessary to insure the same vehicles are being "compared" during the applicable measuring periods. To illustrate this concept consider the following:

The current year and year of examination is 9312. The first year of the dealership LIFO election was for the year ending December 31, 1991. The Form 970 indicates this taxpayer has elected to use the Link Chain, Latest Acquisitions Method to value the inventory. Review of the general ledger indicates the 9112 dealership ending inventory has a dollar value of $224,000. This dollar value was represented by the following vehicles:

Model Year 1992 - December 31, 1991

Model	Quantity	Cost	Extended Cost
Car A	1	$22,000	$ 22,000
Car B	2	23,000	46,000
Car C	6	26,000	156,000
Base Year Cost 9112			$224,000

You have obtained the necessary general ledger entries and invoices and have determined the following apply to 9212 and 9312 regarding this election:

Model Year 1993 - December 31, 1992

Model	Quantity	Cost	Extended Cost
Car A	5	$22,880	$114,400
Car B	6	23,920	143,520
Car C	9	27,040	243,360
Current Year Cost 9212			$501,280

Model Year 1994 - December 31, 1993

Model	Quantity	Cost	Extended Cost
Car A	6	$24,024	$144,144
Car B	7	25,116	175,812
Car C	10	28,392	283,920
Current Year Cost 9312			$603,876

From this information the indices for each of the 3 years of this election can be computed as follows:

The 1991 LIFO Index is 1.000. This is the Base Year of the election. There are no prior items in the inventory.
The 1992 LIFO Index is 1.040. This was determined as follows:

Car Pool 9212
Model Year 1993

		Prior Year		Current Year	
Model	**End Inv Quantiy**	**As of 1991 Vehicle Price**	**As of 1991 Extended Price**	**As of 1992 Vehicle Price**	**As of 1992 Extended Price**
Car A	5	$22,000	$110,000	$22,880	$114,400
Car B	6	23,000	138,000	23,920	143,520
Car C	9	26,000	234,000	27,040	243,360
	20		$482,000		$501,280

Car Pool Index: $501,280 / $482,000 = 1.040

The 1993 LIFO Index is 1.050. This was determined as follows:

Car Pool 9312
Model Year 1994

		Prior Year		Current Year	
Model	**End Inv Quantiy**	**As of 1992 Vehicle Price**	**As of 1992 Extended Price**	**As of 1993 Vehicle Price**	**As of 1993 Extended Price**
Car A	6	$22,880	$137,280	$24,024	$144,144
Car B	7	23,920	167,440	25,116	175,812
Car C	10	27,040	270,400	28,392	283,920
	23		$575,120		$603,876

Car Pool Index: $603,876 / $575,120 = 1.050

It is possible for the price of a vehicle to go down from one year to the next. Such deflation will be accounted for in the index using the same steps which were used to compute inflation.

Where no invoice exists or price cannot be reconstructed for a particular vehicle, for a specific year, the assumption may be made this is a new vehicle entering the inventory and no inflation can be assigned. Any such particular vehicle will receive an index of 1.0000. The dealer may submit information to the contrary which should be considered by the agent. See the section on "Pooling" above, for guidance on determining whether a new item is present.

Once the indices have been calculated the next step of the LIFO computation will be to determine the LIFO layers to add to the reserve.

Please see the Appendix section of this Guide for a comprehensive case study detailing the computation of indices used to compute a LIFO Reserve.

BLS Sanity Check

A simpler means to "ballpark" the taxpayer's LIFO reserve without a great deal of time is referred to as the Bureau of Labor Statistics (BLS) "sanity check." Depending on how detailed the agent wants to get, you can request the taxpayer's yearly non-LIFO and LIFO values and recompute the entire reserve in several minutes, or you can simply compare the taxpayer's indexes to the relevant BLS indexes. This can provide a quick analysis, but should not solely be

used to make an adjustment if that is not the method that has been elected. Factors to keep in mind when using these tables include:

1. Producer Price Index (PPI) - domestic manufacturers
2. Consumer Price Index (CPI) - foreign manufacturers
3. Use quarter closest to taxpayer's taxable yearend
4. Trucks GVW 10,000 lbs. and under (PPI only)
5. Trucks over 10,000 lbs. GVW (PPI only).

Reserve

An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. See Treas. Reg. section 1.472-8(a).

If there is an increment for the taxable year, the ratio of the total current year cost of the pool to the total base year cost of the pool must be computed. This ratio, when multiplied by the amount of the increment measured in terms of base year costs, gives the LIFO inventory value of such increment. The LIFO inventory value of each such increment is referred to in this section as the "layer" and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year.

On the other hand, **when the end of year inventory expressed in terms of the base-year cost** of the pool is less than the beginning base-year cost of the pool, a decrement occurs in the pool for that year. Such a decrement, or liquidation, is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory **(expressed in terms of base year cost)** over the end of the year inventory **(expressed in terms of base year cost)** of the pool. However, if the amount of liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base year inventory is to be reduced by liquidation only after the aggregate of all liquidations exceeds the aggregate of all layers of increment. The liquidation process works the same whether it is under the double extension, link chain or any other method.

The LIFO Reserve calculation, just as with the increment valuation, is the same no matter what method of LIFO the taxpayer elects. The equation for the LIFO reserve is as follows:

NON-LIFO (Inventory per General Ledger)(usually specific cost)
<LIFO> (Less: LIFO Inventory Value)
RESERVE (Cumulative Reserve)

The LIFO reserve shown in the equation is the "Cumulative LIFO Reserve Balance," which is what you should see on the Balance Sheet of the return under "Inventory." This is the amount of reserve that has accumulated over the years since LIFO was first elected. A cumulative amount of reserve is maintained because it represents the present the value of the inventories. If the dealer ever terminates LIFO, the reserve will have to be recaptured.

To find out how much the dealer has deducted each year as a current year adjustment on the reserve, it is necessary to subtract the prior year's cumulative LIFO reserve. The difference is the amount to be adjusted in the current year.

To illustrate these principles, consider the index example introduced in the previous section as an aid to demonstrate the mechanics of computing the LIFO Reserve:

The Base Year was 1991. The Base Year Cost was $224,000. There was no prior inventory.

The taxpayer elected Dollar **Value** Link Chain LIFO.

The dealership had the following cars in ending inventory on December 31, 1991:

Model Year 1992 - December 31, 1991

Model	Quantity	Cost	Extended Cost
Car A	1	$ 22,000	$ 22,000
Car B	2	23,000	46,000
Car C	6	26,000	156,000
Base Year Cost 9112			$224,000

At December 31, 1992, Model Year 1993, the dealership had the following vehicles in ending inventory:

Quantity	Model	CYC	Extended CYC	BOYC	Extended BOYC
5	Car A	$22,880	$114,400	$22,000	$110,000
6	Car B	23,920	143,520	23,000	138,000
9	Car C	27,040	243,360	26,000	234,000
20			$501,280		$482,000

BOYC = Beginning of Year Costs. This is the December 31, 1991, price of the same vehicle showing in the December 31, 1992, ending inventory.

CYC = Current Year Cost. This is the price at December 31, 1992, of the 1993 Models in the December 31, 1992, ending inventory.

The 1992 LIFO Index is 1.04:

LIFO INDEX = (TOTAL CYC / TOTAL BOYC)

$501,280 / $482,000 = 1.04

The 1992 Cumulative Index is 1.04:

(1992 LIFO INDEX x BASE YEAR INDEX)

1.04 x 1.000 = 1.04

The value of the 9212 Ending Inventory at Base Year Cost is $482,000.

$501,280 / 1.04 = $482,000

(1992 CURRENT YEAR COST / 1992 CUMULATIVE INDEX)

Computation of 1992 Increment and Reserve Addition

	Base Year Cost	**Cumm. Index**	**LIFO Value**
Base Year Inventory	$224,000	1.000	$224,000
1992 Increment	258,000	1.040	268,320
	$482,000		$492,320

The 1992 Increment at Base Year Cost ($258,000) is derived by subtracting the Base Year Inventory from the 9212 Ending Inventory at Base Year Cost.

9212 Ending Inventory at Base Year Cost	$482,000
- Base Year Inventory	<224,000>
1992 Increment	$258,000

The 1992 LIFO Value is derived by multiplying the 1992 Increment by the 1992 Cumulative Index, then adding this product to the product of the Prior Year LIFO value which in this example is determined by multiplying the Base Year Cost by the Base Year Index.

Base Year Inventory	$224,000 x 1.000 =	$224,000
1992 Increment	$258,000 x 1.040 =	+268,320
1992 LIFO Value		$492,320

The 1992 LIFO Reserve

Total Current Year Cost	$501,280
Less: 1992 LIFO Value	<492,320>
1992 Reserve Addition	$8,960

At December 31, 1993, Model Year 1994, the dealership had the following vehicles in ending inventory:

Quantity	Model	CYC	Extended CYC	BOYC	Extended BOYC
6	Car A	$24,024	$144,144	$22,880	$137,280
7	Car B	25,116	175,812	23,920	167,440
10	Car C	28,392	283,920	27,040	270,400
23			$603,876		$575,120

BOYC = Beginning of Year Costs. This is the December 31, 1992, price of the same vehicle showing in the December 31, 1993, ending inventory.
CYC = Current Year Cost. This is the price at December 31, 1993, of the 1994 Models in the December 31, 1993, ending inventory.

The 1993 LIFO Index is 1.050:

(TOTAL CYC / TOTAL BOYC)

$603,876 / $575,120 = 1.050

The 1993 Cumulative Index is 1.092:

(1993 LIFO INDEX x 1992 CUMULATIVE LIFO INDEX)

1.050 x 1.040 = 1.092

The value of the 9312 Ending Inventory at Base Year Cost is $553,000.

(1993 CURRENT YEAR COST / 1993 CUMULATIVE INDEX)
$603,876 / 1.092 = $553,000

Computation of 1993 Increment and Reserve Addition

	Base Year Cost	Cumm. Index	LIFO Value
Base Year Inventory	$224,000	1.000	$224,000
1992 Increment	258,000	1.040	268,320
1993 Increment	71,000	1.092	77,532
	$553,000		$569,852

The 1993 Increment at Base Year Cost ($71,000) is derived by subtracting the Base Year Inventory and the 1992 Increment from the 9312 Ending Inventory at Base Year Cost.

9312 Ending Inventory at Base Year Cost	$553,000
1992 Increment	<258,000>
- Base Year Inventory	<224,000>
1993 Increment	$71,000

The 1993 LIFO Value is derived by multiplying the 1993 Increment by the 1993 Cumulative Index, then adding this product to the product of the Prior Year LIFO value which in this example is determined by multiplying the Base Year Cost by the Base Year Index and the product of the 1992 increment multiplied by the 1992 Cumulative Index.

Base Year Inventory	$224,000 x 1.000 =	$224,000
1992 Increment	258,000 x 1.040 =	+ 268,320
1993 Increment	71,000 x 1.092=	+ 77,532
1993 LIFO Value		$569,852

The 1993 Cumulative LIFO Reserve

Total Current Year Cost	$ 603,876
Less: 1993 LIFO Value	<569,852>
LIFO Reserve	$ 34,024

Current Year Addition to LIFO Reserve:

1993 Reserve	$34,024
Less 1992 Reserve	< 8,960>
Addition to Reserve	$25,064

The amount of the addition to the reserve in the current year is the excess of the required reserve over the prior year's reserve.

Simplified LIFO Method: IRC section 474

All taxpayers, except retailers, may elect this Inventory Price Index (IPI) method applying to taxable years beginning after 1981. Manufacturers, processors, wholesalers, jobbers and distributors must use the Producer Prices and Producer Price Index tables. Retailers may use either the Producer Price Index or Consumer Price Index tables.

Small business taxpayers as defined by IRC section 474, contemplate a taxpayer whose average annual gross receipts for 3 preceding taxable years does not exceed $5,000,000. They may use 100 percent of the stated index change, whereas taxpayers who exceed the $5,000,000 gross receipts test may use 80 percent of the change in the BLS indices.

Generally, this IPI method will not be encountered because of the gross receipts test. Auto dealer's gross receipts are usually in excess of $5,000,000.

Chapter 6
Alternative LIFO for Auto Dealers

As demonstrated in the chapter regarding the LIFO Method of Inventory Valuation, LIFO computations are complex. To simplify the dollar-value computation for auto dealerships, Rev. Proc. 92-79, 1992-2 C.B. 457, Alternative LIFO Method, was published, superseded by Rev. Proc. 97-36, I.R.B. 1997-33, 14 (July 31, 1997). This Revenue Procedure applies to new cars and light duty truck. On January 19, 2001 Revenue Procedure 2001-23, Used Vehicle Alternative LIFO Method was published. This Revenue Procedure applies to used automobiles and used light-duty trucks. Automatic change procedures are covered in Rev. Proc. 2002-9. The first part of this chapter discusses the Alternative LIFO Method for new vehicles while the second part discusses the Used Vehicle Alternative LIFO Method.

Alternative LIFO Method, New Cars and Light-duty Trucks
In general, the Alternative LIFO Method is a comprehensive dollar-value, link-chain LIFO method of accounting that encompasses several LIFO sub-methods and may only be used by an automobile dealer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks to value its inventory of new automobiles and new light-duty trucks.

The Alternative LIFO Method is designed to simplify the dollar value computations of automobile dealers. It does this by *not* requiring comparability adjustments from one year to the next. Under the authority of Treas. Reg. section 1.446-1(c)(2)(ii), the Commissioner will waive strict adherence of Treas. Reg. section 1.472-8 comparability requirement in applying the Alternative LIFO Method provided that a taxpayer complies with the requirements stated in the revenue procedure.

Summary of Rules
The Alternative LIFO Method is available to any automobile dealer engaged in the business of retail sales of new automobiles or new light-duty trucks for its LIFO inventories of new automobiles and new light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which are also referred to as class 1, 2, or 3 trucks. Discussion of pertinent areas of this revenue procedure is summarized in the following paragraphs.

LIFO Pools
The revenue procedure was not intended to change the pooling rules and all rules in effect prior to Rev. Proc. 92-79 remain in effect. All new automobiles and demonstrators (regardless of manufacturer) must be included in one LIFO pool and all new light trucks and demonstrators (regardless of manufacturer) must be included in another separate LIFO pool. Section 4.02(1) states that pools must be established for each "separate trade or business." There is little guidance on just what constitutes a separate trade or business. However, certain factors such

as the location of multiple franchises, whether there is separate management, personnel and recordkeeping functions at each location can be used to determine whether each franchise is a separate trade or business.

Specific Identification Increment Method
The current-year cost of the items making up a pool must be determined by reference to the actual cost of the specific new automobiles or new light-duty trucks in ending inventory. Therefore, the actual cost of the specific vehicles on hand at year-end will be the current-year cost of such vehicles.

Item of Inventory
Rev. Proc. 97-36 focuses on model codes with the intent that the model code will apply to a specific vehicle with a specific base vehicle cost.

Section 4.02(3) of Rev. Proc. 97-36 requires that an item of inventory (inventory category) be "* * * determined using the entire manufacturer's base model code number that represents the most detailed description of the base vehicles" characteristics, such as model line, body style, trim level, etc." (Emphasis added). Many manufacturers identify the "most detailed description" by a combination of alphanumeric characters, commonly called model codes or model code numbers. However, some manufacturers use the same characters to identify base vehicles with different detailed descriptions. Other manufacturers have no model codes at all. The term "shared code" describes this situation.

The reference to "model code number" was intended only to provide a label for the "most detailed description" of the base vehicle. Taxpayers who focus only on the "model code number" may not be in compliance with the clear and specific requirements of the revenue procedure. Some manufacturers change their model code by one digit or letter to reflect only a year change, not a model change. This would not be a new item. By using only the alphanumeric vehicle identifier, (i.e. the model code number) vehicles with different base costs could be treated as the same item category. For example: the 1995 Ford Explorer, model code number U34, is available in four versions, with four different base prices.

Model Code	**Description**	**1995 Base Price**
U34	XL Utility 4DR	$19,948
U34	XLT Utility 4DR	$22,320
U34	Eddie Bauer Utility 4Dr	$26,293
U34	Limited Utility 4DR	$30,183

Use of the model code number U34 would allow four distinctly different vehicles with a base cost difference of over $10,000 to be treated as the same item category. This was not the intent of the revenue procedure. Because the intent is to measure inflation, an interpretation that focuses merely on the model code and ignores the most detailed description is improper and a misapplication of the

revenue procedure. Such an interpretation could result in deflation where there is inflation or inflation where there is actually deflation. Additionally, the rate of inflation or deflation may be different. The Ford Explorer again provides an example:

Model Code	Description	1995 Base Price	1994 Base Price	Price Diff.	Index
U34	XL Utility 4DR	19,948	18,169	1,779	1.0979
U34	XLT Utility 4DR	22,320	20,324	1,996	1.0982
U34	Eddie Bauer Utility 4DR	26,293	22,503	3,790	1.1684
U34	Limited Utility 4DR	30,183	25,455	4,728	1.1857
		98,744	86,451		1.1421

The above example illustrates the variance in the inflation rate for vehicles with the same model code. The index can also vary significantly based on changes in the taxpayer's product mix.

The following examples illustrate changes in product mix. (Assume no quantity change. EOY = End of Year; BOY = Beginning of Year)

Example 1

	Description	Quantity	Base Price	Total Cost
EOY	Limited Utility 4DR	4	30,183	120,732
BOY	XL Utility 4DR	4	18,169	72,676

Index - 1.6612

Changing the product mix from low cost vehicles to high cost vehicles results in an abnormally high index.

Example 2

	Description	Quantity	Base Price	Total Cost
EOY	XL Utility 4DR	4	19,948	79,792
BOY	Limited Utility 4DR	4	25,455	101,820

Index - .7836

Changing the product mix from high cost vehicles to low cost vehicles results in an abnormally low index.

Inflation is more accurately reflected in clearly defined item categories and both of the above examples produce distorted indices.

To properly determine an item category, a taxpayer must, as specifically stated in the revenue procedure, use the "* * * most detailed description of the base vehicle's characteristics * * *." Some taxpayers interpret "model code number" to

mean only the alphanumeric character. This is incorrect. Had this been the intention of the Service, any reference to the "most detailed description" would have been unnecessary. The intention of the Service was that an item must be determined using "* * * the most detailed description of the base vehicle's characteristics * * *." which may be identified by a unique model code. If no unique code is present, the item must be identified by its detailed description.

The revenue procedure's language is clear and specific that an item must be identified, not merely by its model code number, but by the most detailed description of the base vehicle. While the term "shared code" is not found in the revenue procedure, it does describe model codes that apply to more than one base vehicle and must be treated as separate items.

Cost of the Vehicle Used for Purposes of Computing the Pool Index
The actual base vehicle cost of each specific vehicle in ending inventory is used to compute the LIFO index. The pool index computed from only the base vehicle cost is applied to the total vehicle cost of all vehicles in the pool at the end of the taxable year.

Definition of a New Item
Section 4.02(5) of the Revenue Procedure provides three situations when a new item category is created:

"i. Any new or reassigned manufacturer's model code * * * that is caused by a change in an existing vehicle, or
ii. [A] manufacturer's model code, * * * created or reassigned because the classified vehicle did not previously exist.
iii. Additionally, if there is no change in a manufacturer's model code but there has been a change to the platform * * * that results in a change in the track width or wheel base, whether or not the same model name was previously used by the manufacturer, a new item category is created."

Generally, if there has been a change to the most detailed description corresponding to the base cost of the vehicle, either in the number or description, which is caused by a change in an existing vehicle, a new item category is created.

The Motor Vehicle Technical Adviser Program analyzes all vehicles each year to determine whether a new item category is created under the situations specified above. Contact that office to receive a list of new item categories.

Treatment of a New Item Not in Existence in the Prior Year
The automobile dealer must use the current-year base vehicle cost of the new item category as the prior-year-base vehicle cost of that item category.

Item in Existence in the Prior Year, but Not Stocked
If the automobile dealer did not stock an item in ending inventory at the end of the prior year, the automobile dealer must determine the prior-year-base vehicle cost by using a manufacturer's price list in effect as of the beginning of the last month of the prior taxable year.

Computations
The computational methodology is illustrated in the following example for ABC Lexus who elected Alternative LIFO for its taxable year ending December 31, 1992.
Ending Inventory Schedule
(This example is limited to a new car pool.)

Stock Number	Model Invoice Number	Description	Amount
45810	9100A	LS400 4-DR Sedan	$ 33,065.00
45820	9010A	ES250 4-DR Sedan	19,079.00
45822	9100A	LS400 4-DR Sedan	35,633.00
45853	9100A	LS400 4-DR Sedan	33,777.00
45854	9010A	ES250 4-DR Sedan	18,941.50
			$140,495.50

Step # 1
Obtain the actual invoice for each vehicle in the ending inventory.

Step # 2
Group all of the invoices from Step 1 by item category. In this example, we have two (2) item categories as follows:

Model #	Description
9100A	LS400 4-DR Sedan
9010A	ES250 4-DR Sedan

Step # 3
For each item category, add together the base vehicle costs.

Item Category - Model 9100A, LS400, 4DR Sedan

Stock #	Base Vehicle Cost
45810	$30,400
45822	30,400
45853	30,400
Total Base Vehicle Cost	$91,200

Item Category - Model 9010A, ES250, 4DR Sedan

Stock #	Base Vehicle Cost
45820	$17,466
45854	18,081
Total Base Vehicle Cost	$35,547

Step # 4
Compute an average base vehicle cost for each item category.

Item Category - Model 9100A, LS400, 4DR Sedan
$91,200 divided by 3 vehicles = $30,400

Item Category - Model 9010A, ES250, 4DR Sedan
$35,547 divided by 2 vehicles = $17,773.50

Step # 5
Compute the total current year base vehicle cost.

Item Category	Total
9100A, LS400 4DR Sedan	$ 91,200
9010A, ES250 4DR Sedan	35,547
Total Current-Year Base Vehicle Cost of the Pool	$126,747

Step # 6
Compute the total base vehicle cost of the ending inventory at the prior year's base vehicle cost.

By performing the same steps, number 1, 2, 3, and 4 above for the preceding year's ending inventory, you would obtain the preceding year's average base vehicle cost. In this example, we will assume that the average base vehicle cost for model 9100A was $29,756 and for model 9010A was $16,810.

Item Category	# of Vehicles in Current Year's Ending Inventory	Preceding Year's Average Base Vehicle Cost	Total Average Base Vehicle Cost
9100A, LS400	3	$29,756	$ 89,268
9010A, ES250	2	16,810	33,620
Based vehicle cost of ending inventory at prior year based vehicle cost			$122,888

Step # 7
Compute the current year index.
$126,747 divided by $122,888 = 1.0314

Step # 8
Compute the cumulative index. The cumulative index at the beginning of the year of change was 1.0000 due to restatement. Restatement is discussed later in this section.

1.0000 x 1.0314 = 1.0314

Step # 9
Compute the total current year total vehicle cost by adding together the total invoice costs. (NOTE: not base cost only)

Stock Number	Model Number	Description	Amount
45810	9100A	LS400 4-DR Sedan	$ 33,065.00
45820	9010A	ES250 4-DR Sedan	19,079.00
45822	9100A	LS400 4-DR Sedan	35,633.00
45853	9100A	LS400 4-DR Sedan	33,777.00
45854	9010A	ES250 4-DR Sedan	18,941.50
			$140,495.50

Step # 10
Compute the total cost of the current year's ending inventory at base year cost.

$140,495.50 divided by 1.0314 = $136,218

Step # 11
Determine if there is an increment for the current year by comparing the total cost of the pool's current year ending inventory at base year cost with the prior year.

In this example we will assume that the total cost of preceding year's ending inventory at base year cost was $116,774.

$136,218 - 116,774 = $19,444

Since the current year's inventory at base year cost is greater, there is an increment.

Step # 12
Value the current year's increment at current-year cost.

$19,444 x 1.0314 = $20,055.

Step # 13
Since there was an increment, step # 13 is not applicable. However, if there is no increment for a pool (rather, a decrement), reduce the LIFO layers in reverse chronological order until the decrement is fully absorbed.

Step # 14
Compute the total LIFO value for the pool. In this example we will assume that the LIFO Value as of December 31, 1991, was $117,327.

Year	Amount
01/01/90 (Base Year)	$105,798
12/31/90	9,424
12/31/91	2,105
Total LIFO Value for the Pool (12/31/91)	117,327
12/31/92	20,055
Total LIFO Value for the Pool (12/31/92)	$137,382

Other Considerations
Discussion of other areas of pertinence regarding Alternative LIFO are summarized as follows:

1. Audit Protection
   If an automobile dealer timely files a Form 3115, Application for Change in Accounting Method, under the procedures provided in this revenue procedure and effects the change to the Alternative LIFO Method in accordance with all of the requirements and conditions of this revenue procedure, an examining agent may not propose that the automobile dealer change the same method of accounting for a year prior to a year of change required under this revenue procedure.

2. Conformity
   Automobile dealers who elect the LIFO method of inventory valuation are required to meet certain conformity requirements. Financial statements and reports issued by the automobile dealer must be issued on a LIFO basis. Alternative LIFO does not provide audit protection for conformity violations.

3. Item Category Without Consideration of Model Year
   New models are generally introduced in the fall of each year. An automobile dealer may have 2 model years of a single vehicle with the same model code. The revenue procedure does not distinguish an item category by model year. Therefore, if an automobile dealer's inventory contains 2 model years of a single vehicle they will be included in one item category to arrive at an average cost for this item category.

4. IPI Computation Method Changes
   An automobile dealer that uses the IPI computation method must also change from the IPI computation method to another acceptable method for its goods other than new automobiles and new light duty trucks. For parts and accessories, the automobile dealer must change to the dollar value, index

method. For used vehicles, the automobile dealer must change to the dollar value, link chain method.

5. Restating the Base Year
   Section 9.02(8) of Rev. Proc. 92-79 and section 5.03(8) of Rev. Proc. 97-36 require that the year of change become the new base year and that the cumulative index at the beginning of the year of change must be restated to 1.0000. Prior years' layer valuation indices are converted to less than 1.0000, assuming a period of rising prices. The mechanics of restating the base year are illustrated in the following example. In this example, 1992, is the year of change.

1991 Inventory Value at Current Year and Base Year Cost

Year	Base Year Cost	Current Year Cost [1]	Index
12/31/91	$116,774	$128,451	1.1000

[1] Taken from the general ledger.

LIFO Inventory Layers Before the Year of Change

Year	Base Year Cost	Index	LIFO Value
01/01/90	$105,798	1.0000	$105,798
12/31/90	9,062	1.0400	9,424
12/31/91	1,914	1.1000	2,105
	$116,774		$117,327

Restating the Existing LIFO Layers as of January 1, 1992

Year	Old Base Year Cost	New Base Year Cost	Ratio	LIFO Value
01/01/90	$105,798	$116,378	.9091	$105,798
12/31/90	9,062	9,968	.9454	9,424
12/31/91	1,914	2,105	1.0000	2,105
	$116,774	$128,451		$117,327

To determine the new base year cost, multiply the existing base year cost of each layer by the cumulative index preceding the year of change. In this example, the cumulative index preceding the year of change is 1.1000. The LIFO layer values remain the same. After the new base year cost is determined, the restated indices are computed by dividing the LIFO value of each layer by its new base year cost. In this example, the ratio for 1990 is .9454 ($9,424 divided by 9,968).

Used Vehicle Alternative LIFO Method

On January 19, 2001, the Internal Revenue Service published the Used Vehicle Alternative LIFO Method; Revenue Procedure 2001-23. This new method incorporates a computational methodology similar, although with some significant differences, to the method used in Rev. Proc. 97-36, Alternative LIFO for New Vehicles.

Overview of the Method
The Used Vehicle Alternative LIFO Method applies to taxpayers that sell used automobiles or used light-duty trucks and is effective for tax years ending on or after December 31, 2000. For purposes of the revenue procedure, used automobiles and used light-duty trucks are defined as previously titled vehicles and do not include demonstrator vehicles typically used in new car dealerships.

The new method is an *elective*, comprehensive link-chain method that includes several special rules and required sub-methods. In the opinion of the Commissioner, provided that dealers properly implement and apply the method described in Revenue Procedure 2001-23, income from the sale of used vehicles will be clearly reflected and the method will be accepted as an accurate, reliable, and suitable method of computing a LIFO inventory index. However, all computations under the Used Vehicle Alternative LIFO Method remain subject to verification upon examination of the dealer's tax return.

General Rules and Definitions
In general, dealers that elect the Used Vehicle Alternative method will compute the LIFO index by reference to average ***base vehicles*** that correspond to the vehicles in the dealership's ending inventory. The LIFO index computed using the base costs and the methodology in the revenue procedure is applied to the ***current-year cost*** of the dealership's ending inventory.

Section 4.02(1) of the revenue procedure defines ***base vehicle*** as "…the most relevant combination of (a) a detailed base model description, consisting of model line, body style, and trim level…and (b) an associated manufacturer's base model code number…" When computing the LIFO index, dealers must determine base vehicle prices by reference to an ***official used vehicle guide***.

The revenue procedure provides a specific definition of ***current-year cost*** for purchased vehicles and for trade-in vehicles (§4.02(4)(a) and (b)). The current-year cost of trade-in and purchased vehicles includes the vehicle's purchase price plus reconditioning costs, delivery charges, and any other costs properly allocated to the vehicle, i.e. §263A costs. "Cost" for a vehicle acquired by purchase is easily identified by reference to the sales documents. However, the "cost' of a trade-in vehicle is not as clear. §4.02(4)(b) specifically defines the "cost" of a trade-in vehicle by reference to Revenue Ruling 67-107, i.e. the wholesale price of a comparable vehicle reflecting the actual vehicle's actual mileage, condition, options and accessories.

As a simplifying measure, the revenue procedure provides for the use of an "***official used vehicle guide***" in the computation of the LIFO index. "Official used vehicle guide" is defined as a guide that is "…widely recognized and utilized in the used vehicle dealer industry." The selected guide must be used consistently and must be the appropriate guide for the dealers region.

When determining current-year cost of trade-in vehicles, the guide must cover the day of acquisition of each specific vehicle. When computing the LIFO index, current-year cost must be determined using the guide in effect on the last day of the dealer's current taxable year. Prior-year cost must be determined by reference to the guide covering the last day of the dealer's preceding taxable year.

It is important to note that any change in the particular used vehicle guide or any change in the precise manner in which the guide is used represents a change in method of accounting. Accounting method changes generally require the Commissioner's consent. (§4.02(2)) Revenue procedure §4.02(3) requires dealerships to establish two used vehicle ***pools*** for each separate trade or business. The pools consist of a pool for all used light-duty trucks, regardless of manufacturer and a pool for used automobiles, regardless of manufacturer.

The revenue procedure also provides some of the first guidance on where to pool the new generation of hybrid vehicles. Section §4.02(3) provides that "used sport utility vehicles and used hybrid vehicles…may be included initially in either the used automobile or the used light-duty truck…pool." The original selection is a method of accounting and any deviation requires the consent of the Commissioner.

General Index Guidelines

To compute the annual LIFO index for each pool, the dealership must compare the current and prior year base costs for each vehicle in ending inventory. The properly determined current-year base vehicle price (as defined in §4.02) is matched to a comparable base vehicle of the same age and in average condition in the prior year. When no comparable prior-year base vehicle exists, the current-year base vehicle cost is also used as the prior-year base vehicle cost, i.e. that vehicle receives an index of 1.000. The current-year cost and prior-year cost are also identical if there is a change in the vehicle's wheel base or track width, regardless of whether the base vehicle code and description has changed.

Changing to the Used Vehicle Alternative LIFO Method

Dealerships must follow the automatic change provisions of Revenue Procedure 99-49, with some modifications, to change to the Used Vehicle Alternative LIFO Method. With one exception, if the change is made for the first or second taxable year ending on or after 12-31-00, the taxpayer may change to the new method automatically even if the dealership is under examination. **Caution**: If the dealership is under examination and used car LIFO is a pending issue, the automatic change provisions do not apply. An issue is pending if the Service has provided written notification indicating that an adjustment is being made or will be made regarding a method of accounting. The exact amount of the adjustment may not yet have been determined. The definition of pending issue can be found in §6.01(6) of Revenue Procedure 2000-38.

Changes to the Used Vehicle Alternative LIFO Method are made on a cut-off basis that requires that the value of the used vehicle inventory at the beginning of the year of change must be the same as the inventory value at the end of the prior year. Note: The revenue procedure contains special rules if the dealer has previously improperly accounted for a bulk bargain purchase or uses the IPIC method. For further information see Section 5.02(2) and §5.03(2).

Conditions of Change

Dealerships must also comply with several conditions in order to use the Used Vehicle Alternative LIFO Method including compliance with the conformity requirements of Treasury Regulation 1.472-2(e).

Electing dealerships must maintain complete books and records of the computations under the method. Records must include the used vehicle guides used in the index computation. LIFO inventory cost increments and the values of the increments must be retained. The year of change to the new method becomes the new base year {§5.01(3)}.

The dealership's LIFO election must be reviewed to determine whether the initial election included used vehicles. If not, the dealership must file a Form 970 electing LIFO for used vehicles. Prior to adopting the new method, dealerships should also insure that vehicles are properly pooled and if necessary combine or separate pools to comply with the revenue procedure's requirements.

Information to request when examining the Alternative LIFO Methods

An pro-forma Information Document Request relating to these Revenue procedures should incorporate the following request:

1) Copy of Form 3115, Application for Change in Accounting Method, and all attachments.
2) Computation of current index workpapers by pool including:
    a) Current year's ending inventory schedules,
    b) Invoices for all items in current year's ending inventory,
    c) Prior year's ending inventory schedules,
    d) Invoices for all items in prior year's ending inventory,
    e) Applicable price lists for items in existence in the prior year but not stocked in current year's ending inventory; and
    f) All schedules that group model lines and compute average base cost at beginning of the year and at the end of the year,
3) Computation of LIFO inventory value workpapers by pool.
4) Rebasing computations by pool.
5) If you changed from the IPI method for parts and accessories to the dollar value, index method, provide workpapers to support computations.
6) If you changed from the IPI method for used vehicles to the dollar value, link chain method, provide workpapers to support computations.
7) Financial Statements.

Chapter 7
Extended Service Contracts and Aftermarket Products

Introduction

The automotive dealership industry plans for products, tangible and intangible, that the consumer may add to the new vehicle during or after consummation of the sale. This “aftersale market” is substantial and includes, but is not limited to, products such as financing, wheels merchandise, extended service contracts and service.

This section focuses on the sale of Automobile Dealership Aftersale Market Products as they relate to the sale of new and used vehicles. Products sold primarily include extended service contracts, credit life insurance and credit accident and health insurance. Though references in this section concern new vehicles, these products have substantially similar application to used vehicles. At the end of this chapter are suggested audit techniques and a flow chart to assist the agent in identifying vehicle service contracts and maintenance contracts (VSC) issues. This is also to provide guidance to dealers and practitioners on the proper tax treatment of service contracts. A VSC audit technique flow chart is the last exhibit of this chapter as a visual aid.

Extended Service Contracts

Motor vehicle dealers sell extended service contracts (also known as mechanical breakdown contracts or multi-year service warranty contracts) for used cars and as a supplement to the standard manufacturers' warranty for new cars. The plans cover repairs for specified components, and may be purchased for a variety of terms and miles. The minimum term is usually 2 years and the maximum is usually 7 years, one manufacturer offers 10 years. The charge for the plan may be separately stated on the vehicle sales contract, or there may be a separate contract for the plan.

Regardless of what type of plan is sold, an administrator usually handles administrative functions and pays claims. In addition, the administrator determines the "cost" of the plan and provides a cost schedule to the dealers. Based on the cost schedule, dealers establish the selling price of the service contracts and retain a portion of the price as commission. The commission amount is usually reported as income in the year the contract is sold. Treatment of the remainder of the selling price varies depending on what type of plan is sold. Vehicle service contracts and maintenance contracts are a significant source of aftersale income. They can also be a significant source of confusion regarding the correct tax treatment of the programs.

Dealers may offer the contracts as principals or as sales agents of manufacturers, distributors, administrators, insurance companies, or another party. An agent is one who sells the product of a third party *without assuming* the legal obligations of the products sold. Typically, the agent receives a fee for the sale and necessary administrative services rendered. A principal is a party to the contract who *assumes* the risk of the contract provisions and is directly responsible for any ensuing liabilities. The principal derives compensation from the profit built into the cost of the product.

Dealers often offer more than one "brand" of service contracts with each contract offering different terms and conditions. The dealers may operate as the principal, also referred to as “obligor,” on some contracts and as an agent on others.

When dealers act as sales agents, they retain a selling commission and remit the balance to the plan administrator. When dealers act as principals, they *may* purchase an insurance policy to cover their liability under the service plan. When the dealer is the principal and covers its risk by purchasing insurance, there are two transactions: one between the dealer and the customer, and the second between the dealer and an insurance company.

If the dealer does not purchase insurance, it may enter into an arrangement whereby a portion of the selling price is deposited into an "escrow" or "trust" account and a small portion of the price is used to purchase "stop-loss" or "excess loss" insurance.

Regardless of what type of service contract the dealer sells, the contracts are usually memorialized on documents provided by the administrator or promoter. The terms and conditions of each contract must be reviewed to determine whether the dealer is the agent or the principal.

Credit Life Insurance; Credit Accident and Health Insurance

Many consumers who finance the purchase of a vehicle, purchase Credit Life Insurance and/or Credit Accident and Health Insurance (also known as Credit Life and Disability Insurance). If the buyer dies before the loan is paid off, Credit Life Insurance benefits pay off the remaining balance. Thus, Credit Life Insurance is decreasing term insurance.

Credit Accident and Health Insurance pays the buyer's monthly loan payment when the buyer is disabled, as defined in the insurance certificate, after a specified waiting period, if any. The payments continue as specified in the insurance policy, usually as long as the buyer is disabled.

States have regulations concerning the sale of credit life and disability insurance that are enforced by an insurance commissioner. These regulations may affect premiums, commissions, etc. and usually provide that the insurance must be sold through an insurance company that is authorized to sell this type of insurance in the state where the dealership is located.

Most dealerships sell both Credit Life and Disability Insurance in conjunction with the sale of vehicles and it is a significant source of income for the dealership. This income is usually in the form of commissions (up front) ranging from 30 to 50 percent. Some states place a cap on the commission percentage. The dealership may also receive income through retrospective agreements and/or reinsurance arrangements.

Retrospective Agreements

Retrospective arrangements are "back ended" and are programs designed to allow the dealer to participate in the profitability of the insurance business. Reinsurance programs

are alternatives to commission caps imposed and regulated by many states. Reinsurance is the transfer of risk from the primary insurance company to the reinsurance company that may be established by the dealer. Reinsurance arrangements were first used by dealerships for their sales of Credit Life and Disability Insurance as a way to increase their commissions above the state cap. However, reinsurance arrangements are frequently used now in connection with VSC's.

General - ESC

Dealerships frequently offer extended service contracts to their customers in connection with the sale of a vehicle. Extended service contracts provide for repairs to covered vehicle components during a designated term. The term runs parallel to the manufacturer's warranty coverage and for an extended period beyond the manufacturer's warranty term. In other words, the customer is paying an additional amount for an extra two to seven years beyond the manufacturer's prescribed term.

The dealership often sells more than one type or brand of service contract and may be either, the "principal" / "obligor" or "agent." If the dealer is an agent of the administrator, insurer, or other party, the contract will contain language that indicates that the contract is between the vehicle purchaser and the other party, not the dealership. The contract administrator is also named in the contract.

If the dealer is the principal, the contract will contain provisions indicating that the contract is between the dealer and the vehicle purchaser. The contract would also contain language indicating the administrator and the party that insures that dealer's interest. In addition to the vehicle service contract, other documents are important to the extended service contract program. Other documents include an administrator agreement and an insurance policy.

Regardless of whether the dealer acts as an agent or the extended service contract is a dealer obligor plan, the administrator generally provides the vehicle service contract documents.

All contracts related to the service contract plan must be examined to determine whether a dealership is an agent or principal. Proper tax treatment of extended service contracts depends on an accurate determination of who is obligated under the contract.

Role of Administrator

An administrator is usually an unrelated party. They are responsible for administering service contracts for the dealerships. A dealership could have agreements with several administrators to provide this service.

The administrator provides the dealership with "dealer cost schedules" which establish administrative fees to be remitted to the administrator for various contract terms and classes of vehicles. The fees may change from time to time by the administrators. The difference between the actual price paid by the customer and the amount remitted to the administrator is retained by the selling dealership. The actual sales price of service contracts is subject to negotiation between the dealership and the customer, and the

prices varied accordingly. A portion of the amount paid to the administrators may be used to purchase insurance related to service contract claims.

The purchaser (customer) is directed to return the vehicle to the dealer in the event of a mechanical breakdown. Repairs performed by another repair facility are not covered by the contract unless the purchaser secures the Administrator's prior authorization. When the Administrator authorizes covered repairs by another repair facility, the Administrator arranges for payment of the claim from a reserve fund on the dealer's behalf.

Agent versus Principal/Obligor
A dealer can market after-sale products as either an agent or as a principal. Dealers sometimes attempt to structure these transactions so they will be classified as agents due to the favorable tax treatment.

What an agent or principal/obligor is in the context of the sale of extended service contracts can be loosely defined as follows:

1. Agent
   An agent is one who sells the products of a third party insurer without assuming the legal obligations or insurance risk of the product sold. The agent receives a fee for the sale and necessary administrative services rendered. The activities of an agent are not strictly limited to sales of insurance. In the past, some dealerships were selling factory extended "warranties" as agents for a product that was not then considered by the parties to be an "insurance" product.

2. Principal/Obligor
   A principal is a party to the contract who assumes the risk in the contract, is directly responsible for any ensuing liabilities that may arise and derives compensation from the profit built into the product sold. The principal in the automobile context will generally insure the obligations undertaken in these contracts with a third party insurer, but remains the primary obligor to the consumer.

As a principal/obligor, dealers should include in income the full amount received from the consumer for the mechanical breakdown contract. The amount remitted for the insurance premium should then be amortized over the term of the contract.

Dealer "Agent" Extended Service Contracts
If the extended service contract is between the vehicle purchaser and an administrator, insurance company or other party, the dealership acts as an agent and earns a commission. Generally, the dealership determines the selling price of the extended service contract and forwards a portion to the administrator based on a "cost schedule." The commission income must be accrued when the contract is sold. The commission amount is the difference between the extended service contract selling price and the amount the dealer forwards to the administrator, insurance company, or other party. TAM 9218004 provides guidance on determining agent vs. principal and the proper tax treatment of the commission income.

Note: Private Letter Rulings (PLRs) AND Technical Advisory Memorandums (TAMs) are addressed only to the taxpayers who requested them. Field Service Advisory's (FSAs) are not binding on Examination or Appeals, nor are they final determinations. Furthermore, Section 6110(k)(3) provides that PLRs, TAMs and FSAs may not be used or cited as precedent.

Dealer "Obligor" Extended Service Contract

When the extended service contract is between the vehicle purchaser and the dealership, the dealership is the "obligor" or "principal" on the contract. When a dealership acts as obligor or principal, it may purchase an insurance policy that insures its liability under the service contract. Thus, there are two transactions: one between the dealer and the customer, and the second between the dealer and an insurance company.

A. <u>Issues: Dealer Agent and Dealer Obligor Programs</u>

All contracts related to the service contract plan indicate whether a dealership is an agent or principal/obligor. Proper tax treatment of extended service contracts is determined by whether the dealer is the agent or obligor.

1. Dealer Agent programs
 a. Commissions must be included in income in the year the VSC is sold.
2. Dealer Obligor programs
 a. Selling price of the VSC must be included in income in the year the VSC is sold.
 . Service Warranty Income Method (SWIM) may be elected.
 b. Insurance premiums must be amortized over the term of the contract.
 c. Administrative fees can be pro-rated if the taxpayer can demonstrate a reasonable manner in which to estimate the amount (cost) and timing of services.

B. <u>Documents Needed</u>

1. Request a listing of all VSC/maintenance plans sold to the dealership during the year(s) under examination.
2. For each program sold, request the following information:
 a. Copies of actual, executed vehicle service contracts
 b. Copies of any promotional material
 c. Copies of any and all agreements and documents including all endorsements, amendments, and schedules between the dealership and other parties to the program.
 ° Documents may include but are not limited to: dealer agreements(s), administrator agreements(s), contractual liability insurance policy, service contract reimbursement insurance policy, consulting agreement(s), management agreements(s), reinsurance agreements(s), and warehouse agreements(s)
 d. Request that the dealership provide, in writing, samples of all accounting entries for all income and expenses.
3. Request a written statement from the owner of the dealership concerning:

- Payments made by any party to the program, directly or indirectly, to the dealership owner, any relative of the owner, or entity owned (all or in part) or controlled by the owner.

4. Do not be afraid to ask questions about the dealership's programs.
   a. Do not limit questions to the dealer's representative, controller, or employees.
      - The dealer principal (dealer/owner/shareholder) may be the only one fully informed regarding the details of the programs.

C. <u>Audit Techniques</u>

1. Determine by review of the **vehicle service contract** language whether the VSC is dealer obligor or dealer agent.
   a. Generally, dealer obligor contracts state that the VSC is a contract between the vehicle purchaser and the dealership.
   b. Dealer agent contracts are typically between the vehicle purchaser and an administrator or insurance company.
   c. Dealer obligor contracts contain a provision naming an administrator and/or insurer and may contain terms similar to the following:
      - The agreement is not an insurance policy.
      - The dealer is financially responsible for all repairs under the VSC.
      - The dealer's obligations under the contract are insured by "Insurance Company."
      - The administrator is not obligated under the contract.

2. For dealer obligor contracts:
   a. Analyze the **administrator agreement** to determine the dealership and administrator's responsibilities under the program. (Note: Some dealerships participate in multiple programs that apply to the same VSC. For instance, one program provides basic program administration and claims handling while a second program simultaneously provides for the establishment of the dealership's PORC. As a result, the dealership may have multiple administrative agreements, insurance policies, etc. To determine the proper tax treatment on the sale of the VSC, the ***entire*** transaction must be analyzed.)
      - The administrator agreement may include a provision for a reserve or escrow account, the establishment of a PORC, payment of various fees to parties related to the dealership or administrator, etc.
   b. Review amendments, endorsements, and schedules for clues to other agreements, payments to related parties, etc.
   c. Analyze the **insurance policy** to determine the coverage and to determine the "name insured".
      - Generally, dealer obligor programs provide for a contractual liability policy naming the dealership as the insured.
      - Determine if there is any common ownership between the dealership and the insurance company.
      - Determine if the dealership or other party related to the dealership provides indemnification to the insurance company.
      - If the dealership purchased insurance from an unrelated insurance company and did not enter into a reinsurance agreement, determine if the selling price of the contract is included in the income in the year the contract is sold.

- Determine if the cost of insurance was amortized over the contract life.
- Determine if the dealership properly elected and applied the Service
- Warranty Income Method (SWIM) of reporting income.
- Determine how the dealership accounted for administration fees.

D. Aftersale Market Products Issues and Authority

I. <u>Dealer Obligor Contracts –Insurance Purchased (No PORC involved)</u>

1. Include selling price of VSC in income in the year sold.
2. Cost of insurance must be amortized over the life of the contract.
3. SWIM (*see below*) allows the qualified advance payment amount (including a provision for interest) to be deferred provided that certain conditions are met including:
   a. SWIM must be properly elected and applied.
      - To properly elect SWIM, the dealership **must** purchase insurance from an unrelated party.
      b. Insurance premiums **must** be amortized.
4. Administrative fees can be amortized if the taxpayer can demonstrate a reasonable manner in which to estimate the amount (cost and timing of administrative services. If not, a deduction should **not** be allowed until the end of a contract.

Dealerships that sell dealer obligor contracts and purchase insurance to cover their risks often report the income in a manner similar to a dealer agent contract, i.e. report only the commission income. To properly account for a dealer obligor contract, the dealership must include in income the *entire* sales price of the service contract.

<u>Income Issues</u>:
Automobile Club v. *Commissioner*, 353 U.S. 180 (1957): Generally, taxpayers that determine their taxable income using the accrual method of accounting must include advance payments in income when received. The Supreme Court applied this rule *Automobile Club* v. *Commissioner*, to membership dues collected 1 year in advance. The rule was also applied to service contracts in *Streight Radio and Television, Inc.* v. *Commissioner*, 280 F.2d 883 (7th Cir. 1960) where the taxpayer had unrestricted use of the funds.

Rev. Proc. 71-21, 71-2 C.B. Page 549 provides for an election to defer advance payments for services where the services are to be performed by the end of the next tax year.

When a dealership is the principal on an extended service contract, the sales price of the service contract constitutes an advance payment and the dealership must include the full sales price in income when the contract is sold. The exception provided by Rev. Proc. 71-21 does not apply since the terms of the contracts are 2 years or more, and the services will not be performed by the end of the taxable year after the year of sale.

In *Hinshaw's, Inc.* v. *Commissioner*, T.C. Memo. 1994-327: The Tax Court specifically addressed this issue in the dealership context in two cases. In *Hinshaw's, Inc.* v. *Commissioner,* the Tax Court ruled that all amounts collected for extended service contracts were includable in income in the year received.

In Rameau Johnson, et al, v. Commissioner 108 T.C. 448 (1997), aff'd in part, rev'g in part, 184 F.3d 786 (8th Cir. 1999), the dealerships retained a portion of the contract price as profit and forwarded the remainder to the administrator for deposit in an escrow account, for payment of administration fees, and for the purchase of excess loss insurance. The escrow amounts earned investment income. Dealers received distributions from the escrow accounts, within certain limitations, for specified purposes such as compensation for covered repairs, cancellations, and the release of "unconsumed reserves" at the expiration of a contract. The dealerships included in current income the profit portion of the contract price but included the escrow amounts as they were released.

The Court ruled that when the dealership sold an extended service contract, it acquires a fixed right to receive, and must currently include in gross income, the portion of the contract price deposited in escrow.

The Court also ruled that the dealer is treated as the owner of the escrow account and must currently include investment income earned by the accounts in gross income of the dealership.

<u>Amortization Issues:</u>
Higginbotham-Bailey-Logan Co. v. *Commissioner*, 8 B.T.A. 566:
When dealers pay a premium to insure their liability under the service plan that they sell, the term of the insurance is the same as the term of the contracts. Insurance premiums for policies covering more than 1 year must be amortized ratably over the term of the policy. Taxpayers using the accrual method of accounting must prorate and deduct ratably over the term of the policy prepaid insurance premiums.

In *Hinshaw's, Inc.* above, the Tax Court specifically addressed amortization of insurance purchased to cover the dealer's risk under the extended service contract. The Court ruled that the dealership "* * *entered into contracts with its customers that required [it] to protect the customers from vehicle service costs for up to 7 years. [The dealership] then purchased insurance to protect itself from having to pay those costs; instead, the costs would be paid by an insurance company. Since [the dealership] will benefit from this coverage for more than 1 tax year, petitioner must capitalize the cost of the insurance."

Toyota Town, Inc. et al, TC Memo 2000-40, aff'd 268 F.3d 1156(9th Cir.) (2001):
Generally, the dealers must amortize insurance expenses; amortization begins when the contract is issued; the dealers cannot net the contract price and insurance costs. Should the dealers elect the SWIM method (Revenue Procedure 92-98) dealers must first comply with Revenue Procedure 92-97.

In summary, when a dealership acts as the obligor on an extended service contract and purchase insurance to cover its risk, it must include in income the full sales price of an extended service plan at the time of sale, and is allowed to deduct the insurance premium ratably over the term of the plan.

Service Warranty Income Method (SWIM)

In general, payments received by an accrual method taxpayer for services to be performed in the future must be included in gross income in the taxable year of receipt. The Service recognized that this treatment resulted in a significant and unique cash flow problem for dealerships that sell extended service contracts to customers in connection with the sale of motor vehicles and immediately pay a third-party to insure their risks under the contracts.

To remedy this situation, the Service made an administrative decision to permit these dealerships to adopt or change to a special method of accounting for advance payments that would alleviate the cash flow problem but would generally conform economically to the tax treatment of advance payments under current law.

Rev. Proc. 97-38, previously 92-98, provides for an alternative reporting method, the "Service Warranty Income Method" (SWIM). Taxpayers who elect SWIM may spread a portion of the service warranty contract income over the life of the contract. The amount of income that can be deferred is equal to the amount that is paid by the taxpayer to an unrelated third party to insure the taxpayer's obligations under their contracts. The amount qualifying for deferral is called the "Qualified Advance Payment Amount."

The SWIM method *only applies* when insurance is purchased from an *unrelated party.*

Dealerships that elect to defer the qualified advance payment amount must increase the income to be reported by adding on an imputed income amount on a level basis over the shorter of the actual term of the service warranty contract or a 6 taxable-year period.

In addition to automobile dealers, manufacturers and wholesalers may use SWIM for fixed-term service contracts on motor vehicles or other durable consumers goods purchased by a customer with a separately stated amount for the service warranty contract if the taxpayer purchases insurance from an unrelated third party and makes payment to the insurer within 60 days after the receipt of the advance payment for the insurance costs associated with the policy.

In general, this method of accounting permits these taxpayers to recognize and include in gross income, generally over the period of the extended service contracts, a series of equal payments, the present value of which equals the portion of the advance payment qualifying for deferral.

The Service Warranty Income Method (SWIM) was originally implemented in Rev. Proc. 92-98 (superceded by Rev. Proc. 97-38.) For complete information on the

implementation of the Service Warranty Income Method please see the revenue procedures.

Rev. Proc. 97-38 Example

Facts:

5 Contracts Sold January	1, 2000, @ $1,600 =	$8,000
5 Contracts Sold December	1, 2000, @ $1,600 =	$8,000
Total		$16,000

Dealership pays w/in 60 days of receipt of each advance payment, *$1200 per contract to an unrelated third party to insure (in an arrangement that constitutes insurance)

Term - 5 Years
*Insurance Premium $ 1,200 each
AFR 10 percent

Qualified Advance Payment Amount [2] $12,000 x .2398 = $2,878 [1]

Non Deferred Income $ 4,000 [3]

[1] From tables found in Rev. Proc. 97-38 based on term of years (5) and the AFR (10%). (10 contracts x 1200=12,000)

[2] Definition of terms used in this example can be found in Rev. Proc. 97-38.

[3] Non Deferred Income: $16000 – 12000 = $4000
Total contracts sold less Qualified Advance Payment Amount = Non Deferred Income

	2000	2001	2002	2003	2004	2005
Non Deferred Income	$4,000					
Deferred Income	$2,878	$2,878	$2,878	$2,878	$2,878	
	$6,878	$2,878	$2,878	$2,878	$2,878	
Amortization	<1,300>	<2,400>	<2,400>	<2,400>	<2,400>	<1,100>
Taxable Income	$5,578	$478	$478	$478	$478	<1,100>

Total (5578 +478+478+478+478-1100= 6390)	$6,390	
Non Deferred	4,000	
Additional Income	$2,390	[4]

[4] This additional income is based on the add on AFR interest. This is the cost to the taxpayer for deferral of income and use of the Government's money during this time.

Court Cases:
Toyota Town, Inc, et al, TC Memo 2000-40, affd. 268 F.23d 1156 (9th Cir.) (2001): a consolidated case of several dealers who elected the SWIM method. The tax court held that the dealers must amortize insurance expenses. The amortization begins when the contract is issued. The dealers cannot net the contract price and the insurance costs. The 9th circuit affirmed the tax court decision and held that the dealers must comply with the method of accounting for the related insurance expenses prescribed in Rev. Procedure 92-97 as a condition of adopting the SWIM method.

Rameau Johnson et al v. Commissioner, 108 T.C. 448 (1997) aff'd in part, rev'g in part, 184 F.3d 786 (8th Cir. 1999): a decision about dealer's use of escrow or trust accounts in connection with their service contracts. The court determined that the sales price of the contract is income when received. The claims are deductible when paid and administrator fees are amortized over the life of the contract. The stop loss insurance costs must be amortized. The interest income is investment income to the taxpayer (dealer) when earned.

Contract Construction

Generally, a dealership is aware when it is a principal on a service contract. Most contracts explicitly state the dealer is a principal or an obligor. Some dealers may claim they are not principals, even though the contract explicitly states they are.

The courts have followed the IRS's interpretation of these contracts determining the dealer a principal, where the facts warrant. They have held that the IRS may consider evidence outside a written contract (parol evidence) if the terms of an agreement are unclear or ambiguous. The court determined in, *Rochester Development Corporation* v. *Commissioner*, T.C. Memo. 1977-307, CCH 34,630(M), the IRS may consider the surrounding circumstances and oral testimony of a transaction if the contract's terms of an agreement are not clear. See *Commissioner* v. *Danielson*, 378 F.2d 771 (3rd Cir. 1967) *cert. denied*, 389 U.S. 858 (1967), *Joan S. Schatten* v. *United States*, 746 F.2d 319 (6th Cir. 1984), and *Johnie Vaden Elrod* v. *Commissioner*, 87 T.C. 1046 (1986).

However, parol evidence will not be allowed where there is no such ambiguity and the terms are clear. Where the contract is unambiguous, the courts have indicated they will narrowly construe the terms of the contract and uphold its clear meaning. For a taxpayer to challenge the Commissioner's construction of an agreement's clear and unambiguous form, some federal circuit courts have held the taxpayer must show proof that the agreement was unenforceable because of mistake, undue influence, fraud, or duress. See *Rochester Development Corporation* v. *Commissioner*, T.C. Memo. 1977-307, CCH 34,630(M).

Change in Accounting Method Concerns and IRC section 481(a)

Treas. Reg. section 1.446-1(a) defines method of accounting as not only the overall method of accounting of the taxpayer, but also the accounting treatment of any item. A method of accounting is established by the proper treatment of an item in the first year that the taxpayer has the item or by improper treatment of the item in the first 2 years that the taxpayer has the item. A material item is one involving the timing of its inclusion or deduction. A change in method does not include correction of mathematical or posting errors or tax computation errors or of an item not involving a question of timing.

Treas. Reg. section 1.446-1(e)(2)(ii), states that a material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. A method of accounting involves the consistent treatment of a material item. A material item is any item that involves the proper time for the inclusion of an item in income or the taking of a deduction (Treas. Reg. section 1.446-1(e)(2)(ii) and Rev. Proc. 91-31, 1991-1 C.B. 566). Rev. Proc. 97-27 provides a definition of "method of accounting." It states: "…the relevant question is generally whether the practice permanently changes the amount of taxable income …" Consistent treatment is established by using an improper method for 2 or more tax years (Rev. Proc. 97-27 and Rev. Rul. 90-38, 1990-1 C.B. 57) and a proper method for 1 year (Treas. Reg. section 1.446-1(e)(1)).

Under the method of accounting employed by some dealerships, only a "net" amount of the retail sale price of a dealer obligor mechanical breakdown contract is reported in the taxable year of the sale of the contract. This "net" represents the amount by which the sales price exceeds the insurance and administrative expenses. This method results in the exclusion from income, or early deduction of, expense items that properly should either be amortized over the life of the mechanical breakdown contract, or be deducted as economic performance occurs.

Requiring the dealer to change from expensing insurance premiums to amortizing them is a change in accounting method. This change affects the timing of the deduction of a material item.

A new dealership filing its first return has not established an accounting method where it erroneously deducted in its first year of operation, the entire premium for a multi-year period.

Under IRC section 481(a), when computing taxable income for any taxable year, "… (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding year was computed then (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted..."

Treas. Reg. section 1.481-1(a)(1) provides that a change in method of accounting to which IRC section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item.

IRC section 481(b) provides for a limitation on tax where the change in method of accounting is substantial. This section allows for a computation of tax over 3 years if the method of accounting changed was used in 2 preceding tax years and the increase to taxable income for the year of change exceeds $3,000.

When adjustments are made under IRC section 481(a), the statute of limitations is not an issue. IRC section 481 provides that taxable income for the year of change must be computed by taking into account all adjustments necessary to prevent items from being duplicated or omitted. This includes amounts that would otherwise be barred by the statute of limitations. *Graff Chevrolet Company* v. *Ellis Campbell, Jr.*, 343 F.2d 568 (5th Cir. 1965).

A second adjustment under IRC section 446(b) accounts for the difference in taxable income determined under the new method of accounting for the year of change as compared to the old method.

Rev. Proc. 97-27 provides the administrative procedures applicable to changes in methods of accounting. It applies a gradation of incentives to encourage voluntary compliance with proper tax accounting principles, and to discourage taxpayers from delaying the filing of applications for permission to change an improper accounting method.

Service Contract Overpayment Programs

The sale of vehicle service contracts (VSC) continues to be a popular source of additional income for automobile dealerships. Vehicle service contracts are available in a variety of formats, with an assortment of options, and may name the dealership or another party as the obligor. Due to the varied programs available, the proper tax treatment can be complicated. This section is intended to address only **one** aspect of **some** service contract programs, i.e. the possible diversion of income using an "overpayment" agreement. It is **not** intended to clarify all issues related to VSC or to be inclusive of all areas of potential non-compliance.[1]

The VSC option described in this section (diversion of income from the dealership and non-reporting of the income by the recipient) presents an opportunity for confusion, inconsistent tax treatment, and possible widespread non-compliance. The Motor Vehicle Technical Advisor (MVTA) is evaluating this issue to determine the scope of the non-compliance. This section is the first step in a program to provide guidance to IRS and industry personnel of the proper treatment of the issues and the possible effects of non-compliance.

[1] Proper tax treatment of the transaction will vary depending upon the specifics of the VSC program. Any potential tax issues related to other aspects of the transactions are not the subject of this section.

Overview of the Issue

The programs may vary slightly in operation; they can be identified by various names such as "over submits, dealer override agreements, over remit programs, or management contracts " and are found in non-dealer obligor programs and dealer obligor programs for new and used vehicles.

Example

Facts

In conjunction with the sale of a vehicle, the dealership also sells the customer a vehicle service contract. The price of the vehicle service contract is $800. The dealership is required to pay the obligor/administrator $400 under the contract.

No "over payment arrangement"

The dealership retains $400 as commission (retention amounts will vary by program) and submits the remaining $400 to the obligor/administrator. [2] Assuming that the program is a pure dealer agent program, the dealership reports $400 as income.[3] Generally, there is no unreported income issue.

"Over payment" arrangement in place

The dealer executes a voluntary supplemental agreement to pay to the obligor/administrator an amount in excess of the contractually required amount. For example, rather than retaining $400 and submitting $400 as in the example above, the dealer may submit $550 to the administrator and retain only $250.

The supplemental agreement between the dealership and the obligor/administrator allows the dealership to determine the amount of the overpayment and to designate a “beneficiary” to receive the overpayment amount. The designated “beneficiary” may be an individual, e.g. the dealership shareholder, spouse, child, etc., a corporation, e.g. the dealership, a related corporation, or another entity e.g. reinsurance company or a related S corporation.

The supplemental agreement may require the inclusion of the beneficiary's Federal Tax Identification number or Social Security number and the obligor/administrator may issue Forms 1099 if the beneficiary is an individual, partnership, or sole proprietor. If the beneficiary is a corporation, a Form 1099 is not required. On a periodic basis, generally monthly, the obligor/administrator aggregates the over submitted amounts and remits the total amount to the beneficiary.

By reducing the amount retained by the dealership from $400 to $250, the overpayment effectively reduces the income reported by the dealership by the $150 over submitted amount. The $150 over submitted amount might be reported as income by the “beneficiary,” however if no Form 1099 is filed, there is no tracking of the beneficiary.

[2] Depending upon the program, the amount submitted to the obligor/administrator may be used to purchase insurance, be placed into a trust or escrow account, or be used for other purposes

[3] The tax treatment will vary significantly if the program is a dealer obligor program or contains other features such as escrow or trust accounts.

Even if the beneficiary reports the income, the overpayment amount represents income to the dealership.

Discussion

There are many reasons, in addition to reducing reported income why a dealership might execute an over payment agreement. According to some industry sources, reducing the profit on the sale of a vehicle service contract reduces the base amount on which the Finance and Insurance Manager's sales commission is based. The over payment programs also allow an individual to redirect capital to another entity that enjoys a more favorable tax treatment. Regardless of why a dealership engages in the over payment program, it is vital that the program be treated properly for tax purposes.

Preliminary analysis indicates that the proper reporting of vehicle service contract overpayment amounts rests on the definition of gross income and the principle of assignment of income. By making an overpayment to the obligor/administrator and designating a "beneficiary' to receive the over payment amount, the dealership assigns income to the beneficiary.

IRC §61 defines gross income as income from whatever source including compensation for services such as fees and commissions. Dealerships earn income on the sale of vehicle service contracts. Ordinarily, the difference between the selling price of the vehicle service contracts and related expenses represents income to the dealership. When a dealership makes a payment to the obligor/administrator in excess of the amount ordinarily required, the dealership *artificially reduces the income* reported on the sale of the service contract.

The controlling principles regarding assignment of income issues are found in *Lucas vs. Earl*, 281 U. S. 111 (1930). Generally, the question is whether a taxpayer is responsible for the tax on an amount or whether some other person or entity that receives the amount at the direction of the taxpayer should pay the tax on the item. The Court ruled that the "…fruit must be hung on the tree from whence it came…" and that the taxpayer that directed the payment of the amount to another party is responsible for the appropriate income tax on that amount.

Overpayments made to the VSC obligor/administrator represent income earned by the dealership and assigned to the beneficiary. *Lucas vs. Earl*, supra, requires income to be allocated to the dealership that earned the income. Depending upon the relationship of the beneficiary to the dealership owner, the overpayment may be characterized as a non-deductible dividend to the dealership owner or in some other fashion.

A. Issue:

a. Is the overpayment amount income to the ultimate recipient (dealer/obligor/shareholder/owner)?

b. Is the overpayment a deductible expense?

c. Is the overpayment a dividend?

B. Documents Needed

1. Request a listing of all VSC/maintenance plans sold b the dealership during the

year(s) under examination.

1. Request a listing of all Dealer over submit, Dealer Override, Dealer Remit or Management Programs
   a. Request copies of all voluntary supplemental agreement to pay an administrator a fee in addition of the contractually required amount
2. For each program sold, request the following information:
   a. Copies of actual, executed vehicle service contracts
   b. Copies of any promotional material
   c. Copies of any and all agreements and documents including all endorsements, amendments, and schedules between the dealership and other parties to the program.
      - Documents may include but are not limited to: dealer agreements(s), administrator agreements(s), contractual liability insurance policy, service contract reimbursement insurance policy, consulting agreement(s), management agreements(s), reinsurance agreements(s), and warehouse agreements(s)
   d. Request that the dealership provide, in writing, all accounting entries for all income and expenses.
3. Request a written statement from the owner of the dealership concerning:
   - Payments made by any party to the program, directly or indirectly, to the dealership owner, any relative of the owner, or entity owned (all or in part) or controlled by the owner.
4. Do not be afraid to ask questions about the dealership's programs. Do not limit questions to the dealer's representative, controller, or employees.
   - The dealer principal may be the only one fully informed regarding the details of the programs.

C. Audit Techniques

1. Determine by review of the **vehicle service contract** language whether the VSC is dealer obligor or dealer agent.
   a. Generally, dealer obligor contracts state that the VSC is a contract between the vehicle purchaser and the dealership.
   b. Dealer obligor contracts contain a provision naming an administrator and/or insurer and may contain terms similar to the following:
      - The agreement is not an insurance policy.
      - The dealer is financially responsible for all repairs under the VSC.
      - The dealer's obligations under the contract are insured by "Insurance Company."
      - The administrator is not obligated under the contract.

2. For dealer obligor contracts:
   a. Analyze the **administrator agreement** to determine the dealership and administrator's responsibilities under the program. (Note: Some dealerships participate in multiple programs that apply to the same VSC. For instance, one program provides basic program administration and claims handling while a second program simultaneously provides for the establishment of the dealership's

PORC. As a result, the dealership may have multiple administrative agreements, insurance policies, etc. To determine the proper tax treatment on the sale of the VSC, the ***entire*** transaction must be analyzed.)

- The administrator agreement may include a provision for a reserve or escrow account, the establishment of a PORC, payment of various fees to parties related to the dealership or administrator, etc.

b. Review amendments, endorsements, and schedules for clues to other agreements, payments to related parties, etc.

c. Analyze the **insurance policy** to determine the coverage and to determine the "name insured".

- Generally, dealer obligor programs provide for a contractual liability policy naming the dealership as the insured.
- Determine if there is any common ownership between the dealership and the insurance company.
- Determine if the dealership or other party related to the dealership provides indemnification to the insurance company.
- If the dealership purchased insurance from an unrelated insurance company and did not enter into a reinsurance agreement, determine if the selling price of the contract is included in the income in the year the contract is sold.
  - Determine if the cost of insurance was amortized over the contract life.
  - Determine if the dealership properly elected and applied the Service Warranty Income Method (SWIM) of reporting income.
  - Determine how the dealership accounted for administration fees.

d. Analyze the **supplemental agreement** between the dealership and the obligor/administrator to determine the amount of the overpayment and to designate a "beneficiary" to receive the overpayment amount.

- The designated beneficiary may be an individual, (dealership/shareholder, spouse, child; corporation/dealership; related corporation, or another entity, i.e. reinsurance company or a related S corporation.
- The agreement may require the inclusion of the beneficiary's Federal Tax Identification Number or Social Security number and the obligor may issue Forms 1099 if the beneficiary is an individual, partnership or sole proprietor.

Conclusion

The overpayment program is just one option in the variety of vehicle service contract programs that are available. The lack of uniformity in the overpayment programs makes it difficult to formulate a "one size fits all" approach to the proper tax treatment.

Definitions

Administrator:

An administrator is usually an unrelated party. They are responsible for administering service contracts for the dealership

Agent:

If the dealer is an agent of the administrator, insurer, or other party, the contract will contain language that indicates that the contract is between the vehicle purchaser and

the other party, not the dealership. The contract administrator is also named in the contract.

"Principal" / "Obligor":
If the dealer is the principal, the contract will contain provisions indicating that the contract is between the dealer and the vehicle purchaser.

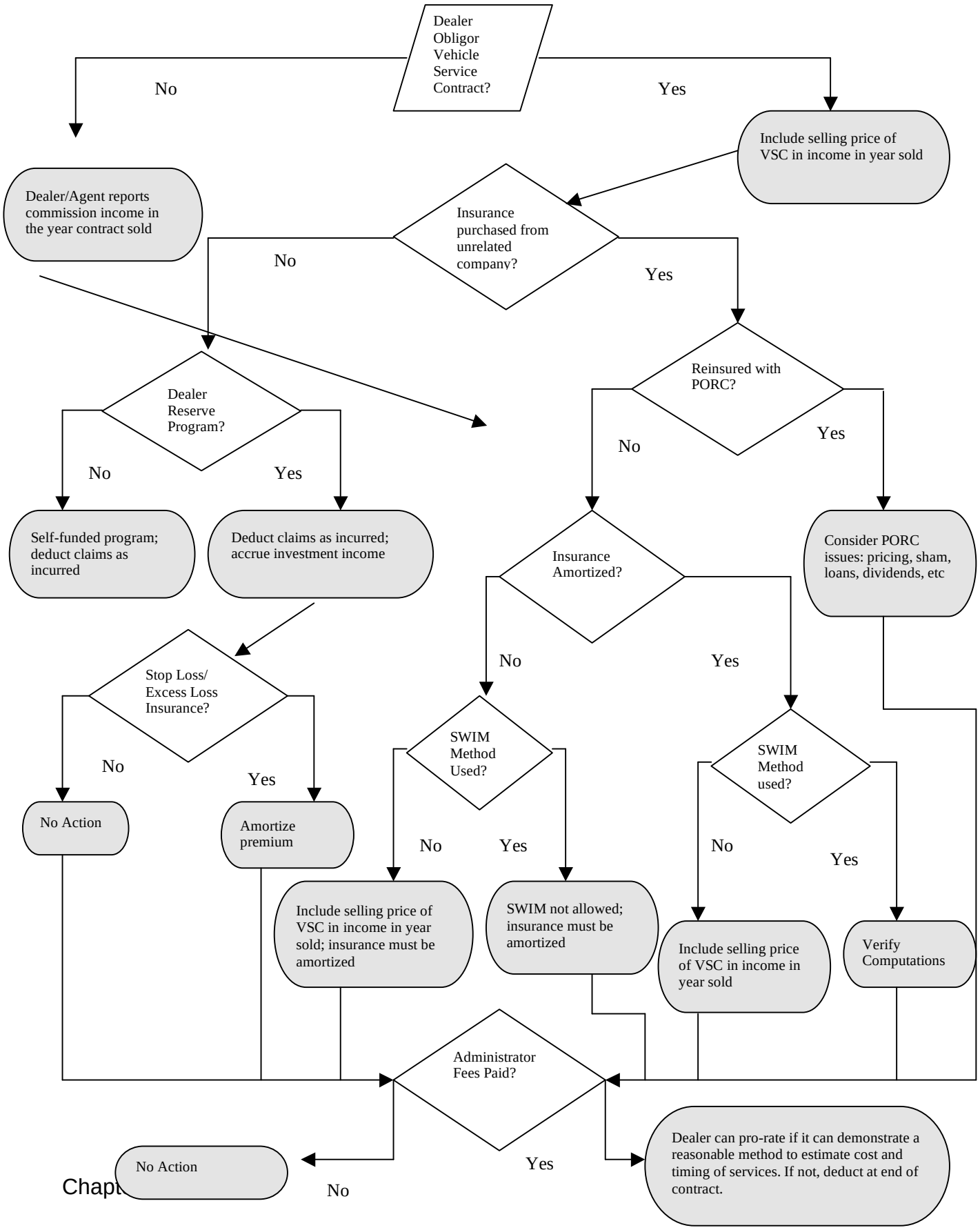
Vehicle Service Contract:
(VSC) also known as an extended service contract primarily for vehicles, new or used.

Administrator Agreement:
An agreement between the dealership and administrator's responsibilities provided to the extended service contract program. (Note: Some dealerships participate in multiple programs that apply to the same VSC. For instance, one program provides basic program administration and claims handling while a second program simultaneously provides for the establishment of the dealership's PORC. As a result, the dealership may have multiple administrative agreements, insurance policies, etc.)

Service Warranty Income Method (SWIM):
An election under Revenue Procedure 97-38, previously 92-98, which provides for an alternative Income reporting method, the "Service Warranty Income Method" (SWIM). Taxpayers who elect SWIM may spread a portion of the service warranty contract income over the life of the contract. The amount of income that can be deferred is equal to the amount that is paid by the taxpayer to an unrelated third party to insure the taxpayer's obligations under their contracts. The amount qualifying for deferral is called the "Qualified Advance Payment Amount." The SWIM method only applies when insurance is purchased from an unrelated party.

Service Contract Overpayment Programs:
Also known as Dealer over-submit, Dealer Override, Dealer Remit or Management Programs. This is a supplemental program that may be included in the vehicle service contract. This calls for a voluntary supplemental agreement to pay an administrator a fee in addition of the contractually required amount.

VSC Audit Technique Flow Chart



Chapter 8
PORC

Introduction

In today's business climate, it is not unusual to find that producers (e.g. service providers, lenders, retailers) offer customers the option of purchasing insurance products such as extended service contracts, credit life insurance, involuntary unemployment insurance, and property insurance. In some cases the reinsurance company is owned by the producing company. In others, it is owned by shareholders of the producer, e.g. auto dealerships. Even though the reinsurance company may not actually be owned by the "producer" of the insurance business, but rather by shareholders of the producer, the company is often referred to as a Producer Owned Reinsurance Company or PORC.

PORCs may be associated with a variety of producers including, but not limited to, auto dealerships, furniture stores, rent-to-own stores, electronics stores, credit card companies, and lending institutions. Products reinsured into the PORC can include extended service contracts, credit life and disability insurance, theft and property damage insurance, credit card and loan default insurance, and involuntary unemployment insurance.

The PORC is generally part of a closely held group of companies and is frequently formed in an off-shore domicile with minimal capitalization requirements and regulatory oversight. Although formed off-shore, the PORC typically makes a Section 953(d) election to be treated for tax purposes as a U.S. corporation and to take advantage of favorable U.S. insurance company tax laws. Depending upon the type of business reinsured, the company may be subject to IRC Section 806 for life insurance companies, IRC Section 501(c)(15) for insurance companies that are not life insurance companies and that have premiums less than $350,000, or IRC Section 831(b) which enables insurance companies that are not life insurance companies and with premiums between $350,000 and $1.2 Million to elect to be taxed only on investment income. In April, the President signed H.R. 3108, Pension Funding Equity Act of 2003, that contains revisions to IRC Section 501(c)(15) effective for tax years beginning after December 31, 2003. The Act contains a "Change in Income" test. For stock companies, the premium income test ($350,000) has been replaced with a gross receipts test raised to $600,000, half of which (or more) must be premium income. An Insurance Business Activity Test is also imposed. By using the life insurance company definition in IRC 816(a) as the definition of insurance, a business activity test has been imposed (at least 50% of the business must be insurance issuance business).

It is important to note that not all PORCs are abusive. However, due to the nature of the company and the favorable insurance tax provisions, the entities are inherently abusible. In order to address the potential abusive use of PORCs, the Service issued Notice 2002-70, 2002-44 I.R.B. 765 (November 4, 2002) .

PORC as a Listed Transaction – Notice 2002-70

Issued in November of 2002, the Notice notified taxpayers that the Internal Revenue Service and Treasury Department had become aware of a type of transaction used by taxpayers to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. The notice alerts taxpayers and their representatives that these transactions often do not generate the federal tax benefits that taxpayers claim are allowable for federal income tax purposes. The notice also alerts taxpayers, their representatives, and promoters of these transactions, to certain reporting and record keeping obligations and penalties that they may be subject to with respect to these transactions.

The Notice describes the transaction as one that "generally involves a taxpayer ("Taxpayer") (typically a service provider, automobile dealer, lender, or retailer) that offers its customers the opportunity to purchase an insurance contract through Taxpayer in connection with the products or services being sold. The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed."

The Notice advises taxpayers that many of the transactions described in the Notice have been designed to use a reinsurance arrangement to divert income properly attributable to a taxpayer to a related reinsurance company that is subject to little or no federal income tax. Finally, the Notice notifies taxpayers that the Service intends to challenge the purported tax benefits from these transactions on a number of grounds..

The Notice sets forth three arguments the Service may use to challenge the purported tax benefits from these transactions.

1. First – that the PORC entity is not an insurance company if it does not have as its primary and predominant business activity the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

2. Second – if the pricing is not at arm's length, then the parties have failed to properly allocate income, deductions and other items between the taxpayer and its reinsurance company. Under this theory, additional income would be allocated to the taxpayer. See GAC Produce Co. v. Comm'r., T.C.M. 1999-134.

3. Third – looks to whether the transaction is a sham. In appropriate cases, the IRS may disregard the insurance and reinsurance arrangements, and thereby require taxpayer to recognize an additional portion of premiums received from its customers as its income, if the

arrangements are shams in fact or shams in substance. See Kirchman v. Comm'r., 862 F.2d 1486, 1492 (11th Cir. 1989).

Transactions that are the same as, or substantially similar to, the transaction described in the Notice that involve taxpayers claiming entitlement to the benefits of I.R.C. §§ 501(c)(15), 806, or 831(b) are identified as "listed transactions." The Notice informs taxpayers that the Service may impose penalties on participants in these transactions or substantially similar transactions involving taxpayers claiming entitlement to the benefits of Sections 501(c)(15), 806, or 831(b) or, as applicable, on persons who participate in the promotion or reporting of such transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Designating a transaction as a listed transaction imposes certain disclosure obligations on taxpayers under Procedure and Administration Regulation section 1.6011-4. Taxpayers that participate in a listed transaction are required to attach a statement disclosing such participation to each tax return covering a year in which they participated in the transaction. A copy of the disclosure statement must be filed with the Office of Tax Shelter Analysis (OTSA) for the first year of participation. For taxpayers that participated in a transaction which subsequently became listed, a copy of the disclosure statement should be filed with OTSA for the first tax year ending after the date the transaction was designated as a listed transaction.

PORC Formation

In the 1970s, insurers began offering reinsurance programs to large producers using U.S. based PORCs for life and disability reinsurance programs, but these PORCs needed substantial capitalization and were heavily regulated. In the late 1970s and 1980s, offshore PORCs began to appear and soon became popular because they were more flexible in terms of coverage they could write and because the levels of capitalization were lower, thus allowing more moderately sized producers to establish a PORC.

The formation of a PORC involves consideration of several factors. Some of the more important factors include: formation costs, capital requirements, investment restrictions, taxes, reporting, security of assets and overall regulatory environment.

Today, many controlled PORCs are incorporated in foreign jurisdictions. Offshore PORCs are typically more attractive to companies because they offer minimal capitalization requirements and a relaxed regulatory environment. Formation can be accomplished in a shorter period of time and the cost of operation is modest. Many offshore locations allow all of the PORC's assets to be held in the United States and the level of financial reporting is greatly reduced.

The PORC Transaction

The following is an example of a typical PORC transaction. The fact patterns may vary considerably from this example and may become quite complex. To properly understand a PORC transaction, it must be analyzed individually and the examiner must follow the flow of funds, understand the relationships between all parties, and analyze all documents.

A typical PORC transaction begins with a taxpayer that is engaged in the business of selling products and/or services to consumers e.g. a retailer, lender, auto dealership. Consumers may purchase products and services for cash or they may finance the purchase by executing an installment note, a revolving charge retail agreement with the taxpayer, or some other finance method.

As part of the transaction, the consumer is offered the opportunity to obtain an insurance contract in connection with the product or services being purchased. Customers are not required to purchase this insurance. However due to the high profitability of the products, they are aggressively promoted and many customers agree to purchase one or more of the insurance products.

The taxpayer may sell the insurance products to its customers as an agent for an unrelated insurance company or as the primary obligor on the product. The insurance may provide coverage for the property or the customer's ability to repay the outstanding loan balance in the event of unforeseen circumstances.

For example, acting as an agent, a retailer offers to sell an extended service contract to its customers as part of their sale of products. The contracts provide for the repair of any covered function of the product during the term of the contract. Typically, the contract provides the customer with coverage for repair or replacement costs if the item breaks down or is lost, stolen, or damaged. Alternatively, the retailer may offer a contract to the customer, which obligates the retailer to perform or pay to correct any product deficiencies. In either situation, the retailer may then arrange with an unrelated insurance company to provide insurance coverage for the risks associated with the insurance product sold by the retailer.

In a typical non-PORC structure, the producer receives an up-front sales commission equal to a percentage of the premium paid by the consumer for selling the insurance in accordance with an agency agreement. The producer may also share in the profitability of the insurance business by receiving a retrospective sales commission from the insurance company based on the loss experience of the insurance business. According to industry representatives, formation of a PORC provides the producer of insurance business another opportunity to share in the profits of this lucrative business. The off-shore domicile of a PORC facilitates the formation of this new profit center by allowing a reduced initial investment and minimal regulation.

Formation of the Off-Shore Entity

Generally, the producer or shareholders of the producer, with the assistance of a promoter, administrator, or other party, forms a PORC in a foreign jurisdiction with a nominal capital contribution. Caribbean islands such as Nevis and the Turks and Caicos islands are popular choices for PORC domiciles.

There are numerous factors that companies consider when deciding where to incorporate a PORC. For instance the company may look at the jurisdiction's requirement for:

- Capitalization
- Investment Restrictions
- Surplus
- Reporting
- Income and Local Taxes
- Government Fees
- Overall Regulatory Structure

Although formed in a foreign jurisdiction, funds in the PORC typically remain in the U.S and the investment of the funds is often directed by parties related to the producer. In addition, the PORC will usually make an IRC § 953(d) election to treat the PORC as a domestic insurance company. Depending upon the mix of business reinsured, the PORC may claim tax exempt status and file a form 990. Or it may claim favorable insurance treatment under IRC § 831(b) as a small property and casualty company or IRC § 806 as a small life insurance company.

The purpose of the PORC is to reinsure the risks of business initially placed with a "fronting" insurance company. The fronting company may be a well known traditional insurance company. Or it may be a company related to the promoter or administrator of the PORC transactions. Reinsurance is the transfer of risk and premium from one insurance company to another. In a typical transaction the fronting company transfers or "cedes" a percentage of the risk and the premium, less ceding fees, to the PORC.

The insurance policy and the reinsurance agreement create the impression that business is being conducted "offshore." Although the PORC may, in form, be off-shore, its business is generally carried on at the producer's business location, with funds typically deposited at the producer's U.S. bank or investment company.

Retailers typically agree to reduce their historic sales commission upon formation of the PORC. Additionally, any retrospective commissions which the retailer was entitled to receive prior to formation of the PORC are usually eliminated.

General Structure Example

Without a PORC

A U.S. retailer sells or leases electronics and furniture. The retailer sells a $100

insurance contract acting as an agent for a regulated U.S. insurance company. The retailer earns a $40 up-front sales commission and forwards $60 to the insurance company. The insurance company earns a $10 fee on the policy and provides a $50 retrospective commission to the retailer based on favorable loss experience. In this case, the retailer earned $90 on the sale of a $100 insurance policy.

With a PORC

A U.S. retailer sells or leases electronics and furniture. The retailer establishes a reinsurance company in the Turk & Caicos Islands, which makes an IRC § 953(d) election to be treated as a U.S taxpayer. The retailer sells a $100 insurance contract acting as an agent for a regulated U.S. insurance company, earns a $20 up-front sales commission, and forwards $80 to the insurance company. The insurance company earns a $10 ceding fee on the policy and forwards $70 to the reinsurance company as a reinsurance premium. In this case, the retailer has reduced its taxable income by $70 by transferring funds to the PORC.

POTENTIAL PORC AUDIT ISSUES

As discussed earlier, the potential legal positions on PORC issues are outlined in Notice 2002-70 as follows:

1) The PORC entity is not an insurance company
    - To qualify as an insurance company, the PORC must have as its primary and predominant business activity the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies.

2) The pricing of the insurance product must be arms length
    - If the pricing is not at arm's length, then the parties have failed to properly allocate income, deductions and other items between the taxpayer and its reinsurance company. Under this theory, additional income would be allocated to the taxpayer

3) The transaction may be a sham.
    - In appropriate cases, the IRS may disregard the insurance and reinsurance arrangements, and thereby require taxpayer to recognize an additional portion of premiums received from its customers as its income, if the arrangements are shams in fact or shams in substance.

Applicable Code Sections

IRC § 953(d)

Although formed offshore to take advantage of limited capital requirements and lack of regulatory oversight, a PORC generally makes an election under IRC §953(d) to be treated as a U.S. corporation. Treatment as a U.S. corporation allows the PORC to utilize the favorable U.S. insurance tax provisions.

IRC § 953(d) allows a foreign corporation engaged in the insurance business to elect to be treated as a U.S. corporation for purposes of imposing U.S. tax. The election is available to a foreign corporation that is a controlled foreign corporation (as defined in IRC § 953(d)(1)(A)) that would be taxable under subchapter L for the taxable year if it were a domestic corporation. A corporation that makes the election under IRC § 953(d) must waive all benefits granted to it by the U.S. under any treaty between the U.S. and any foreign country.

To be effective for a taxable year, the IRC § 953(d) election must be filed by the due date prescribed in IRC § 6072(b), with extensions, for the U.S. income tax return that is due if the election becomes effective.

The election is effective for the first taxable year for which it is made and for each subsequent taxable year in which the requirements of Rev.Proc. 2003-47 and Notice 89-79 are satisfied.

The election can be made for taxable years beginning after December 31, 1987. If a foreign corporation makes this election, it will be subject to tax in the U.S. on its worldwide income.

IRC §4371

In general, section 4371 imposes an excise tax on each policy of insurance, indemnity bond, or annuity contract for hazards, risks, losses or liabilities, wholly or partly within the United States issued by any foreign insurer or reinsurer to or for, or in the name of a domestic corporation or partnership, or a resident individual. The tax imposed by this section is as follows:

1. 4% of the premium paid on a policy of casualty insurance or indemnity bond
2. 1% of the premium paid on a policy of life, sickness, etc
3. 1% of the premium paid on such reinsurance policies

Section §4371 Excise taxes do not apply when there is a valid 953(d) election. However, if the taxpayer is determined not to be an insurance company, the 953(d) election may be terminated.

Termination or revocation of the 953(d) election may cause the foreign reinsurer to be subject to the section 4371 Excise tax. In addition the revocation of a 953(d) election may cause the shareholders of the foreign corporation to be liable for Subpart F inclusions for taxable years in which the election is not effective.

Examiners should consult with an Excise Tax Specialist if it is determined that the PORC does not qualify as an insurance company, thus invalidating the 953(d) election.

IRC § 501(c)(15)

Prior to 1986, IRC § 501(c)(15) provided tax exemption for small non-life mutual

insurance companies. The Tax Reform Act of 1986 ("1986 Act") expanded the universe of IRC § 501(c)(15) organizations in two important respects: (1) It allowed stock companies to qualify for exemption as well as mutual insurers in an attempt to create parity between stock and mutual insurance companies and (2) It changed the measure of the dollar ceiling from a gross receipts test to a premium income test.

Because of these changes, there was a dramatic increase in the number of IRC 501(c)(15) applications for exemption from Federal income tax. After the 1986 Act, small for-profit insurance companies, insurance companies in liquidation, and reinsurance companies have applied for exemption under 501(c)(15).

The most advantageous tax treatment comes from the application of IRC § 501(c)(15) to the PORC. Under this provision, tax exemption is available to insurance companies, other than life insurers, if the net written premiums for the tax year do not exceed $350,000. Premiums from all members of the taxpayer's controlled group (as defined in IRC § 1563, with modifications) are aggregated for purposes of the $350,000 limitation. Two areas of abuse may occur from the use of a PORC operating under IRC § 501(c)(15).

IRC § 806

Another example of tax protection in an insurance company is that, while taxable, life insurance companies with assets less than $500 million get a special tax deduction under IRC § 806. This deduction is 60 percent of so much of their life insurance taxable income for the year as does not exceed $3 million. The deduction is phased out to the extent of 15 percent of their life insurance taxable income in excess of $3 million, and disappears entirely when the life insurance taxable income reaches $15 million.

IRC § 831(b)

A third example of tax protection involves insurance companies, other than life insurers, which have premiums in excess of $350,000 but no more than $1.2 million. Insurance companies, other than life, that meet this criteria can elect under IRC § 831(b) to pay tax on only their taxable investment income.

Conclusion

All PORC transactions may not be considered abusive. An examiner must gather and review all of the pertinent facts and circumstances surrounding the PORC transaction. Any challenges by the Service will very much fact-intensive and may vary case by case.

Currently, there are no "bright-line" tests to distinguish an acceptable PORC transaction from an unacceptable PORC transaction. Relying on existing guidance and depending upon the facts and circumstances of each case, an examiner will exercise auditor judgment to differentiate an abusive PORC transaction from a PORC transaction which complies with both the spirit and the letter of the law.

Chapter 9
Advertising Associations

Most dealerships advertise through the use of an advertising association. An advertising association is a separate entity whose purpose is to buy advertising on behalf of its members. Dealerships pay a predetermined amount to fund the advertising association. The association is usually a corporation, but it can be a Section 277 association or a non-profit entity. Dealerships, and/or their shareholders, are members of the advertising association, and can own its stock. The members elect a Board of Directors who operate the association. Most advertising associations do not have a profit motive.

An association is usually organized by

- Franchiser (Manufacturer)
- Ownership
- Geographic area

Franchiser (Manufacturer)

Most dealerships participate in an advertising association that is sponsored by the dealerships' franchiser. This association advertises on behalf of the manufacturer for the type of cars sold by the dealer. For each car purchased by the dealer, a set amount from each vehicle invoice is sent to the advertising association. This amount is separately stated on the invoice. This can be a flat amount or a percentage of the purchase price of the vehicle, including options. The franchiser or the advertising association determines the advertising contribution. Dealerships deduct this as advertising expense, or as part of Cost of Goods Sold.

Ownership

A dealer may own franchises in separate locations and use an advertising association to advertise on behalf of the franchises. In this situation, it is possible, but rare, for the advertising association to be a related party of the dealer. Usually an advertising association has many dealership members.

Geographic Area

It is common for a municipality to designate a parcel of land for auto franchises. This is usually a small geographical area that makes it possible for a customer to shop for several brands of vehicles without having to travel to several locations. This is commonly referred to as an auto mall. The auto mall is often established by a city in order to increase sales tax revenue. The auto mall's dealers usually pay fees to an advertising association that advertises oh behalf of the auto mall.

Interview Questions

- Determine if the dealership is a member of one or more advertising associations
- Inquire if the dealer is a member of the Board of Directors, which is responsible for the association funds.
- Inquire how the dealer accounts for advertising fees and rebates on the dealer's tax return

Documents to Request

- Obtain a copy of the advertising association's tax return, if the dealer is a related party.
- Statements from the advertising association that show how the dealer's funds were accounted for.

Audit Techniques

Most adjustments result from related party transactions, timing adjustments, double deductions or unreported income. Follow the flow of advertising funds:

- Were the funds spent on advertising?
- When were the funds spent?
- Who spent the funds?

Determine where the advertising expense is being deducted on the return. As stated earlier, the most common areas are the advertising expense account, or as part of Cost of Goods Sold. The vehicle invoice will have a separately stated item for advertising expense. Trace this to the books to determine where this is being deducted.

Typically, when a dealer becomes a member of an advertising association sponsored by a franchiser (manufacturer), the dealer signs an authorization that allows the franchiser to add a pre-determined amount to his vehicle invoice for each vehicle delivered to the dealer. The franchiser collects these funds and transmits them to the advertising association. The advertising association spends the funds for advertising on behalf of the members.

Issue Identification

Some issues that may arise during the examination of advertising associations are:

Unreported Income

It is common for the association to return excess funds not spent within the calendar year to the dealerships. This rebate should be reported as income on the dealership's return or offset against the advertising expense.

The rebate may be in the form of a management fee, travel and entertainment reimbursement or some other form of compensation. This should be reported as income.

The rebate may be credited as a liability or other expense.

If the advertising association does not spend all of the funds it has collected, and does not return the funds to its members, the courts have determined that these funds are not income to the dealers. (Ford Dealers Advertising Fund vs. Commissioner, 55 T.C. 761 (1971) aff'd 456 F22 2SS (5th cir. 1972 and Greater Pittsburg Chrysler Dealers Associatio of Wester PA v. US, 77-1 USTC 9293, W.d.a. 1977 Non Acq. 1974-2 CB 5) The taxpayers argued that the advertising association acted in the capacity of a trustee for the funds and that the funds were restricted. The courts agreed.

Double Deductions
As stated earlier, vehicle invoices separately state the advertising expense. If this amount is included as part of Cost of Goods Sold, there should not be a separate expense on the return. If a dealership is on the LIFO method of inventory, advertising fees are not included as part of Cost of Goods Sold.

Timing of Deductions
For franchise (manufacturer) arrangements, the dealer can deduct the advertising expense in the year paid based on the payment of the advertising amount and that the dealer can reasonably expect that the amounts will be used for advertising within 3 ½ months of the following year (1.461-4 and PLR 9243010 issue #5).

However, for associations that are related parties, a dealership cannot deduct advertising expenses until the advertising association has provided the advertising. Regulation 1.461-4(d)(2) states that if the liability of a taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as the services or property is provided.

ASSOCIATION TAX RETURNS
The tax returns filed by advertising associations are usually not complicated but may not show all of the year's activity. They may reflect the following:
- Rebates sent to the dealerships may be shown on the return as Returns and Allowances. A schedule may be attached.
- "Other income" is usually interest income.

Section 277 returns

IRC 277 states that expenses attributable to furnishing services or other items of value to members can only be deducted with respect to member income. General and administrative expenses not associated with furnishing services or other items of value to members, such as interest expense, may be deducted with respect to nonmember income.

Note: Private Letter Rulings (PLRs) AND Technical Advisory Memorandums (TAMs) are addressed only to the taxpayers who requested them. Field Service Advisory's (FSAs) are not binding on Examination or Appeals, nor are they final determinations. Furthermore, Section 6110(k)(3) provides that PLRs, TAMs and FSAs may not be used or cited as precedent.

In TAM 9429003, the Service determined that an advertising association was a Section 277 member organization because the association's primary purpose was to furnish goods or services to its members for a purpose that was not exempt from taxation.

The association's corporate purpose was to collect, and expend funds for advertising, and promote the products and services of its member dealers. The contributions paid by the dealers were voluntary. The dealers elected a board of directors to act on behalf of all of the members of the association, for their exclusive benefit. They did not receive

compensation. The IRS determined that IRC 277 was enacted to address this type of organization.

Supporting Law

IRC section 446(b): If the taxpayer's treatment of income and expenses relating to the advertising association distorts income, a change of accounting method is required.

IRC section 481(a): Prior period adjustments resulting from a change in accounting method should be used to compute the open year deficiency.

IRC section 7701(a)(3): For Internal Revenue Code purposes, the term "corporation" includes associations and joint-stock companies.

Rev. Rul. 74-318: Where an advertising association has discretionary control in the use of the advertising fees paid by the member dealerships and the manufacturer, amounts are includable in gross income with ordinary deductions allowable.

Rev. Rul. 74-319: An advertising fund established by franchise dealers, administered under a written contract by the manufacturer who receives and bills non-refundable fees, spends the accumulated funds on national advertising only (for the dealer's benefit), accounts for the funds separately in the books, and carries yearend balances as a liability to the dealers, is an association taxable as a corporation.

Treas. Reg. section 1.461-4(d)(2): Advertising fees are deductible when economic performance occurs, i.e., when the money is spent on advertising.

Ford Dealers Advertising Fund vs. Commissioner, 55 T.C. 761 (1971) aff'd 456 F22 2SS (5th cir. 1972 and Greater Pittsburg Chrysler Dealers Associatio of Wester PA v. US, 77-1 USTC 9293, W.d.a. 1977 Non Acq. 1974-2 CB 5) state that excess funds not spent by the advertising association, and not returned to its members, are not income to the member dealers.

PLR 9429003 addresses an advertising association that qualifies as an IRC 277 organization.

Boating Trade Ass'n of Metro. Huston vs. U.S. 35 AFTR2d 1228 (SD Tex. 1975) states that arranging for a business service such as advertising, is a service organization that qualifies as an IRC 277 organization.

Chapter 10
Sales of Dealerships

This chapter discusses the applicable law and potential audit issues involving goodwill, covenants not to compete and consulting agreements when a dealership is sold or transferred.

When a dealership is sold, as a general rule, the assets are sold and the stock is liquidated. For most sales of profitable dealerships, goodwill is a material asset. As a condition of the sale, it is common for the parties to enter into covenant not to compete and a consulting agreement. A portion of the sales price is allocated goodwill, commonly referred to as “blue sky” in the auto industry, and to each agreement. In most cases, these agreements are valid and serve a useful business purpose for the both the buyer and seller. In the financial statements, goodwill may be broken down into specific elements such as customer lists and workforce in place which has no impact on the tax result.

In a covenant not to compete, the buyer wishes to protect the market for which he has paid a significant sum of money. The seller in turn receives compensation for agreeing not to open the same franchise within a specified geographical area or to compete directly with the buyer. Self employment tax is not applicable to a pure covenant not to compete.

In a consulting agreement, the seller agrees to provide the buyer with assistance after the sale and to perform specific duties for a specified period in return for compensation. The seller is generally an independent contractor.

The tax treatment of goodwill, a covenant not to compete and a consulting agreement can be summarized as follows:

	Buyer	**Seller**
Goodwill	Amortize 15 years	Sec. 1231 asset
Covenant not to compete	Amortize 15 years	Ordinary income
Consulting agreement	Deduct as incurred	Ordinary income

<u>Documents to Request</u>

- Complete sales agreement, including all exhibits and addendums.
- Complete covenant not to compete agreement
- Complete consulting agreement
- Documentation to determine how the value of Goodwill was calculated

<u>Interview Questions</u>

- Has there been a recent sale or purchase of a dealership?
- Is the taxpayer currently a party in a covenant not to compete and/or consulting agreement?

Audit Techniques

Goodwill and covenant not to compete agreements

On the buyer's books, the covenant not to compete should be capitalized and a deduction taken for amortization. This is true regardless of whether any expenses associated with the agreement are deductible pursuant to IRC 162.

The judicial tests found in *Forward Communications Corporation v. United States,* 608 F.2d 485 (Ct. Cl., 1979), can be applied to determine the validity of a covenant not to compete. The following tests can help determine whether any part of the purchase price may be separately allocated to these agreements:

- *Whether the amount paid for the covenant is severable from the price paid for the goodwill.*
  The sales contract should specify a specific price paid for the covenant not to compete. The other terms listed in the covenant not to compete agreement should be specific enough to distinguish the covenant not to compete from the sale of goodwill. For example, the covenant not to compete should include a provision for breach of contract if the seller fails to comply with the terms of the covenant. If there is no provision, the covenant may be disguised goodwill.

  The buyer amortizes both the covenant not to compete and goodwill over a 15 year period. However, the seller recognizes the amount received for the covenant not to compete as ordinary income. The amount received from the sale of goodwill is taxed as capital gain income, except that to the extent that amortization has been taken, it is recaptured as ordinary income under Section 197(f)(7). Consequently, it is advantageous to the seller for the covenant not to compete to be disguised as goodwill.

  If there is no allocation, the buyer and seller must be able to demonstrate that they intended that some portion of the sales price be assigned to the covenant not to compete when they executed the sales contract.

- *Whether the covenant had some independent basis in fact or a valid business purpose.*
  a) Rev. Rul. 77-403 expands this analysis:
     i) In the absence of the covenant, determine if the seller desires to compete with the purchaser.
        - Is the seller retiring or retired?
        - Is the seller moving out of the area?
        - Is the seller involved in another line of business?

     ii) The ability of the seller to compete effectively with the buyer.
        - Determine if the seller is in a financial position to compete with the buyer.

     iii) The feasibility of the seller effectively competing with the buyer, considering the business and market within the time and area specified in the covenant not to compete.

- Is the geographical area covered in the covenant not to compete reasonable? Common sense applies. A manufacturer will not allow a new dealership to open if it jeopardizes an existing one. The covenant not to compete should cover an area large enough to prevent the seller from operating a franchise that would compete with the buyer.

If the covenant not to compete does not comply with the provisions of IRC 197 and the regulations there under, IRC 1060 requires a reallocation be made to the assets other than the covenant not to compete that were sold as part of the sale of the dealership.

Since the enactment of IRC 197, there is no effect on the seller's tax treatment regardless of the allocation of the sales price between the IRC 197 assets and the remaining assets. However, the allocation of the purchase price may have a significant tax effect on the buyer because the buyer is able to amortize IRC 197 assets over a 15-year period but must capitalize and depreciate the purchase price allocated to the remaining assets for periods of up to 40 years. The potential exists for an excessive amount to be allocated to IRC 197 assets for the benefit of the buyer.

Tax effects of indirect acquisitions

If a taxpayer acquires an *indirect* interest in a business in connection with a covenant not to compete agreement, the covenant must be amortized over a 15 year period. This is true even if no assets were sold or exchanged.

In *Frontier Chevrolet Co. v. Commissioner; 116 T.C. 289* (2001) affirmed, 329 F3rd 1131, (9th Cir. 2003), the Tax Court determined that if a shareholder redeems its stock, the covenant not to compete, entered into in connection with the stock redemption, must be amortized over 15 years under IRC 197.

Two shareholders controlled Frontier Chevrolet. Menholt, an individual, owned 25%, and Roundtree Automotive Group, a management company, owned 75%. Roundtree actively managed Frontier Chevrolet. Menholt was an employee of Roundtree. In 1994, Frontier Chevrolet redeemed 100% of its stock. After the redemption, Menholt became 100% shareholder of Frontier Chevrolet. In connection with the redemption, Roundtree entered into a covenant not to compete agreement with Frontier.

The court ruled that because Frontier's redemption caused Menholt to own 100% of its stock, the noncompetition agreement was entered into connection with the stock sale agreement and it must be amortized over 15 years. Frontier argued that it did not acquire an interest in a trade or business pursuant to the stock transaction because it acquired no other new assets. The court cited the legislative history of IRC 197, which states that an interest in a trade or business includes not only the direct acquisition of the assets of the trade or business but also the acquisition of stock in a corporation that is engaged in a trade or business.

Pre IRC 197 sales agreements

As stated earlier, covenants not to compete are amortized over 15 years regardless of the life of the covenant if the related assets were acquired after August 10, 1993. If the

taxpayer enters into a binding contract prior to August 10, 1993, the covenant is amortized over the life of the covenant.

In *Burien Nissan, Inc., et al. v. Commissioner;* T.C. Memo. 2001-116 (May, 2001), appellate decision, 92 AFTR 2nd 6199, 9/16/2003, the Court held that when the parties to a stock purchase agreement make substantial changes to that agreement, a new agreement is executed and the prior agreement is disregarded for purposes of IRC 197. The court determined that the prior agreement was not a binding contract.

Two individuals, Johnston and McLaughlin, owned 100% of Burien Nissan's stock. In 1990, prior to the enactment of IRC 197, Johnston and McLaughlin entered into an agreement to sell their stock to three individuals. A noncompete agreement was required. The 1990 agreement was breached because Johnston and McLaughlin did not receive any payments for their stock. In 1993, Johnston and McLaughlin amended the 1990 agreement substantially changing both terms of the sale and the noncompete agreement. This agreement included a termination clause of the 1990 contracts.

The Court held that the1993 agreement was a separate and distinct contract that was not merely an amendment of the1990 contract. The court concluded that Burien Nissan didn't acquire a noncompetition agreement until 1993 and that Burien Nissan must amortize the payments over 15 years under IRC 197.

Other issues
A covenant not to compete must be amortized over a 15 year period regardless of the terms of the agreement. The only exception is if all the assets associated with the covenant are sold or become worthless, the balance of the amortization may be written off at that time. Regulation 1.197-2(g)(1)(iii).

Sales between related parties merit careful consideration. It is common for dealerships to be sold or exchanged among family members. Often this occurs as the original owner retires or is otherwise unable to operate the dealership. Consider the application of IRC 267 and 318 in these situations.

Consulting agreements
It is common for the buyer to retain the services of the seller for a specified period of time and enter into a consulting agreement. These agreements typically cover a period of up to 5 years. The seller generally agrees to provide the buyer with technical assistance, advice and consulting with respect to the management and operation of the dealership, business principles employed, analysis of market conditions and other matters pertaining to the profitable operation of the business.

Tax effect
If the agreement is reasonable and there is evidence that the seller has performed services, the buyer's cost is treated as compensation and is deductible according to the buyer's method of accounting. Regulation 1.197-2(b)(9) states that a consulting agreement **does not** have the same effect as a covenant not to compete to the extent that the amount paid under the agreement represents reasonable compensation for services actually rendered.

The same common sense principles that apply to the covenant not to compete agreement should be employed in determining the reasonableness of a consulting agreement.

Supporting Law

IRC 197 and its regulations govern the definition of goodwill and covenant not to compete agreements. IRC 197 generally became effective for assets acquired after August 10, 1993. IRC 197 allows both goodwill and covenants not to compete to be amortized over a period of 15 years, using the straight-line method.

IRC 197(a) states that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable IRC 197 intangible asset.

IRC 197(c) defines the term "amortizable section 197 intangible" as intangible property that is acquired by the taxpayer and held in connection with the conduct of a trade or business or an investment activity.

IRC 197(d)(1) includes goodwill and covenants not to compete as IRC 197 intangible assets.

IRC 197(f)(3) requires amounts paid by the buyer pursuant to a covenant not to compete to be capitalized.

Regulation 1.197-2(b)(9) states IRC 197 intangibles include any covenant not to compete entered into in connection with the direct or indirect acquisition of an interest in a trade or business. This includes an acquisition in the form of an asset acquisition, a stock acquisition, a redemption and the acquisition or redemption of a partnership interest.

Regulation 1.197-2(f) states IRC 197 intangible assets are amortized using the straight-line method over a period of 15 years.

Rev. Rul. 77-403 lists factors to determine if a covenant not to compete has a valid business purpose.

Forward Communications Corporation v. United States, 608 F.2d 485 (Ct. Cl., 1979) – defines judicial tests in covenant not to compete agreements.

In *Frontier Chevrolet Co. v. Commissioner; 116 T.C.289 (* 2001), the Tax Court determined that if a shareholder redeems its stock, the covenant not to compete, entered into in connection with the stock redemption, must be amortized over 15 years under IRC 197.

In *Burien Nissan, Inc., et al. v. Commissioner;* T.C. Memo. 2001-116 (May, 2001), the Court held that when the parties to a stock purchase agreement make substantial changes to that agreement, a new agreement is executed and the prior agreement is

disregarded for purposes of IRC 197. The court determined that the prior agreement was not a binding contract.

In *Howard Pontiac-GMC, Inc v. Commissioner,* T.C. Memo 1997-313, the Court reduced the value of the taxpayer's covenant not to compete agreement. The taxpayer argued that the seller was a significant competitive threat to his business; therefore the value of the covenant was proper. The Court determined that the taxpayer did not take into account the low probability of the seller being able to obtain another identical franchise in the same geographical area as the buyer.

In *Heritage Auto Center, Inc v. Commissioner,* T.C. Memo 1996-21, the Court reduced the value of the taxpayer's covenant not to compete and consulting agreements. In determining the value of the covenant, the Court determined that the seller was not a major competitive threat because he had a tarnished reputation in the auto community. In determining the value of the consulting agreement, the Court determined that no meaningful and significant negotiations took place.

Chapter 11
Related Finance Companies

A “Related Finance Company” or RFC, is a financing company owned by an automobile dealership. It provides financing for customers that cannot obtain financing through normal channels. The customer is required to make payments usually at the dealership’s location. This type of arrangement is usually advertised by the dealership as a “buy here pay here” plan. The “buy here pay here” plan is common with stand alone used car dealerships, but many new car dealerships utilize this type of plan for their used car sales.

How does it work?
Dealerships involved in this practice establish a financing entity (herein referred to as a “Related Finance Company” or RFC), typically an S Corporation, which acts as the lender in the dealership’s financing arrangement. The same shareholders that own the dealership usually own the S Corporation.

When the vehicle is sold, and it is determined that the customer needs special credit assistance, the dealership writes the note at term (high interest rate) with recourse to the RFC. The note is sold at a significant discount to the RFC substantiating the discount by citing high risk. The dealership books a current and deducted loss for the difference between the full contract and the discounted contract. The RFC accrues income as it becomes earned, subject to IRC section 162 deductions.

Legitimate Uses of a Related Finance Company
There are several valid business purposes for establishing an RFC. An effective RFC removes the collection burden from the dealership; allowing dealership personnel to operate the dealership.

Some RFCs are so well managed that their discount rates can be lower than those offered by a third party. The RFC may be more familiar with the contracts it purchases due to its close relationship with the dealership, allowing the dealership to be more selective when it offers credit. An RFC may allow a dealership relief from regulatory restrictions, and to distance itself from adverse publicity resulting from collection activity.

A valid RFC should have the following characteristics:
- When the finance contract is sold to the RFC, title has been transferred to the RFC in accordance with title and lien holder laws
- The discounting of the car dealer’s receivables are sold to the RFC at their fair market value
- There is a written arms-length contract between the dealership and the RFC
- The finance contracts are normally sold without recourse between the two related

parties
- The RFC is responsible for repossessions
- The RFC is operated as a separate entity from the dealership and has the following characteristics:

    - Adequate capital to pay for the contracts
    - Meets all state and local licensing requirements
    - Maintains its own bank accounts
    - Has its own address and phone number and operates as a separate entity from the dealership
    - Maintains its own books
    - Has its own employees and they are compensated directly by the RFC
    - Pays its own expenses
    - The customers are making payments to the RFC, not to the dealership

In addition to financing loans, some RFC's will offer other dealer-related services, such as credit life policies, extended warranty coverage and auto insurance coverage.

<u>Journal Entries of a properly formed RFC</u>
An RFC, operating as a separate business, which has purchased notes from a dealer at FMV, will have the following journal entries:

Example #1
Facts: Dealer sells a used car to a customer for $6,300. The entire purchase price is financed for a period of three years. The customer's payments are $175 per month (175 x 36 mo. = $6,300). The customer has a poor credit history. The dealer sells the note to the RFC at a 40% discount, which is considered the FMV. In this example, the RFC does not meet the related party requirements under Section 267.

Assume 100% gross profit. Ignore interest income.

DEALER (Accrual basis)			**RFC** (Accrual Basis)		
Account	**Debit**	**Credit**	**Account**	**Debit**	**Credit**
01-01-X1					
Notes Rec-customer	6,300				
Sales		6,300			
To record sale of vehicle					
Cash	3,780		Notes Rec – Customer	6,300	
Loss on Discount		2,520	Deferred Revenue		2,520
Notes Rec – Customer		6,300	Cash		3,780
To record sale and transfer of note to RFC at a 40% discount			*To record purchase of note from dealer*		
12-31-X1					

	Cash	2,100	
	Notes Rec – customer		2,100
	To record payments on note		
	Deferred revenue	840	
	Sales		840
	To record first year profit. The RFC has recovered 1/3 of the $2,520 discount as income. (840 x 3 = 2,520)		
12-31-X2			
	Cash	2,100	
	Notes Rec – customer		2,100
	To record payments on note		
	Deferred revenue	840	
	Sales		840
	To record second year profit. The RFC has recovered 2/3 of the $2,520 discount as income.		
12-31-X3			
	Cash	2,100	
	Notes Rec – customer		2,100
	To record payments on note		
	Deferred revenue	840	
	Sales		840
	To record third year profit. The RFC has recovered the remaining 1/3 of the $2,520 discount as income.		

Note that if the customer had defaulted on the loan, the balance in the RFC's deferred revenue account will never be recognized.

Issue Identification

Tax issues arise when the dealership and the related finance company do not treat the sale and financing properly or when the RFC is merely a shell corporation that does not engage in any business activities.

EXAMPLE #2:

Background: DEALER is a dealership that sells new and used cars. DEALER has a separate used car lot and advertises itself as a "buy here pay here" lot. DEALER finances most sales at the maximum legal interest rate.

RFC, a finance company, is created with capital contributions from DEALER to purchase notes receivable from DEALER'S used car lot. The notes receivable are purchased at a discount. In essence, RFC is a factoring business.

Both DEALER and RFC file their income tax returns as an S corporation. DEALER uses the accrual method of accounting. However, RFC uses the *cash* method of accounting.

The same shareholder owns 100% of both DEALER and RFC.

RFC is located in the offices of DEALER. RFC has no employees and does not have a business address or telephone listing of its own. DEALER'S employees maintain all of RFC's books and records.

RFC does not have any funds with which to purchase notes receivable from any car dealership. It does not have any loans or lines of credit with any financing institution or its shareholders.

RFC does not advertise, has no telephone listing or business office, and does not solicit business. No other dealers are aware of its existence.

RFC purchases notes from DEALER at a 40% discount. The RFC makes no attempt to select the better performing notes. There are no documented negotiations of discount rates, the particular notes to be purchased, or other elements commonly found in factoring agreements.

DEALER never receives cash at the time of sale from RFC. This is because RFC has no cash with which to pay DEALER. Rather, DEALER and RFC set up intercompany accounts to recognize the 60% due DEALER. The DEALER collects the payments from the customer. At the time the DEALER collects the payments from the customer, RFC recognizes income and reduces the loan balance due DEALER.

DEALER sells several of the notes receivables to unrelated entities at a discount. However these entities buy only the most current or best performing notes receivable. When such sales are consummated, DEALER receives cash, title is transferred to the buyer and DEALER relinquishes its files. When DEALER factors the notes receivable to RFC, the note files are not relinquished. Title is not transferred to RFC. DEALER maintains the control of the note files and record keeping for RFC.

Journal entries (made by the taxpayer):
On 01/01/X1, DEALER forms an RFC and invests $3,780 in capital contributions.

On 01/01/X1 DEALER sells a used car to a customer for $6,300. The entire purchase price is financed. The car is financed for three years. The customer's payments are $175 per month. DEALER sells the note to RFC at a 40% discount. Assume 100% gross profit. Ignore interest income.

DEALER (Accrual basis)			**RFC** (Cash Basis)		
Account	**Debit**	**Credit**	**Account**	**Debit**	**Credit**
01-01-X1					
Investment in RFC	3,780		Cash	3,780	

Cash		3,780	Common Stock/PIC		3,780
To record investment in RFC			*To record capitalization of RFC*		
Notes Rec-customer	6,300				
Sales		6,300			
To record sale of vehicle					
Notes Rec - RFC	3,780		Notes Rec – Customer	6,300	
Loss on Discount		2,520	Deferred Revenue		2,520
Notes Rec - Customer		6,300	Notes Payable - Dealer		3,780
To record sale and transfer of note to RFC at a 40% discount			*To record purchase of note from Dealer*		
12-31-X1					
Cash	2,100		Deferred revenue	840	
Note Rec -customer		2,100	Sales		840
To record first year payments from customer ($175 x 12 mo.)			*To record first year profit. The RFC has recovered 1/3 of the $2,520 discount as income. (840 x 3 = 2,520)*		
Cash	1,260		Notes Payable - Dealer	1,260	
Notes Rec - RFC		1,260	Cash		1,260
To record RFC's payment of loan			*To repay Dealer loan ($3,780 / 3)*		

12-31-X2					
Cash	2,100		Deferred revenue	840	
Notes Rec - customer		2,100	Sales		840
To record second year payments from customer			*To record second year profit.*		
Cash	1,260		Notes Payable - Dealer	1,260	
Notes Rec - RFC		1,260	Cash		1,260
To record RFC's payment of loan			*To repay Dealer loan*		
12-31-X3					
Cash	2,100		Deferred revenue	840	
Notes Rec - customer		2,100	Sales		840
To record third year payments from customer			*To record third year profit.*		
Cash	1,260		Notes Payable - Dealer	1,260	
Notes Rec - RFC		1,260	Cash		1,260
To record RFC's payment of loan			*To repay Dealer loan*		

Issues

1. Whether there has been a change in method of accounting when an RFC is used to defer income.
   - *Adjustment: The $2,520 is adjusted to $840 per year to match the RFC's recognition.*
2. Whether Internal Revenue Code Section 267 disallows a loss from the sale of notes receivable by a car dealer to an RFC.
   - *Same adjustment as above. DEALER cannot take the $2,520 loss until RFC*

recognizes it into income.

3. Whether IRC 482 applies to the loss claimed by a dealer from the sale of notes receivable to an RFC, should be disallowed because the RFC existed only in form, and the transactions between the dealer and the RFC lack economic substance.
   - *Dealer not allowed a loss on discount of $2,520 if a valid sale did not occur.*
4. Whether IRC section 482 applies to the loss claimed by a dealer from the sale of notes receivable to an RFC because the notes receivable were sold at less than the fair market value amount.
   - *If the RFC is valid, revenue agent can accept the sale to the RFC, but adjust the discount to the FMV*
   - *If the RFC is not valid, revenue agent can disallow the entire loss from the sale*
5. Whether a dealer and an RFC are members of a controlled group for the purposes of IRC section 267 and thereby eligible for the special loss recognition rules of Treas. Reg. Section 1.267(f)-1(f). Under this section, a dealer is allowed to defer a loss on related party sale of a note receivable until the note is transferred outside the controlled group.
   - *In order to qualify under this section, the note must have been sold at FMV.*

Note that the RFC has recorded the receipt of the notes receivable from the customer; however, it is the dealer that is receiving the payments from the customer.

<u>Audit Techniques</u>

- Determine the ownership percentages between the dealership and the RFC. If the common ownership is greater than 50%, then IRC 267 applies.
- If the RFC is on the cash basis, determine if its method of accounting should be changed to the accrual method.
- Determine if the notes were sold at their FMV to the RFC.
    - If not, then consider the following arguments:
        - If the TP is a member of a controlled group, then the dealer is not entitled to loss deferral pursuant to Reg. 1.267-1(f).
        - If the loss should be disallowed under IRC 482
- If the RFC lacks economic substance, the transactions between the dealer and the RFC should be disallowed.

<u>Change of accounting method</u>

IRC 267(a)(2) requires that income and expense transactions between related parties are required to maintain the same method of accounting. Therefore, the RFC must recognize income at the same time as the dealer. This, in effect, puts the RFC on the accrual basis.

Reg. 1.446-1(d)(1) defines the rules for taxpayers engaged in more than one business. This section states that if a taxpayer is engaged in more than one business, a different method of accounting may be used for each trade or business, provided the method

used for each clearly reflects income. However, no trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for each trade or business [Reg. 1.446-1(d)(2)]. If by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the businesses so that the income of the taxpayer is not clearly reflected, then the trades or businesses of the taxpayer will not be considered to be separate and distinct [Reg. 1.446-1(d)(3)].

Deduction disallowance
An alternative treatment is that no deduction is allowed to the dealership until the cash is actually received and recognized as income by the finance company.

Loss disallowance – IRC 267
In general, if the common ownership between the dealer and the RFC is greater than 50%, the dealer is not entitled to deduct a loss on the sale of notes to the RFC. [IRC 267(a)(1)]. IRC 267(b) lists the relationships that are governed under IRC 267(a)(1).

However, if the dealership is an S corporation qualifying as a member of a controlled group (at least 80% common ownership), then the S corporation is entitled to loss deferral until the note is transferred outside of the controlled group [IRC 267(f)]. In order for the taxpayer to qualify for loss deferral under this rule, the sale of the receivable between the dealer and the RFC *must be at FMV.* [Reg. 1.267(f)-1(f)]

Lack of economic substance
The discounting transactions must have economic substance. The primary reason for selling receivables are to obtain cash (improve cash flow) or to shift risk. An RFC typically deals with a customer base that generally has poor or non-existent credit. The default rate on buy here/pay here notes is substantially higher than on general bank loans. A separate RFC removes the financial risk from the dealership entity.
This economic fact is recognized both by the interest rates charged by the dealer or finance company and the reserves that independent finance companies generally maintain. If both of these are missing, it is a good indication that the sales transactions lack economic substance.

TAM 9704002 is a blue print for a related finance company. The RFC was formed by the dealership shareholder. There was a “transfer” of contracts to RFC at less than face value. The dealership deducted losses on transfer. The TAM concluded that the transactions were not “arm’s length” and that they lacked economic substance. The factors that were considered were:

- The RFC was undercapitalized
- There were no written sales contracts
- There were no cash payments between parties
- There were no employees or facilities

- Purchasers were not informed of the transaction
- Lien holder was not changed
- Profits were loaned to related entities or shareholder

PLR 9704002 addresses transactions between and RFC and a dealer. The IRS determined that no sale consummated between the RFC and the dealer.

Note: Private Letter Rulings (PLRs) AND Technical Advisory Memorandums (TAMs) are addressed only to the taxpayers who requested them. Field Service Advisory's (FSAs) are not binding on Examination or Appeals, nor are they final determinations. Furthermore, Section 6110(k)(3) provides that PLRs, TAMs and FSAs may not be used or cited as precedent.

The IRS determined that the transfer of dealer notes to the RFC was not a sale of property based upon the following factors:

- Upon the transfer of the notes, the dealer still had burdens of ownership:
  - Dealer's employees collected the payments and performed repossessions
  - Dealer bared the risks of the credit-worthiness of the notes
  - Dealer's financial position did not change when the notes were transferred to the RFC
- RFC was thinly capitalized
- Dealer, not the RFC, was responsible for repossessions
- Title was not transferred to the RFC
- RFC could not have sold the notes, because they did not have legal title
- Borrowers were not notified that the loan was reassigned to the RFC
- If a vehicle was damaged in an accident, the dealer, not the RFC had the right to any insurance proceeds.
- There were no written sales contracts between the dealer and the RFC

Determination if a loan is sold at FMV

The following factors should be considered in the determining whether a dealer sold its receivables at FMV:

Request a sample of car jackets for loans that were sold to the RFC and loans that were sold to third parties. Compare the following:

- Was the debtor unable or unlikely to obtain financing from third parties to finance the purchase?
  - The car jacket usually includes a credit report on the borrower. If the discount rate is large, the customer will have a poor credit history.
- Review the car jackets of sales where the loans were sold to third parties and compare those to loans sold to the RFC.
  - If the loans were sold to the RFC at FMV, then similar loans sold to third parties will have a similar discount rate.

- How often are payments on the loan required: weekly, biweekly, or monthly?
    - Required weekly payments generally indicate higher credit risk.
- Prior to the discount date, what is the dealer's collection history on the loans? Poor customer collections decrease the value of the note receivables.

Determine the average dealer markup on dealer-financed sales and the average dealer markup on third party financed and cash sales. The dealer may already have this information available. If the markup is the same, then the face amount of the note should be the FMV of the note on the loan date. To the extent the markup is higher on dealer-financed sales, the FMV of the loans are less than their face value on the loan date.

Example:

Cost Basis	2,100	2,100
Plus: Markup	2,100	3,150
(100%, 150% respectively)		
Sales Price	4,200	5,250
Less: Down payment	(200)	(200)
Loan Amount	4,000	5,050
Discount to FMV		(1,050)
		4,000

$1,050 / $5,050 = 21%

Accordingly, there is a 21% difference among the face amount of the note, $5,050 and the FMV of the note, $4,000 when the loan is made.

If the dealer discounted the $5,050 note by 21% within a few days of the loan to its RFC, then the loan was most likely made at FMV.

If instead, the dealer discounted the $5,050 the following day to its RFC at a 30% discount for a sales price of $3,535 ($5,050 x .70), then the note was sold for less than its FMV of $4,000. This results in the $1,515 loss on the loan sale being deferred ($5,050 loan amount (basis) less sales price of $3,535 = $1,515 loss).

Other factors to consider:

- Were the loans offered for sale to third party loan discounters?
    - What were the terms of the offer and how do they compare with the terms of the actual sales to the RFC?
    - Compare the credit worthiness and sale terms with similar transactions of the RFC.

- How soon after the loan date were the loans discounted?
    - The closer the discount date is to the loan date, the less chance of significant factors that could lead to a FMV different than the face amount of the receivables.
- Are the notes receivable discounted or sold on an individual note by note basis?
    - Varying discount rates is indicative of individual note discounting. A flat discount rate for specific time periods is indicative of bulk discounting.
- Are all notes discounted, or does the RFC pick and choose the notes it acquires?
- What is the credit checking procedure of the dealer before selling a vehicle with in-house financing?
    - Compare this to the credit checking procedure of notes sold to third parties.
- What steps did the dealer take to determine the FMV of the loans before they were sold?
- What steps did the RFC take in determining the FMV of the loans before they were acquired?
- Has the prime interest rate increased or decreased since the date of the loan? The FMV of a loan decreases if interest rates increase.

Computation of Adjustment

Adjustment: Change the RFC's accounting method to accrual.

This adjustment is made when the agent is accepting the RFC as a separate business entity, but income is distorted due to IRC 267 and 446.

Finance contract discount-losses claimed		xxx a
Subtract installment collections reported as income		(xxx) b
Add IRC 481 adjustment (year of change only)	xxx	
Equals: Increase to taxable income		xxx
	===	

a – This number should reflect the finance contract discount deductions or losses claimed by the dealer on contracts discounted, assigned, or sold to the RFC. These amounts are usually included in the car dealer's cost of sales amounts but may be reflected as a separate line item.

b – If the RFC reported any income on the finance contract principal collections, this amount is subtracted out here. This is necessary because we are requiring the car dealer to use the accrual method, and any income reported by the RFC subsequent to the date of sale is a duplication of already reported income.

Note that interest income is not adjusted on the RFC return, and remains fully taxable to the RFC.

Adjustment: Disallow the RFC for tax purposes.

This assumes that the agent has determined that the sales of the receivables to the RFC are not recognized for tax purposes because the sales have no economic substance. All other unrelated income and expenses of the RFC remain on the RFC return. If the RFC is a C corporation, the 1120 may have an unusable NOL.

Finance contract discount-losses claimed		xxx
Add RFC net taxable income or subtract net taxable loss		xxx
Subtract installment collections reported as income		(xxx)
Add IRC 481 adjustment (year of change only)	xxx	
Equals: Increase to taxable income		xxx

Initial Document Requests

- All agreements for the following parties including but not limited to amendments, restatements:
    - Dealer and the RFC
    - RFC and its shareholders
    - RFC and all other related parties
- A finance contract which has been discounted which is representative of other contracts.
- Copies of the discount agreement and a sample copy of a discounted contract for contracts that is utilized with unrelated third parties.
- A copy of a completed loan agreement
- A copy of credit, collection and repossession policies in effect
- A copy of all notes and or written loan agreements between the RFC, the dealer, its shareholders, and any other related party including renegotiated notes
- A copy of all licenses and permits for the RFC by any government agency

- A copy of all promotional literature, brochures or other information furnished to the owner, manager, and/or key employees in conjunction with the decision to form an RFC
- A copy of any Forms 3115 filed for either the RFC or the dealership.

Initial Interview Questions

During your initial interview, determine the following:

- Before the RFC was formed, did the dealership discount finance contracts to third party finance companies?
- Who is recorded as lien holder with the department of motor vehicles?
- Who retains the original car title and tag records
- Is the RFC a separate legal entity
    - Type of entity for federal and state
    - Licenses that the RFC holds
- Ownership of the RFC
- How was the RFC capitalized (cash, loans, third-party financing, etc)
- Type of books and records maintained by the RFC
- The RFC's method of accounting
- Types of duties performed by the dealer and the RFC's employees
    - Determine who performs the following, and for which entity
        - Credit checks
        - Credit decisions
        - Monitoring of loan accounts
        - Collection of loan accounts
        - Repossession of vehicles
        - Management of RFC
        - Bookkeeping functions of RFC
- Has the RFC filed payroll tax returns?
- Is the RFC located in the same location as the dealer?
    - If the location is in the same building, ask the following:
        - Are separate offices maintained?
        - Is there a separate phone number for the RFC?
        - How are common costs allocated? (Utilities, overhead, etc)
            - Are there written agreements for shared costs?
- Who owns the location of the RFC and the dealer?
    - If a related party, ask the following
        - Rental arrangements
        - Existence of written agreements
- Since the RFC was created
    - Does the dealer sell contracts to third party finance companies?
        - Are these discounted?
    - Has the amount of dealer financing increased?
        - If yes, by how much?
    - Has the taxpayer modified the level of customer credit risk he or she would self-finance?
    - Has the taxpayer modified:
        - Collection procedures?
        - Repossession procedures?

- What percentage of finance contract customers are unable to obtain financing elsewhere due to poor or no credit?
- Discounting of finance contracts:
    - How is FMV determined for both the contracts sold to the RFC and contracts sold to third parties?
    - What is the amount of the discounts?
    - How is the discount determined?
- Have there been any significant changes in business practices since the formation of the RFC?
- What fees, if any, are paid by either the dealership or the RFC?
    - Example of fees are acquisitions fees per contract, collection service fees, repossession fees
- Repossessions
    - Which entity makes the decision to repossess a car?
    - Who reports the repossession gain or loss on the contract?
    - How is the transfer of the vehicle back to the entity treated for book and for tax purposes?

Supporting Law

IRC 267a: No deduction is allowed for losses between the following related persons:

- Family members [IRC 267(b)(1)]
- And individual and a corporation, when the individual owns more than 50% of the outstanding stock [IRC 276(b)(2)]
- Two corporations which are members of the same controlled group [267(b)(3)]

IRC 267(f) and Reg. 1.267(f)-1(f) define “controlled group” for purposes of IRC 267(b)(3). It allows an S corp to defer a loss until the note is transferred outside the group. However, the note must have been sold at FMV

IRC 267(a)(2) requires that income and expense transactions between related parties are required to maintain the same method of accounting.

Reg 1.446-1(c)(2)(i) provides that in any case which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized by the Commissioner.

Reg. 1.446-1(d)(1), (2), and (3) define “separate and distinct” trade or businesses.

IRC 453(b)(2): an installment sale accounting method cannot be applied to disposition of inventory of the taxpayer.

IRC 482: The examining agent can attribute income among related entities in a manner that clearly reflects income.

Reg. 1.482-1A(b)(1) states that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

IRC 9722: if a principal purpose of any transaction is to evade or avoid liability under the IRC, tax may be computed without regard to that transaction.

PLR 9704002 addresses transactions between and RFC and a dealer. The IRS determined that no sale consummated between the RFC and the dealer.

Commissioner v. Hansen, 59-2 USTC 9533, 360 US 446, 3 L. Ed 2d 1360, 79 S. Ct. (1959), and *Resale Mobile Homes, Inc.* 92-1, USTC 50,282, aff'g 91 TC 1085 (1988) held that the dealers are required to report as income the full amount of their sales without reduction for finance or holdback reserves.

<u>Transfer of title cases</u>
Higgins vs. Smith, 40-1 USTC 9169, 308 U.S. 473, 84 L. Ed 406, 60 S. CT 355 (1940). Title has to transfer in order to have a sale.

Lyon Co. v. US 78-1 USTC 9379, 435 US 561, 573 (1978) states that if no formal title has passed, ownership of property has not transferred.

<u>Economic substance court cases</u>
Rice's Toyota World, Inc v. Commissioner, 81 TC 184, 209 (1983) requires business transactions to meet a minimum threshold of a business purpose or economic objective.

Moline Properties, Inc v. Commissioner, 43-1 USTC 9464, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1942), covers sham corporations.

Lucas v Earl, 281 U.S. 111 (1930): income is taxable to the earner.

Coliss v. Bowers, 2 USTC 525, 281 US 376, 378 (1930) stated that taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid.

Gregory v. Helvering, 293 U.S. 465 (1935), the court concluded that sham transactions are not recognized for federal income tax purposes and losses generated by such transactions are not allowed.

RFC CHECKSHEET

Is the RFC a separate legal entity from the dealership?	
Does the RFC meet all state licensing requirements?	
Does the RFC maintain proper business licenses?	
Does the RFC comply with title and lien holder laws?	
Does the RFC have adequate capital to purchase the notes?	
Does the RFC have its own address and operate from separate facilities?	
Does the RFC maintain its own books separate from the dealership?	
Does the RFC have its own phone number?	
Does the RFC have its own employees?	
Does the RFC compensate the employees directly?	
Does the RFC pay its own expenses?	
Does the RFC maintain its own bank accounts separate from the dealership?	
Operation:	
Does the lien holder on the finance contract change from the dealer to the RFC?	
Does the dealership notify the customer that the finance contracts have been sold?	
Does the RFC pay the dealership for the contracts at the time of purchase?	
Does the RFC purchase contracts from unrelated parties?	
Does the RFC have written contracts with the dealership?	
If so, do the agreements state how the discount rates are determined?	
Does the discount rate approximate the actual loss experience?	
Are the financial contracts non-recourse?	
Does the RFC handle repossessions?	
Does the dealership sell any finance contracts to any unrelated finance companies?	
Does the RFC report income on a pro-rata basis?	
Did the profit reported on the initial sale of the vehicle exceed the loss on the sale of the finance company?	
Does the RFC have a business purpose?	
Did the RFC investigate items such as the borrower's credit history, length of the note, age of the vehicle, and payment history prior to determining the value of the note?	

Chapter 12
Passive / Non-Passive Considerations

Introduction
Many taxpayers involved with auto dealerships have interests in other entities and activities. As a result of their complex financial affairs, the compliance with passive loss rules and regulations of IRC section 469 should be verified. Please recall that due to the rules of that section, generally only passive income can offset passive losses. This means that the taxpayers will have losses from passive activities that are not deductible in a particular year unless income from other sources is properly characterized as passive income.

Should this issue be considered?
It is important for the agent look at the individual and related entity returns to determine if the taxpayer is in compliance with the passive loss rules. The only way to determine compliance with this complex section of the law is to gain an understanding of the relationships of the various entities and activities the taxpayer has an interest in.

Example
The taxpayer, who is also a shareholder in a large C-Corporation auto dealership owns several rental properties (passive by definition, with some exceptions, under IRC section 469(c)(2)). Making over $150,000 per year, taxpayer is not entitled to the $25,000 passive loss offset for rental real estate. The taxpayers' rental losses for the year are about $100,000. The taxpayer creates a partnership that purchases assets from the C-Corporation and then rents the dealership the land and building at a rent that produces partnership net income of $100,000. Taxpayer flows this $100,000 partnership net income through to his 1040 as passive income. The taxpayer is attempting to offset his passive loss of $100,000 against this income.

Under Treas. Reg. section 1.469-2(f)(6), the rental income is recharacterized as non-passive. This means that the taxpayer cannot offset passive losses from other activities against the rental profit. Any rental income generated from the rental of property by the taxpayer to a trade or business in which the taxpayer materially participates is treated as non-passive income.

In this situation, the $100,000 profit would be recharacterized as non-passive and the $100,000 passive loss would be carried forward.

Audit Techniques
1. Secure all lease agreements.
2. Inspect Shareholder's Forms 1040 to determine if the issue is viable.
3. Question the taxpayer directly where circumstances warrant such action.

If after inspecting Forms 1040, passive income is seen to be offsetting passive losses, it should be scrutinized. Make sure the income is not subject to the recharacterization

rules of Treas. Reg. sections 1.469-2 and 1.469-2T as well as the material participation rules of Treas. Reg. section 1.469-5T.

Treas. Reg. section 1.469-2T(f) sets forth specific criteria for recharacterizing income from passive to non-passive. The most pertinent to auto dealerships follow:

Law

1. Treas. Reg. section 1.469-2T(f)(3)
   Net income from the rental of property in which less than 30 percent of the unadjusted basis of the property is subject to depreciation is considered NON-PASSIVE.

2. Treas. Reg. section 1.469-2(f)(6)
   For tax years ending after May 10, 1992, the net income from the rental of any property to a closely held C-Corporation, an S-Corporation, a partnership, is considered NON-PASSIVE if the taxpayer to whom this income flows to materially participates in the activities of the lessee.

   Note: It is unclear where in the regulations that a trust is included in these rules. A trust is included as a pass through entity in Treas. Reg. section 1.469-4T(b)(2)(i) which is applicable only to that section. Treas. Reg. section 1.469-4T(b)(2)(ii)(B) is no longer included as a temporary regulation.

   Note: That for 1992 and before, this rule applied for all except a closely held C-Corporation (Treas. Reg. section 1.469-4T(b)(2)(ii)(B)).

   Treas. Reg. section 1.469-2T(f)(8) limits recharacterization if the taxpayer is required to recharacterize gains from significant participation activities and also gains from the rental of nondepreciable property, the maximum amount of gain to be recharacterized is the greater of the two computations.

If the rental income producing entity is not clearly connected to the dealership, it may still be necessary to pursue the issue.

If the taxpayer materially participated in an activity other than rental activity, then the income is non-passive per IRC section 469. Treas. Reg. section 1.469-5T sets forth the criteria for determining material participation.

In identifying the correct treatment of income from an activity, it may be necessary to question the taxpayer directly.
Whenever an agent encounters a Passive / Non-Passive situation it is suggested the MSSP guide on Passive Activity Losses be referenced for a more detailed discussion of the passive loss rules and suggestions for audit techniques of passive loss issues.

Conclusion

The most efficient way of looking for a passive issue is by securing all related returns. Verify the taxpayer did not mitigate his tax liability with respect to a passive loss. If so, a close scrutiny of the means by which this was accomplished is warranted.

Chapter 13
Voluntary Employees' Beneficiary Associations

In the 1980's, the tax treatment of contributions to funded welfare benefit plans changed with the enactment of IRC sections 419 and 419A. This change is important since larger automobile dealerships tend to use such funding to purchase vehicles. If a dealership has an employee welfare benefit plan that is funded through either a Voluntary Employees' Beneficiary Association (VEBA) trust or a taxable trust, you will want to verify that payments to the trust comply with the rules of sections 419 and 419A, as well as certain other sections.

This chapter is included in this Guide for agent awareness only. In 1993, the former Industry Specialization Program created an Issue Specialist position for audit issues involving sections 419 and 419A and VEBAs. As a result of the reorganization, ISP's were placed in the Pre-Filing and Technical Guidance section of the Large and Mid-Size Business division. The ISP position was renamed to that of "Technical Advisor." The Technical Advisor for sections 419 and 419A (VEBAs) can be found on the web site.

For more detailed information on audit issues in this area of law, you can go to the Technical Advisor's intranet site at: http://lmsb.irs.gov/hq/pftg/veba/. The website contains hyperlinks to various court cases involving sections 419 and 419A, Frequently Asked Questions and reference material that includes the electronic versions of all of the training texts in this area.

What is a VEBA?

VEBA is an acronym for "voluntary employees' beneficiary association." They are trusts that are exempt from tax under the provisions of IRC section 501(c)(9). A VEBA is a "welfare benefit fund" to which sections 419 and 419A will apply if it is part of a plan of an employer through which the employer provides welfare benefits to employees and their beneficiaries. While welfare benefit funds can also be taxable trusts, most welfare benefit funds apply for exempt status as VEBAs in order to reduce or eliminate income taxes at the trust level. VEBA's file Form 990, whereas taxable trusts file Form 1041.

A "welfare benefit" is an employee benefit other than those to which IRC sections 83(h), 404, and 404A apply. The most common types of welfare benefits are medical, dental, disability, severance and life insurance benefits. It is important to remember that an examination of an employer's deduction for its contribution to a welfare benefit fund is not an examination of the trust itself. The actual examination of a VEBA trust itself must be handled by an agent from the Tax Exempt and Government Entities division.

What do I need to do?

In order to determine if there are potential examination issues in this area, first ask the taxpayer (or their representative) about (1) the nature of the employee benefit plan, (2) the types of benefits provided, (3) whether the benefits are paid through a welfare benefit trust, (4) whether the plan or the benefits provided under the plan purport to be the subject of a collective bargaining agreement and (5) whether the trust purports to be a 10-or-more employer plan. If your taxpayer is providing employee benefits through an employee welfare benefit fund, contact the Technical Advisor, or his assistant, for advice on how to proceed. As mentioned earlier, you should also visit the TA's website for the latest information on potential issues in this area. Experience has shown that the proper examination of issues involving sections 419 and 419A is very fact intensive and involves extensive legal and actuarial analysis. Case development generally involves the issuance of third-party summonses to obtain relevant information.

If there are potential audit issues in your case, you should obtain copies of all documents relating to the creation or adoption of the plan and trust. This should include copies of all promotional material (including any cost-benefit proposals and legal opinions) and details on all contributions made to the fund and payments made from the fund. If the plan involves benefits that are provided through either individual or group insurance products, obtain copies of the policies and/or certificates of insurance and details on all premiums paid and policy values. You should also obtain a listing of the participants in the plan and the type and amount of benefits being provided to each participant. Secure copies of the Forms 5500 filed by the plan and the Forms 990 or Forms 1041 filed by the trust. The section 419 and 419A Technical Advisor's website has some pro forma IDRs which can be adapted to fit the facts of your specific case. The Technical Advisor can provide you with IDR's designed to cover specific plans. You should also determine the names and addresses of all third parties involved in the plan (e.g., benefit consultants/promoters, insurance salespersons, trustees, insurance companies, etc.).

Audit Potential

There are many closely-held businesses claiming deductions for contributions to welfare benefit funds that claim to be exempted from the deduction limitations of sections 419 and 419A because they meet the requirements of sections 419A(f)(5) (for separate funds under collective bargaining agreements) or 419A(f)(6) (for 10-or-more employer plans). In 1995, the Service issued Notice 95-34 warning taxpayers about potential problems with promoter claims regarding 10-or-more employer plans. In 2000, the Service issued Notice 2000-15 classifying such arrangements as abusive corporate tax shelters. Treasury issued Proposed Regulations covering 10-or-more employer plans on July 11, 2002. The most recent Tax Court case involving such plans, Neonatology Associates, P.A., et al., v. Commissioner, 115 T.C 43 (2000) aff'd 299 F. 3d 221 (3rd Cir. 2002), found that the majority of the contributions to one such plan were actually constructive dividends and thus nondeductible to the corporation and currently includible in the shareholder's income. The Court upheld the Service's imposition of penalties on both the corporate and individual entities.

Since promoters of these arrangements tend to promise business owners current deductions for benefits to be received in the future, we expect that the popularity of these products will increase if Congress enacts tax legislation prospectively reducing

the individual federal income tax rates. For more information on the types of plans being marketed, you can go to any Internet search engine and search under the terms: “welfare benefit funds,” “VEBA,” “Section 419A(f)(6)” or “Section 419A(f)(5).”

Technicalities

In general, sections 419 and 419A limit an employer’s deduction for contributions to a welfare benefit fund to the amount of the benefits actually paid during the year by the fund (determined using the cash-basis method of accounting) plus a limited allowance for reserves for incurred but unpaid claims and post-retirement medical and life insurance benefits. Section 419A(c)(1) allows a limited reserve for incurred but unpaid claims for disability, medical, SUB or severance pay and life insurance benefits.

If the fund qualifies as a separate fund under a collective bargaining agreement, in general, section 419A(f)(5) provides that there is no “account limit” for such reserves. Section 419A(f)(6) provides, in general, that the deduction limitations under sections 419 and 419A do not apply if the fund qualifies as a 10-or-more employer plan. In order to qualify, the plan must not maintain “experience-rating arrangements” with respect to individual employers, nor can any employer normally contribute more than 10% of the total contributions made by all employers.

Sections 419 and 419A are not applicable if the benefits provided by the plan are determined to be deferred compensation. In these situations IRC section 404 controls. In general, section 404(a)(5) provides that an employer’s deduction takes place in the year in which the amount attributable to the contribution is includible in the employees’ gross income. However, if more than one employee participates in the plan, an employer can only take a deduction if separate accounts are maintained for each employee.

In all situations, sections 419 and 419A comes into play only if the contributions to the fund are otherwise deductible under the Code. For example, if the contribution was determined to be a constructive dividend, and thus not otherwise deductible, then sections 419 and 419A would not be applicable. (See, e.g, Neonatology Associates, supra.)

Conclusion

If you have any questions relating to this area of law, please contact either the Technical Advisor or one of his assistants.

Chapter 14
Other Prevalent Auto Practices

This chapter discusses three main segments: income issues, compensation issues and other miscellaneous issues. The topics updated and/or added are: compensation issues: service tech tools, manufacturer's incentive, shuttlers; income issues; auto demonstrator vehicles, other miscellaneous: Cores, used car donation programs; a new credit for electric cars; hybrid vehicles; cost segregation and cancellation of dealership franchises.

1. SERVICE TECHNICIAN TOOL REIMBURSEMENTS

The Motor Vehicle Technical Advisor, under the Pre Filing & Technical division of Large and Midsize Business Division (LMSB) Retail Industry finalized the following Coordinated Issue, dated July 21, 2000.

◊ **ISSUE:** Whether amounts paid to motor vehicle service technicians as reimbursements for the use of the technicians' tools are paid under an accountable plan?

◊**CONCLUSION**: Generally, amounts paid to motor vehicle service technicians (service techs) as tool reimbursements not meet the accountable plan requirements. Amounts paid under an unaccountable plan are included in the employee's gross income, must be reported to the employee on Form W-2 and are subject to the withholding and payment of federal employment taxes.

■ **FACTS**

Motor vehicle service technicians (service techs) are hired as employees by dealerships, repair and body shops, and various other enterprises to perform repair and maintenance services on vehicles. As a condition of employment, service techs are required to provide and maintain their own tools, which are kept on-site at the business locations. Generally, the tools are used exclusively by the technician to whom they belong. Service techs are paid hourly wages.

Instead of paying an hourly wage for the performance of services, many employers bifurcate the hourly wage paid to the service techs into "wages" and "tool reimbursements". These plans purport to fall under the aegis of accountable plans as described in Internal Revenue Code (the Code) section 62 and the regulations thereunder. Under I.R.C. § 62(c) reimbursements for employee business expenses meeting certain requirements are not wages includible in income or subject to the withholding and payment of employment taxes. These plans may be administered either by a third party for a fee or by the employer.

In a typical arrangement, the hourly wage paid to the service tech is divided into a wage portion and a tool reimbursement portion. Income and employment taxes are withheld and paid on the wages, but no income or employment taxes are withheld on the tool reimbursement. Employers use various methods to determine the amount paid as tool reimbursement. For example, the method used might measure the hourly value of the tools the service tech owns multiplied by the number of hours the service tech worked.

The method may consider the type of tool, its useful life, original cost or replacement value, geographic location of the worker and other factors. Alternatively, service techs could be paid a tool allowance or advance not based upon the value of the tools or the expenses incurred in use. None of the methods, however, are directly correlated with or based exclusively upon the actual expenses paid or incurred by the service technician for tools. In a typical arrangement amounts paid as tool reimbursements are not reported on Form W-2, but are sometimes reported on Form 1099.

■ APPLICABLE LAW

Wages

In general, wages are defined for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax withholding purposes as all remuneration for employment unless otherwise excluded. I.R.C. §§ 3121(a), 3306(b) and 3401(a). There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses. However, Treasury reg. § 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. Treas. reg. §§ 31.3121 (a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations, and Treas. reg. § 1.6041-3(h)(1) of the Income Tax Regulations.

Accountable Plan

Whether amounts are paid under an accountable plan is governed by I.R.C. § 62, which includes the provisions on employee reimbursement or other expense allowance arrangements. Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his or her performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of I.R.C. § 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under § 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of I.R.C. § 62(c) if it meets “the three requirements” set forth in paragraphs (d), (e), and (f) of Treas. reg. § 1.62-2: business connection, substantiation, and returning amounts in excess of expenses.

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. Treas. reg § 1.62-2(c)(2)(i). The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the

employee on Form W-2, and are subject to withholding and payment of employment taxes. Treas. reg. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2).

An arrangement meets the business connection requirement of Treas. reg § 1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 through section 196), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses described in paragraphs (d)(1) or (d)(2).

Section 1.62-2(e) of the regulations provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent or a third party) within a reasonable period of time. As for the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of Treas. reg. § 1.62- 2(f) provides that this requirement is met if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated.

Section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and the regulation sections, all payments made under the arrangement will be treated as made under a nonaccountable plan.

The Service has not issued any private letter rulings or technical advice memoranda concerning whether a tool reimbursement arrangement meets the accountable plan requirements. However, in a recent unreported decision, *Shotgun Delivery, Inc. v. United States*, No. C 98-4835 SC (January 20, 2000) (*Appeal pending* 9th Circuit), the United States District Court for the Northern District of California granted the government's motion for summary judgment and found that Shotgun's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of I.R.C. § 62(c). The court held that the payments Shotgun made to its employees were wages subject to employment taxes.

In *Shotgun*, the plaintiff, Shotgun, provided courier services. It charged customers an amount, called a tag rate that was based on distance, time required for delivery, waiting time, and weight. The employees used their own vehicles for deliveries and were paid 40 percent of the tag rate. The couriers were compensated with two separate checks. The first check was a "wage check," which paid the couriers a small hourly amount. The second check was for "reimbursement of expenses/lease fee" and equaled 40% of the tag rate minus the amount paid on the wage check. Thus, couriers were always paid 40% of the tag rate. The court found the arrangement was not an accountable plan because it failed to meet the business connection requirement. Under its arrangement, the plaintiff reimbursed its drivers regardless of the actual miles

driven or expenses incurred. The court concluded that "as Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred it was an abuse of section 62(c) an was therefore a nonaccountable plan." That same reasoning applies to tool reimbursements where a portion of the service tech's hourly wage payment is designated as a tool reimbursement, but the amount has no logical connection to the expenses incurred. In the typical tool reimbursement arrangement the employer carves out a portion of the worker's hourly wage and recasts it as reimbursement for expenses, when in fact the amount treated, as reimbursement is not related the employee's expenses.

■ DISCUSSION AND ANALYSIS

Employers typically claim reliance on Rev. Rul. 68-624, 1968-2 CB 424, as authority for designating a portion of an employee's compensation as a payment for the use of tools and excluding that amount from wages. Rev. Rul. 68-624 considers what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver are allocable as wages of the driver for FICA purposes. The facts specify that the corporation hires a truck and driver to haul stone from its quarry to its river loading dock at a fixed amount per load and allocates one third of the amount paid the employee as wages and two-thirds as payment for the use of the truck. The ruling holds that an allocation of the amount paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment does not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Although Rev. Rul. 68-624 has not been obsolete, it should not be relied upon to exclude tool reimbursement payments for service technicians from wages. The analysis in Rev. Rul. 68-624 does not comport with current law because it does not consider the application of I.R.C §62(c). Under current law, tool reimbursements can be excluded from wages only if paid under an accountable plan. An employment contract that merely allocates compensation between wages and tool reimbursements will not satisfy the requirements of I.R.C. § 62(c). To exclude employee reimbursements or other expense allowance payments from wages, an employer must establish an accountable plan. An arrangement will qualify as an accountable plan if it meets the three requirements of business connection, substantiation, and return of excess.

Treas. reg. § 1.62-2(d)(1) specifies that the business connection requirement be met only if the arrangement provides advances, allowances or reimbursements for business expenses that are allowable as deductions and are paid or incurred by the employee in connection with the performance of services as an employee of the employer. Thus, not only must an employee pay or incur a deductible business expense, but also the expense must arise in connection with the employment. If an employer reimburses a deductible tool expense that the employee paid or incurred prior to employment, the reimbursement arrangement does not meet the business connection requirement. Further, if an employer pays an advance or allowance based on, for example, fair tool rental value, regardless of whether the employee incurs (or is

reasonably expected to incur) the type of business expenses described above, the reimbursement arrangement does not meet the business connection requirement. Since service techs are generally required to provide their own tools as a condition of employment, expenses paid or incurred in connection with the tools would constitute ordinary and necessary deductible employee business expenses if not reimbursed. "Paid or incurred" requires that there be an actual expense, not fair rental value or use or some other intangible figure, with which the advance, allowance or reimbursement is associated. In the case of an advance or allowance, the payment by the employer may precede the incurring or payment of the specific expense by the employee, assuming the substantiation requirements are met in a timely manner.

Treas. Reg. § 1.62-2(e)(1) requires that each business expense be substantiated to the payor within a reasonable period of time. Treas. reg. § 1.62-2(g)(1) indicates that, in general, the determination of a reasonable period of time will depend on the facts and circumstances; however, Treas. reg. § 1.62-2(g)(2) provides a safe harbor allowing an advance to be made within 30 days of an expense, substantiation of paid or incurred expenses within 60 days, and the return of excess reimbursements within 120 days of payment or incurring. It is clear from these regulations that an advance or allowance is not intended to be open-ended or unassociated with specific, otherwise deductible, expenses. Amounts paid by the employer not representing specific expenses that are actually incurred by the employee fail to meet the terms of an accountable plan and are considered wages.

In addition to the requirement that substantiation be made on a timely basis, such substantiation of expenses must be detailed and complete. Treas. reg. § 1.62-2(e)(2) requires that, for expenses governed by I.R.C. § 274(d), the employee must submit information sufficient to satisfy the requirements of I.R.C. § 274(d) and the regulations, which deal with substantiating the amount, time, place, and business purpose of the expenses to the employer by adequate records. Treas. reg. § 1.62-2(e)(3) requires that, for expenses not governed by I.R.C. § 274(d), the employee must submit information sufficient to enable the employer to identify the specific nature of the expense and to conclude that the expense is attributable to the employer's business activities. Fair tool rental value, regardless of the accuracy of its estimation, does not satisfy this requirement, as it does not provide any information about the amount of, or the specific nature of, any expenses paid or incurred by the employee.

The requirements set forth in Treas. reg. § 1.62-2(f) regarding the return of amounts in excess of expenses further clarify that only expenses actually paid or incurred may be treated as paid under an accountable plan. Employees are required to return to the payor within a reasonable period of time any amount paid in excess of expenses substantiated. This section specifies that an arrangement advancing money to an employee to defray expenses will satisfy the requirements of an accountable plan only if the amount of money is reasonably calculated not to exceed the amount of anticipated expenditures and the advance is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred. A regular, routine allowance or advance for the rental value or use of tools would not meet this requirement.

Each tool reimbursement arrangement should be reviewed to determine whether the accountable plan rules are met. In addition to the factors previously discussed, there are other factors to take into account. It is relevant to know when the employer began compensating its employees in part with a tool reimbursement program. It should be ascertained whether the arrangement is written, and, if so, the writing should be reviewed to determine if its terms comply with the requirements of an accountable plan. Such writing may be in the form of a lease, an employee handbook, or an employment contract. Whether the written terms of the arrangement are actually followed is important. The service technicians' understanding of the arrangement also should be considered. Employers frequently assert that it is industry practice to pay service techs for the use of their tools. There is no "industry practice" exception to the accountable plan requirements. After analyzing the tool reimbursement arrangement, a determination can be made whether it meets the accountable plan requirements.

Documents to Request – Service Technician Tool Reimbursement

- Employee Contract
- Employment Handbook
- Employee Lease Agreement
- List or Schedule of Service Technicians
- Forms W-2

♦ Audit Techniques – Service Technician Tool Reimbursement

a. Determine by review of the tool reimbursement arrangement whether the accountable plan rules are met. There are three requirements:

Business Connection
Substantiation
Returning amounts in excess of expenses

b. Determine when the employer began compensating its employees in part with a tool reimbursement program.

c. Ascertain if the arrangement is in writing, and if so, the review for the three requirements of an accountable plan mentioned above.

d. Examples of written form are: in the form of a lease, an employee handbook or an employment contract.

e. Ask the employer if the written terms are followed; consider the service technicians' understanding of the arrangement.

f. There is no industry practice exception to the accountable plan requirements.

g. Test compliance: Determine if expenses were not substantiated nor excess expenses were returned to the employer within a reasonable amount of time. these unsubstantiated or excess amounts are paid to a Non-accountable plan subject to Employment Taxes. The taxpayer (employer/dealership) is liable for the withholding taxes unless the employer can show the employees related income and employment tax liability has been paid.

2. MANUFACTURER'S INCENTIVE PAYMENTS TO VEHICLE SALESPERSONS

Incentive payments received as bonuses, prizes, or other incentive awards paid directly by the automotive manufacture or through the dealer to salespersons are *not* subject to federal withholding tax (FIT) or federal insurance contribution act (Social Security Tax -

FICA). Moreover, these payments are not considered to be self-employment income and are not subject to self-employment tax. These payments are reported as "other income" on their federal income tax return, Form 1040. Revenue Ruling 70-337 explains that the salespersons are under direct control of the dealership, who performs the hiring and training functions and have all common law rules apply at the dealership level. The manufacturer directs payments the dealership or salesperson based on a sales quota or other sales incentive reached. The ruling also explains these payments are not considered wages for purposes of FICA. Similarly, no expenses may be taken on Schedule C to offset incentive payment income. Any ordinary and necessary business expenses incurred by salespersons must be reported on Schedule A subject to the 2% AGI limitation. Revenue Ruling 70-337 explains salespersons are under direct control of the dealership, which performs the hiring and training functions and all common law rules apply at the dealership level.

Publication 3204 provides a summary of how these payments should be reported.

3. SHUTTLING SERVICES AND DRIVER/SHUTTLERS

A dealership often uses a vehicle transportation business provide services sometimes referred to as "hiking" or a "shuttling" service to transport vehicles to and/or from the dealership. For example, car rental companies will use transportation companies to transport old rental cars to auction sites. The transportation service may be hired by the dealership as an independent contractor. Summarizing the findings in Leb's *Enterprises, Inc. v US 2000-1 USTC 50,182 indicate* that payments to the drivers performing the services were determined to be employees subject to employment taxes by the employer.

The case involved a vehicle transportation business (Leb's). Leb's provided service for various manufacturers of vehicles and vehicle leasing companies. The various companies hired Leb's to move a vehicle from one location to another. Leb's also provided services for other different companies and Leb's drivers were usually paid a flat rate based upon the distance driven. Leb's treated most of these drivers or shuttlers as independent contractors.

The Revenue Agent reviewed Leb's schedules of payments to workers (drivers), 1099s, employment tax return, reimbursement schedules, time cards, ledgers and interview questionnaires, and determined and had been incorrectly classified as independent contractors. Moreover it was determined that all of Leb's workers did substantially similar work. Leb's treated the workers of its two main clients as employees, but treated its workers from other clients as independent contractors. It also found that many individuals who worked for the two main clients were treated as independent contractors.

The court looked at the taxpayer's consistent treatment of its workers by examining the workers' specific job duties. The court looked at the job performed not the relationship between the workers and the taxpayer. In *Ren-Lyn Corp., 968 F. Supp 363 (N.D. Ohio 1997)* the court determined that the law does not require that the workers performed identical job duties, only that they perform substantially similar job duties. The court found that the workers performed substantially similar work; however workers for one

client were designated and treated as employees, but the other workers were being treated as independent contractors. As a result, Leb's was not entitled to the safe harbor relief provisions under §530.

The court then reviewed the facts about the classification of the workers. The court found that Leb's workers should have been treated and designated as employees and not independent contractors under federal tax laws. This is due to the considerable control of the workers including: means and method, result of individual's work, written instructions about the process and procedures involved in delivering the vehicles to their destination and certain time interval of delivery. Each of the workers were to call Leb's once or twice a day while they were on the road and complete employment applications, take drug tests and attend mandatory meetings. The workers had very little investment in their job.

The court also found support for its holding from the Second Circuit's decision in *Avis Rent-A-Car System, Inc. v. United States, 503 F.2d 423 (2d Cir. 1974).* In that decision, the Second Circuit held that the workers that performed car shuttling services were employees and were improperly treated and designated as independent contractors under employment tax law.

Documents to Request:

a. List or schedule of car shuttlers, porters or car drivers
b. Secure schedule of payments to workers
c. Secure Form 1099's
d. Time cards and ledgers
e. Secure Employment agreement/contracts
f. Secure copies of independent contractors agreements

Audit Techniques

a. Review employment tax returns
b. Inquire about the company's policy on classification of workers
c. Review Form 1099's and match against list of employees.
d. Inquire about reimbursement schedules.
e. Review source documents such as time cards and ledgers.
f. Review company policy about employment applications.
g. Review copies of independent contractors agreements.
h. Have affected individuals answer questionnaires that consider the twenty common law factors in Revenue Ruling 87-41.

4. HOLDBACK CHARGES

When dealers acquire their new car inventory from manufacturers, usually the invoice includes a separately coded charge for "holdbacks." Dealer holdbacks generally average 2-3 percent of the Manufacturer's Suggested Retail Price (MSRP) excluding destination and delivery charges. These amounts are returned to the dealer at a later date. The purpose of the "holdbacks" is to assure the dealer of a marginal profit.

During the examination, the agent should verify that the dealer is not booking "holdbacks" as part of purchases, cost of sales, in valuing inventories, or as any other deduction for Federal income tax purposes.

1. Example

From "window sticker":

MSRP	$10,000
Destination Charges	400
MSRP Retail Total	$10,400

From Dealer Invoice:

Vehicle Factory Wholesale Price	$9,000	
Destination Charges	400	
Advertising Association	100	1% of MSRP
Holdback	300	3% of MSRP
Total Invoice Price	$9,800	
Holdback: coded amount is	(300)	3% of MSRP
Inventory Cost to the Dealer	$9,500	

Dealer makes the following entry on its books:

Inventory	9,500	
Accounts Receivable ("Holdback")	300	
Accounts Payable		9,800

Dealer makes the following entry on its books upon receipt of "Holdback" payment from the manufacturer:

Cash	300	
		Accounts Receivable 300

2. Documents to Request (note, some of these may already be available and previously requested during initial contact with the dealership/taxpayer):
   a. Dealer’s Invoices of Vehicle Purchases
   b. Purchases Journal
   c. General Ledger
   d. Sales Journal

3. Audit Technique
   A. Compare the dealer's invoice with the Purchases Journal and the General Ledger to determine whether dealer is correctly reporting the "Holdback" amounts.
   B. If the dealer properly books the "Holdback" amount at the time the vehicle is purchased, there should not be any reference made to the "Holdback," in the sales journal, at the time the vehicle is sold to the customer.

The Holdback identified as a separately stated charge on the dealer invoice as part of the dealer cost is for example purpose. The amount may show somewhere on the invoice but as information for accounting purposes and *not* as an element of dealer cost.

3. Law
   Rev. Rul. 72-326 provides that the dealer cannot include the $300 "Holdback" as an inventory cost. Thus, the car should be included in inventory at $9,500 and the $300 carried in a receivable account from the factory/manufacturer. The manufacturer, on the other hand, is not required to include the "$300 Holdback" in income.

   Brooks-Massey Dodge Inc. v. *Commissioner* 60 T.C. 884 (1973). The amounts of an accrual basis dealer discount held back by the manufacturer under a plan agreed to by the dealer was taxable to the dealer in years the amount was credited to the dealership's account rather than in years received.

5. WARRANTY ADVANCES

Dealerships perform work on vehicles, as a result of defective materials or workmanship at the time of manufacture. The manufacturer subsequently reimburses the dealership. Because of the time delay from when the work is completed and the date the manufacturer pays the claim, the manufacturer issues credit memoranda or advances to the dealerships based on an averaging calculation (average of warranty claims submitted in a month) thereby reducing the accounts payable of the dealer for parts purchased from the manufacturer. The purpose of the arrangement is to allow the dealer a credit against amounts owed to the manufacturer before the manufacturer processes the warranty bill.

The amount of the credit is adjusted at the beginning of each year based on the average of the previous 12 months warranty claims filed and approved. Since dealers use an accrual method of accounting, all amounts due it from the manufacturer for warranty work performed through the end of the taxable year are includable in gross income. Accordingly, the amounts represented by the credit memorandum issued by the manufacturer, pursuant to the credit arrangement, are not includable in the gross income of the dealer, but merely represent a reduction of the accounts receivable representing the amount due from the manufacturer for warranty work performed.

1. Example-Warranty Advances
   Adjusting Journal Entry:
   Credit Memoranda: ABC Manufacturer $10,000
   Parts Purchased – ABC Manufacturer $10,000
   To record warranty advances from ABC manufacturer

2. Documents to Request- Warranty Advances
   a. Credit Memorandums from Manufacturer
   b. Accounts Payable Journal
   c. Accounts Receivable Journal
   d. General Ledger
   e. Dealer Franchise Agreement

3. Audit Techniques-Warranty Advances
    a. Review adjusting journal entries or reversing entries at year end/beginning of year for warranty advances and compare to Other Income.
    b. Determine that accounts receivable from manufacturer reflect reduction of income of warranty advance.
    c. Determine that accounts payable of the dealer is reduced for parts purchased from the manufacturer of warranty advance.
    d. Review dealer franchise agreement to for the provision of a credit arrangement on warranty advances or other provisions set up for warranty work.

4. Law
   IRC section 446(a) provides, in pertinent part, that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

   IRC section 451 provides that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be accounted for as of a different period.

5. Rev. Rul. 72-595
   The amounts represented by the credit memorandum issued by the manufacturer are not includable in the gross income of the dealer, but merely represent a reduction of the dealer's accounts receivable for amounts due from the manufacturer for warranty work performed.

6. FINANCE RESERVES

One income issue found in new car dealerships has to do with the manner in which Finance Income is reported. When dealerships sell cars, they also arrange financing for the buyer. These finance contracts are usually sold to a financial institution and the dealership typically participates in the income derived from these contracts. The amount of income depends on a pre-arrangement with the financial institution where the dealership earns a greater amount if the financing is more lucrative.

Ordinarily, the financial institution and the dealership establish an account called a "Dealer Reserve Account" that is credited, with the dealership's "commission" for arranging financing for the buyer, when the financing company determines the income allocation. This account may also be charged (reduced) when a contract with recourse to the dealership defaults. In most instances the financial institution holds part of the dealer's reserve to cover contingent events (i.e. in the event the note is prepaid early or the car is repossessed).

I. Example

A dealer sells a car to a customer for the following:

Sales Price (including Sales Tax and license fees)	$10,000
Less: Down payment	1,000
Balance to be Financed	$ 9,000
Finance Charge @ 10 percent	900
Face amount of Installment Note	$ 9,900

The dealer sells the note to a finance company that agrees to pay the dealer a 20 percent commission on the finance charge, or $180.

The correct way for the dealer to handle the transaction is as follows:

	Debit	Credit
Cash	9,000	
Finance Charge Receivable	180	
Customers' account receivable		9,000
Finance Income		180

See current IRM.

A. Audit Techniques--Finance Income
   a. Determine the presence of a "deferred income" account.
   b. Inspect the monthly statements submitted to the dealer by the finance company (is).
   c. Probe into the possible existence of related corporations set up to handle the installment notes. See also the chapter on Related Finance Companies in this Guide.
   d. Sample selected transactions to verify that the taxpayer was using the accrual method.

B. Law
   In *Commissioner* v. *Hansen*, 360 U.S. 446 (1959), the Supreme Court held that the amount held back or retained by the finance company is taxable to the dealership at the time the installment note is sold and the dealership has a fixed right to the reserve account.

   Dealers must include in income all amounts placed in the reserve all deposits into the account regardless of use. See *Resale Mobile Homes, Inc.* v. *Commissioner*, 965 F.2d 818 (10th Cir. 1992).

COMPENSATION ISSUES

In addition to the normal employment tax requirements applicable to auto dealerships, there are other employment tax considerations unique to the auto industry.

1. Auto Demonstrator Vehicles

In December 2001, IRS issued Revenue Procedure 2001-56. This revenue procedure provides guidance for the taxation of the personal use of an auto demonstrator vehicle

provided by automotive dealers to their employees. This revenue procedure allows the dealer, instead of the salesperson, to determine the taxability of a demonstrator vehicle. An auto dealership may use any of the methods in the revenue procedure OR may use the existing rules as defined in IRC 132(j)(3) and Reg. 1.132-5(o)(4).

Rev. Proc. 2001-56, and Publication 4230 for taxpayers, provides four methods to determine the amount taxable to the employees:

- Full Exclusion Method – clarifies the existing rules under current law. This method provides complete exclusion from taxation for the use of a demonstrator vehicle.

- Simplified Out/In Method – provides simplified record keeping requirements for the Full Exclusion Method.

- Partial Exclusion Method- allows for partial taxation of an auto demonstrator vehicle with limited record keeping requirements. Most auto dealerships are expected to adopt this method.

- Full Inclusion Method – allows a dealership to use the Annual Lease Value tables, as defined in Treas. Reg. 1.61-21(d)(2)(iii), to determine the taxable value of a demonstrator.

If the auto dealer cannot qualify for one method, the dealer may qualify for one of the other three methods.

In order to use any of the first three methods, the driver of the demonstrator vehicle must qualify as a full-time salesperson and the dealership must have a written policy. A sample written policy is included in Appendix A and B of the revenue procedure.

The rules to qualify as a full-time salesperson are: [ref. IRC 132-5(o)(5)]

- Must be a full-time employee of an automobile dealer
- Must spend at least half of a normal business day performing the functions of a floor salesperson or sales manager
- Must directly engage in substantial promotion and negotiation of sales to customers
- Must derive 25% of his or her gross income directly as a result of sales activities

The written demonstrator agreement must contain the following:

- Prohibit the use of the vehicle outside of normal business hours by individuals other than full-time salespeople
- Prohibit the use of the vehicle for personal vacation trips
- Prohibit use outside of the sales area in which the dealership's sales office is located
- Prohibit storage of personal possessions in the vehicle
- Employer must reasonable believe that the salesperson complies with the written policy

Any full time employee of the dealership can use the fourth method.

Full Exclusion Method[1]
The Full Exclusion Method allows for full exclusion from taxable income, the use of a demonstration automobile by a full-time automobile salesperson. This method clarifies the existing tax treatment of auto demonstrators under IRC 132(j)(3) and Reg. 1.132-5(o)(4).

It is expected that most dealerships will NOT adopt this method.

Simplified Out/In Method[2]
The Simplified Out/In Method provides a simplified method for a dealer to document the use of a demonstration automobile by a full-time automobile salesperson. Under this method, the total miles that a demonstrator is used during normal working hours is considered business miles and only mileage outside of normal working hours is considered.

For each demonstrator, the dealer must record the mileage at the end of the day and again at the beginning of the following day. The miles driven during this time cannot exceed the salesperson's commute plus 10 miles. The employer must determine if the personal miles exceed an average of 10 miles per day, no less often than monthly. If the average personal miles are less than 10 miles per day, and all other requirements of this section are met, the salesperson's use of the demonstrator is not taxable.

The taxpayer is required to maintain the following records:

- Evidence that the salesperson's personal use by mileage was calculated no less often than once each calendar month. This may include:

    i. Records identifying each demonstrator assigned to each salesperson

    ii. Records identifying the total mileage for each demonstrator

    iii. Records supporting the total use outside of normal working hours. Employer should maintain records of out and in mileage of the demonstrator for each day it is used.

    iv. Records identifying the round trip commuting mileage of each salesperson assigned a demonstrator from the salesperson's home to the dealer's sales office.

The employee is *not required* to maintain any records except to the extent the employee is required to provide information to the dealer to allow the dealer to maintain the records as noted above.

[1] Revenue Procedure 2001-56, Questions 8-10
[2] Revenue Procedure 2001-56, Questions 11-25

Partial Exclusion Method[3]

The "Partial Exclusion Method" provides that an amount is to be included in the taxable income of a full-time salesperson at least monthly for the use of the demonstrator vehicle. Under this method, the dealer is not required to keep any records documenting the use of the demonstrator.

The taxable amount is obtained from the table below and is based upon the value of the vehicle. The taxable amount applies for each day a salesperson is provided a demonstrator, including non-work days.

Value of the Demonstration Automobile	Daily Inclusion Amount
0 - $14,999	$3
$15,000 - $29,999	$6
$30,000 - $44,999	$9
$45,000 - $59,999	$13
$60,000 - $74,999	$17
$75,000 and above	$21

Full Inclusion Method[4]

The Full Inclusion Method is available to *any* full-time employee of the dealership. This method allows an automobile dealer to use the Annual Lease Value tables [Ref 1.61-21(d)(2)(iii)] to determine the amount the employee must include in his or her income for their use of a demonstrator vehicle. This method does not allow any reductions in the inclusion amount for the employee's business use.

The dealer is required to include the taxable amount in the employee's wages no less often than monthly.

Annual Lease Value Table

Value of Demonstration Automobile	Daily Inclusion Amount
$0 - 2,999	$ 3
3,000 - 4,999	4
5,000 - 5,999	5
6,000 - 7,999	6
8,000 - 8,999	7
9,000 - 10,999	8
10,000 - 11,999	9
12,000 - 12,999	10
13,000 - 14,999	11
15,000 - 15,999	12
16,000 - 17,999	13
18,000 - 18,999	14
19,000 - 20,999	15
21,000 - 21,999	16

[3] Revenue Procedure 2001-56, Questions 26-39
[4] Revenue Procedure 2001-56, Questions 40-47

22,000 - 23,999	17
24,000 - 24,999	18
25,000 - 25,999	19
26,000 - 27,999	20
28,000 - 29,999	21
30,000 - 31,999	23
32,000 - 33,999	24
34,000 - 35,999	25
36,000 - 37,999	27
38,000 - 39,999	28
40,000 - 41,999	29
42,000 - 43,999	31
44,000 - 45,999	32
46,000 - 47,999	34
48,000 - 49,999	35
50,000 - 51,999	36
52,000 - 53,999	38
54,000 - 55,999	39
56,000 - 57,999	40
58,000 - 59,999	42

Annual Average Look Back Method[5]

The "Annual Average Look Back Method" is available for a dealer to determine the value of his or her demonstration vehicles provided to its salespersons when the dealer is using the Partial Exclusion Method or the Full Inclusion Method. This method may be used to value the dealerships' demonstrators instead of valuing each demonstrator individually.

The value of any new demonstration automobile is based on the average sales price of all vehicles sold in the prior year. It is calculated by taking the sum of the sales prices of all new car and truck sales in the prior calendar year and dividing that sum by the number of new vehicles sold in the prior year.

Example:

In 2001, (Manufacturer's Statement) New Car Gross Receipts: $23,226,000

The dealership sold 948 vehicles

$$\frac{\$23,226,000}{948 \text{ vehicles}} = \$24,500 \text{ annual average vehicle}$$

Using the table provided for the Partial Exclusion Method, the amount calculated above is between $15,000 to $29,000 range and the daily inclusion amount accordingly is at $6.00/day.

[5] Revenue Procedure 2001-56, Questions 33-34

Using the table provided for the Full Inclusion Method. The amount calculated above is between $24,000 - $24,999 range and the daily inclusion amount accordingly is at $18/day.

The average sales price must be determined in January of each year and must be applied no later than February of that year. In the above example, for each month ending on or after February 1, 2002 to January 31, 2003, the dealer includes in the employees W-2, $6 per day under the Partial Exclusion Method and $18 per day under the Full Inclusion Method.

Some manufacturers' statements state the value of demonstrator vehicles as a separate line item. The dealership is permitted to use this value instead of the broader New Car Gross Receipts item. However, the dealership must the same method from year to year.

Consistency is required
Revenue Procedure, 2001-56, Question 34 provides several examples of determining the annual average sales price of a demonstrator vehicle. For example, if the dealership operates more than one franchise at a single physical location, the annual average sales price for all salespeople may be based on the combined sales of all franchises operating at that store.

If a salesperson is only provided demonstration automobiles from a single franchise operating out of the store, the dealer may base the annual calculation of value of that salesperson on the sales of the specific franchise. In that case, the value for all salespeople in the store must also be based on specific franchises.

The dealer can use this method for used car demonstrators. Questions 33 and 34 address scenarios for used car demonstrators.

Documents to Request
- The dealership's written demonstrator policy
- Payroll records including W-2's and payroll journals
- Listing of employees that were given a demonstrator vehicle
- Determination of the valuation of the demonstrator vehicles

Audit Techniques
The dealership is not required to make an election to use any of the methods in Revenue Procedure 2001-56. Upon examination, ask the dealership which method, if any, the dealership adopted.

As stated earlier, it is expected that most dealerships will adopt the Partial Exclusion Method. The agent should verify the following:
- The dealer has a qualified written policy, the policy was communicated to employees, and there is no evidence that the salesperson violated the written policy.
    - Documentation of communication to employees of the policy may include a copy of a poster notifying employees, a copy of a letter or electronic

communication, or signed statements by the employees acknowledging receipt of the written policy.

- Payroll records should indicate that withholding and income are properly accounted for on a monthly basis
    - The dealer is not permitted to elect under IRC 3402(s) not to withhold income taxes from the portion of the vehicle fringe benefit required to be included in the employees' W-2.
        - The monthly withholding requirement is intended to substitute for more specific record keeping requirements for substantiating the use of the demonstrator. Annual inclusion and withholding of other employment taxes with respect to noncash fringe benefits allowed under Announcement 85-113, 1985-31 I.R.B. 31 is unavailable under the methods provided by this revenue procedure. [6]

- Salespersons are assumed to have the use of a demonstrator for every day of the period under consideration. If the dealer states otherwise, he or she should be able to provide evidence.
- The dealer should be able to support the determination of the value of the demonstrators. If the dealer has multiple franchises, locations and/or has used vehicles for demonstrators, the dealer must be consistent in the valuation method that is employed.

If a dealership does not qualify for one method, the dealer may still qualify to use one of the other methods described in the revenue procedure.[7]

Examples:

- If a dealership attempts to use the Simplified Out/In method and does not qualify (i.e. average personal miles > 10 miles per day), the dealer can use the Partial Exclusion method as long as the correct tax is withheld from the salesperson.[8]

- If a dealership attempts to use the Partial Exclusion method and does not qualify (i.e. employee not a full-time salesperson), the dealer can use the Full Inclusion method as long as the correct tax is withheld from the salesperson.[9]

Inadvertent Errors

Revenue Procedure 2001-56, Question 51 addresses inadvertent payroll errors. If an error is identified and corrected during the calendar year, the dealership is permitted to use the revenue procedure. If the error is NOT corrected within the calendar year, the dealership must determine the taxable amount under the general valuation and substantiation rules.

Employees other than full-time salespeople

[6] Revenue Procedure 2001-56, Question 37
[7] Revenue Procedure 2001-56, Question 1
[8] Revenue Procedure 2001-56, Questions 10 and 25
[9] Revenue Procedure 2001-56, Question 29

If the employee provided the use of a demonstrator is not a full-time salesperson, the full exclusion and the partial exclusion methods do not apply. The employer may use the full inclusion method to determine the value of the demonstrator, but cannot reduce the taxable amount to account for business use by the employee.

Treas. Reg. 1.274-6T provides other methods for excluding from an employee's income a portion of the value of the use of a demonstrator. This regulation generally allows an employer implementing certain written policies restricting personal use to account for commuting and de minimis personal use by any employee by including the $1.50 per one-way commute provided under Treas. Reg. 1.61-21(f)(3) in the employee's income and providing other evidence allowing a determination that use was actually limited.

Questions 48-50 in the revenue procedure address other applications of Treas. Reg. 1.274-6T.

General Valuation Rules
If a dealer does not use any of the above methods and the method he or she does use does not qualify under the code and regulations, the dealer must use the general valuation rules to value the use of the demonstrator vehicles.

2. Fringe Benefits
Often, a dealership permits its employees, shareholders, or directors to use its automobiles or purchase them at a discount. This benefit is includable in the recipient's gross income unless it is excludable by a specific statutory provision. In the case of automobiles provided by a dealer, one of the following may be applicable: no additional cost services, defined in IRC 132(b); qualified employee discounts, defined in IRC section 132(c); and working condition fringes, defined in IRC section 132(d).

Qualified Employee Discounts
The amount of any discount provided to an employee on the purchase of an automobile from the dealer is excludable from the employee's gross income to the extent that the rules of IRC section 132(c) are satisfied. The exclusion applies if the property or service is provided at no charge, at a reduced price, or the benefit is provided through a partial or total cash rebate. Only that portion of the discount that falls within the guidelines is excludable from income. Any discount in excess of that amount must be included in the employee's income.

Documents to Request
- Listing of employees and related parties that received an employee discount
- Determination of how the dealership determined the excludable amount.

Audit Techniques
The maximum excludable discount that an employee can receive on an automobile is the dealer's gross profit percentage on that automobile multiplied by the price at which it is offered to non-employee customers. See IRC section 132(c)(2)(A) and (B). For purposes of this rule, an "employee" includes current employees, spouses of employees, and dependent children of employees, etc. See Treas. Reg. Section 1.132-1(b)(1). Accordingly, discounts provided to non-employee shareholders and directors

are not excludable from gross income under this rule. The amount of any discounts provided to these individuals should be treated as a constructive dividend.

3. Working Condition Fringes

1. General Rule
   An employee's use of an employer-provided automobile is excludable from gross income as a working condition fringe only to the extent the following three requirements are met:
   1) The employee's use of the automobile is related to the dealer's trade or business;

   2) The employee would have been entitled to a deduction for a business expense or for depreciation (IRC sections 162 or 167) if he or she had purchased the automobile that was provided by the employer; and

   3) The business use of the automobile must be substantiated by adequate records under the substantiation requirements of IRC section 274(d). See Treas. Reg. Section 1.132-5(c).

   An "employee" includes current employees, partners who perform services for the partnership, directors, and independent contractors. See Treas. Reg. Section 1.132-1(b)(2).

Documents to Request:

- List of employees that received a vehicle whose value was excluded from their gross income.

Audit Techniques

Auto demonstrator vehicles do not qualify as a working condition fringe. Auto demonstrator vehicles will not qualify under Rule #2 above. Vehicles granted as a working condition fringe should be scrutinized as disguised demonstrator vehicles.

4. Unreasonable Compensation – C Corporations

Most auto dealerships are closely held corporations with a few shareholders. The general manager (sometimes the minority shareholder) is the person who runs the day-to-day operations of the dealership. His or her duties may include: hiring, training, promoting and supervising personnel; maintaining relations with the manufacturer; developing advertising; writing and placing advertising copy; establishing lines of credit and flooring arrangements. However, in most cases the majority shareholder/president of the dealership is the highest compensated employee. Pension contributions are a form of compensation and should be considered in determining whether the amounts deducted as compensation are reasonable.

It is customary for automobile dealerships to pay top management employees incentive bonuses based on a percentage of net profits in addition to their basic monthly salaries, regardless of whether such employees own stock in the dealership. Often the officers and other key employees are paid relatively modest salaries, which are supplemented by the bonuses.

Documents to request

- Payroll records of highly compensated employees
- Listing of year-end bonuses.
- Corporate minutes
- Dealership Franchise Agreement

Audit Techniques

In order to determine if unreasonable compensation issue exists, the following factors should be present:

- Salary and bonuses are in excess of industry practice without a valid business reason.

- The officer/shareholder is not the primary responsible person for the level of growth, productivity and financial success of the dealership.

- If large year-end bonuses were paid, there is no evidence of a pre-determined formula or other industry accepted method of determining the amount paid.

- The shareholder is a relatively new franchise owner with little previous experience, yet the owner's compensation is in excess of the franchiser's guidelines.

IRS has litigated many reasonable compensation cases. In the cases where IRS was successful, the above factors were present.

Audit trail

- Obtain documentation of salaries and wages (paid and accrued) for the managers of the various departments by inspection of Forms W-2 and the payroll registers. Year-end bonuses are reflected as accrued salaries and a detail of the employees would reflect amounts paid to the managers.

- Review the corporate minutes for the authorization of salaries and bonuses. The minutes may reveal the method of determining salaries and bonuses, economic and financial concerns of the corporation and the dividend history of the corporation.

- Dividends paid should be reflected on Schedule M-2 and as a reduction to the retained earnings account.

- Review of prior year tax returns (4 years) could indicate whether the officers had been underpaid in prior years and establish a salary history for the officers.

- Examine the travel and entertainment expense with the intent of scheduling the officer/shareholder's activities (business and non-business) throughout the year.

- The Dealership Franchise Agreement may provide information as to working capital agreements ("Minimum Capital Standard Agreements") and identify certain key employees of the dealership (i.e., president, general managers and shareholders).

- Employee specific factors include:
    - Educational level and experience
    - History of salary increases and changes in responsibility or productivity
    - Employee contributions to the success and growth of the business
    - Comparison of officer's salaries with other comparable dealership

The following court cases have addressed compensation for auto dealerships:

Automotive Investment Development, Inc vs. Commissioner, T.C. Memo. 1993-298. The Court determined that the compensation paid to the owner was reasonable. The officer purchased marginally successful dealerships and increased their profitability dramatically. The owner paid himself according to a formula that was widely adopted in the automotive industry.

Lloyd Schumacher Chevrolet-Buick, Inc. v. United States, 80-2 U.S.T.C. (CCH) Paragraph 9576. The Court held that the compensation paid to the owner was reasonable. The owner was solely responsible for all operations. The increase in sales was attributed to the actions of the owner and the bonus formula he paid himself was reasonable.

Castle Ford, Inc. v. Commissioner, T.C. Memo. 1978-157. The Court revised the compensation paid to its owner. The owner was paid a salary several times higher than his salary paid in the prior year. The owner was able to substantiate part of the increase because the large increase in profits was due to his effort. However, since he had full control of his salary, part of this was considered excessive.

Good Chevrolet v. Commissioner, T.C. Memo. 1977-291, CCH 34,606(M). The Court determined that the compensation was reasonable because of the officers' qualifications, the requirement of minimum working capital, and compensation and bonuses were computed based on a predetermined formula.

Osborne Motors, Inc. v. Commissioner, T.C. Memo. 1976-153. The Court held that the compensation paid to its owners was reasonable. The owners were responsible for all material operations and success of the dealership. Even though the owners spent 3 months of the year out of the area, they reviewed financial information frequently and made decisions based upon that information.

Superior Motors, Inc. v. Commissioner, T.C. Memo. 1974-187. The Court revised the compensation paid to its owner. The Court determined that the bonus paid was not consistent with established industry practice.

Skyland Oldsmobile, Inc. v. Commissioner, T.C. Memo. 1972-17. The Court found that the salary and bonus paid to its CEO was reasonable. The CEO worked long hours, was responsible for all phases of its business, and was responsible for the dealership's improved condition.

East Tennessee Motor Company v. United States, 453 F.2d 494. The Court held that the owner's salary was unreasonable. There was no specific formula used in determining whether his salary was reasonable or unreasonable or was payment for something other than services rendered.

Van's Chevrolet, Inc. v. Commissioner, T.C. Memo. 1967-172. The Court revised the compensation paid to its shareholder. The shareholder did not have a set bonus formula in accordance with industry guidelines.

City Chevrolet Company v. Commissioner, 228 F.2d 894 (4th Cir. 1956). The Court determined that the owners' compensation was unreasonable because the owners did not have an established arms-length salary policy.

Key Buick Co. v. Commissioner, T.C. Memo. 1976-303. The Court revised the compensation paid to the corporation's president. The officer was a part time employee and his salary was not determined by an established policy.

University Chevrolet Company, Inc. v. Commissioner, 16 T.C. 1452 (1941). The Court determined that the compensation paid to the sole owner was excessive. The owner's previous salary determination under a bonus-stock purchasing arrangement adopted by the manufacturer to obtain and establish dealers is not determinative of reasonable compensation of the same officer after he becomes owner of all of the stock.

OTHER MISCELLANEOUS ISSUES

As this section is introduced, several of these fees such as Enrollment and Pool Capping fees refer to sub prime financing. Refer to the Sub Prime Finance chapter for further information.

A. Enrollment Fee – Generally, dealers must pay an enrollment fee to enter into an agreement to transfer notes to a finance company. The dealership may pay a nonrefundable fee to the finance company to join the program. Pursuant to TAMs (IRS Letter Rulings 9840001, 199909002, and 199909003, this fee is an IRC section 263 capital expenditure and is not deductible under Section 162. The Servicing Agreement between the dealer and the finance company meets the definition of a supplier-based intangible under Section 197(b) of the Code and has a 15 year life beginning with the month in which the contract was executed. Since the agreement does not have a fixed duration of less than 15 years, the exception from inclusion under Section 197 of the Code does not apply.

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B. Pool Capping Fee – When the finance company decides that the pool notes should be closed (usually at around 100 notes), the dealership may pay a nonrefundable fee to the finance company to cap the pools. This is done so that the dealership will have a

better prospect of receiving back end payments. The same reasoning used for the enrollment fee can be applied to
the pool-capping fee. The fee covers a period of time, which is not specified in years because it is based on the number of contracts involved. This fee would also fall under IRC §197 of the Code because it is a supplier-based intangible with a value resulting from future acquisition of services pursuant to a relationship in the ordinary course of business with a supplier of services to be used by the taxpayer. The fee would be amortized ratably over a 15- year period beginning with the month in which the fee was paid.

C. Servicing Fee

The Servicing Agreement between the finance company and the dealer will specify the fee charged by the finance company to the dealer to collect the receivables (servicing fee). The servicing fee is usually a percentage of the finance contract. The deductibility of the servicing fee is not an issue if the transfer of the finance contract is deemed to be a sale because it is factored into the amount realized on the sale. If the transfer is deemed to be a loan or an assignment, the servicing fee is not currently deductible when the finance contracts are transferred to the finance company. The fee is deductible as the services are provided by the finance company in accordance with the economic performance rules of IRC §461.

D. Mark to Market

Section §475 of the Internal Revenue Code opened a small window of opportunity for auto dealers to elect Section 475 to mark receivables to market value. For Section 475 to apply, the dealer must have held (owned) the receivable at THE END OF THE APPLICABLE TAX YEAR. If the transfer of the installment contract to the finance company was determined to be a sale, Section 475 does not apply since the dealer no longer owns the receivable.

The IRS Restructuring and Reform Act of 1998 amended Section 475. Mark-to-market can no longer be used for a receivable that is produced from the sale of non-financial goods or services by a taxpayer whose principal activity is the selling or providing of non-financial goods and services.

E. Change in Accounting Method

Depending on how the dealer has reported the transactions, audit adjustments may require a change in method of accounting. If so, an IRC §481(a) adjustment will be made at the beginning of the year of change, usually the first open year under examination. The current year adjustment will be made pursuant to IRC §446. The facts and circumstances of each situation must be considered to determine if a change in method has occurred.

Documents to Request – Change of Accounting Method

- Form 3115 for Request for Approval of Change of Accounting Method, including termination of LIFO inventory valuation method.

Audit Techniques:

- IRM, Section 4.10.3, Examination Techniques, [Revision date: 2001-07-31] Changing a Taxpayer's Method of Accounting.
- If the taxpayer has terminated its LIFO election, review return for Schedule M-1 and "other Income" for LIFO recapture. Request schedule of 481(a) adjustments.
- Review computations for appropriateness and compliance.

F. Used Car Donation Programs

Due to an increasing number of advertisements for used car donations to charity, concern has arisen for two claims made in some of the advertising. In one instance, a charity enters into an agreement with a for-profit company. For a fee, the for-profit company will conduct the entire campaign with little or no involvement by the charity. The for-profit company begins with the solicitation of used auto donations, followed by the vehicle pickup and then final disposition of the vehicle. To be deductible as a gift "to" charity, used cars must, in actuality be given "to" the charity or, at the least, an agent of the charity. The arrangement described above does not qualify as an agency relationship because the charity is not supervising the activity. Thus, the donor is not be entitled to a charitable deduction in any amount. The other concern is proper valuation of the donated vehicle. Some promotions claim full blue book value regardless of vehicle's operating condition. The term "blue book" appears to describe many valuation lists prepared by many different companies. Generally, however, these lists only value used cars "in running condition" (not poor or inoperable condition). Lastly, the charity should be legitimate. Referrals of individual donors may be made to Exempt Organizations now known as Tax Exempt & Government Entities Business Operating Division).

Documents to Request:

a. Form 8282 from the Exempt Organization that shows the Employer Identification Number
b. A qualified appraisal of the vehicle to the donated charity must accompany statement

Audit Techniques:

a. Ask if the taxpayer is related to the exempt organization
b. Consult the Cumulative List of Exempt Organizations Publication 78 or website to confirm exempt status: http://www.irs.gov/bus_info/eo/index.html
c. Inquire about fair market value of donated car- possibly overvalued? Was a used car-pricing guide considered in determining the fair value?
d. Inquire if the dealership is acting as a 3rd Party and making payments to the charity for the donated vehicles during fund raising programs. If so, the donated goods exception (*section 513(a)(3)*) to the unrelated business income tax provisions might not apply. Contact Exempt Organizations for assistance. An EO referral Form 5666 for a collateral examination request may be necessary.

Law: 170(c) (2); 170 (f)(8) and Revenue Ruling 2002-67

Revenue Ruling 2002-67 discusses the car donation issue: a privately owned car dealership administers a section 170(c)(2) charity's car donation fundraising program as its authorized agent. In the examples provided, one individual donates a car in excellent condition to the dealership and another donates a car in poor condition.

The IRS concludes that the donor's transfer of the car to the charity's authorized agent may be treated as a transfer to the charity. Also, the authorized agent may give to the donor the contemporaneous written acknowledgment required by section 170(f)(8). Finally, the IRS concludes that the donor may use an established used car pricing guide to determine the car's fair market value as long as the comparison is for the same make, model, and year, is sold in the same geographical area, and in the same condition as the donated car. If not, the donor must use some other reasonable method.

For information regarding a charity's obligation to report amounts paid and received in connection with fund-raising programs, see Instructions for Form 990 and Announcement 2002-87, 2002-39 I.R.B. 624.

G. Credit for Qualified Electric Vehicles:

IRC section 30(a) allows a credit for up to 10% of the cost of a qualified electric vehicle limited to a maximum credit of $4,000 with no carryback/carryover of any unused credit. The credit is shown on Form 8834 and can be claimed by an individual who buys one for their personal use (does not have to be used in a trade of business).

Toyota and Honda have come out with a gasoline/electric "hybrid" type vehicle, which runs on gasoline but has battery powered drive mechanism, which does not require a charger hookup since the gasoline engine charges the battery (batteries). The Form 8834 cautions that such "hybrids" do not
qualify. See next section on Hybrid Vehicles

H. Clean –Fuel vehicle property: Hybrid Vehicles: Manufacturer's certification of incremental cost

Revenue Procedure 2002-42 sets forth a process that allows a taxpayer who purchase certain clean-fuel vehicle property to rely on a manufacturer's certification of the incremental cost of the property for purposes of the clean-fuel vehicle property deduction under Code Section 179A.

This procedure applies to motor vehicles (other than buses, trucks, and vans with a gross vehicle weight rating greater than 10,000 pounds) that are propelled by both a gasoline internal combustion engine and an electric motor that is recharged as the motor vehicles operate (hybrid vehicles) and that otherwise meet the requirements of §179A.

<u>Qualified Motor Vehicles</u>

To be eligible for the deduction under §179A, a motor vehicle must:

a. Meet the applicable federal and state emissions standard respect to each fuel by which the vehicle is propelled
b. Be manufactured primarily for use on public streets, roads, and highways
   (1) Have at least four wheels; and
   (2) Not operate exclusively on a rail or rails.

Section 179A and this revenue procedure *do not apply* to motor vehicles that are primarily powered by electricity and qualify for the credit provided in §30 or to motor vehicles that are used predominantly outside the United States.

Deduction Amount Limitations.
Under §179A, except in the case of any truck or van with a gross vehicle weight rating greater than 10,000 pounds or any bus with a seating capacity of at least 20 adults (not including the driver), the maximum cost that may be taken into account when determining the deduction is:

- $2,000 for motor vehicles placed in service on or before December 31, 2003.
- The $2,000 maximum is reduced by 25 percent for motor vehicles placed in service in calendar year 2004,
- 50 percent for motor vehicles placed in service in calendar year 2005,
- and 75 percent for motor vehicles placed in service in calendar year 2006.
- No deduction is allowed for motor vehicles placed in service after December 31, 2006.
- No deduction is allowed with respect to the portion of the cost of any property taken into account under §179.

Procedure
.01 *Original Equipment Manufacturer's Certification.* An original equipment manufacturer (or in the case of a foreign original equipment manufacturer, its domestic distributor) may prepare a certification concerning the incremental cost of permitting the use of electricity to propel its vehicles. The certification should contain the following information:

(1) The name and address of the certifying entity;
(2) The make, model, year, and any other appropriate identifiers of the motor vehicle; and
(3) A statement disclosing the total per-vehicle cost to acquire and install the motor vehicle's electric motor and related generating, storage, and delivery equipment. If the total cost exceeds $2,000, the statement may so indicate without disclosing the specific amount of the cost.

The certification should be signed by an officer of the original equipment manufacturer (or, in the case of a foreign original equipment manufacturer, an officer of its domestic distributor). This original signed certification must be sent to:

Internal Revenue Service, Industry Director,

Large and Mid-Size Business, Heavy Manufacturing and Transportation,
Metro Park Office Complex--LMSB,
111 Wood Avenue, South
Iselin, New Jersey 08830.

02 *Internal Revenue Service's Acknowledgment.* The Internal Revenue Service will review the original signed certification and issue an acknowledgment letter to the original equipment manufacturer (or, in the case of a foreign original equipment manufacturer, its domestic distributor). This acknowledgment letter will state whether purchasers may rely on the certification.

03 *Purchaser's Reliance.* Copies of the certification and acknowledgment may be made available to purchasers. Except as otherwise provided in the acknowledgment, a purchaser of a hybrid vehicle may rely on the certification concerning the incremental cost of permitting the use of electricity to propel the vehicle.

I. Cost Segregation

This issue relates to the reallocation of building costs from 39 year to 5, 7 or 15-year MACRS property. It is applied to buildings that are purchased, constructed, renovated or expanded.

An example is "Building Related Costs" and many consulting firms rely on *Hospital Corp of America, Inc. v. Commissioner, 109, T.C. 21* (HCA case) Not acquiesced: FSA 2001-1001

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- Identification of Tangible personal property
  - Not required for normal operation or maintenance of building
  - HCA 5-Year Property identified as
    - Allocable portion of electrical system
    - Wiring for telephones and televisions
    - Carpeting and vinyl tile
    - Vinyl wall covering
    - Plumbing and exhaust systems for kitchen equipment
    - Corridor handrails
    - Room partitions
- Reclassified into shorter depreciation periods

The court case found its focus of inquiry was the ultimate use of property. The Service acquiesced the legal conclusion but not the use of the structural components.
Chief Counsel Advice (CCA) 199921045 mentioned the following:

- Structural component or tangible personal property is a facts and circumstances assessment
- No “bright line” test exists
- Studies must be based on contemporaneous records
- It must not use reconstructed data, estimates, or assumptions with no supporting records
- A change in the recovery period is a change in the method of accounting.
- Revenue Procedure 99-49, 1999-2, C.B. 725 allows for the change using the automatic provisions set forth in the procedure

Audit Techniques:
1. Review Taxpayer’s depreciation schedules
2. Look for recently constructed, renovated, or purchased real property
3. Look for re-allocations of the cost of real property that was placed in service in the past from 39-year to 5,7, or 15 year MACRS.
4. Present in all industries.

Documents to Request:
1. Request the taxpayer’s work papers and supporting documentation
2. Engineering Referral.

This methodology is being promoted by tax consultants, manufacturing industries and accounting firms; and under study by the Large and Mid-Size Business division.

J. Oldsmobile Dealer Franchises and Involuntary Conversion (Internal Revenue Code §1033) treatment

The treatment of payments for Oldsmobile dealers is still being discussed. This section will be updated as the law changes. In July 2002 Senate Bill 2726 was introduced due to the decision of General Motors to eliminate the Oldsmobile product line in December 2000. GM offered Oldsmobile dealers other dealership opportunities to assist in the phase-out of that line. A revenue ruling is pending at the writing of this section.

There is a private letter ruling issued in 2002 which applies specifically only to that dealership.

At issue:

Does the cancellation of Oldsmobile franchises qualify for capital gains treatment?

The requirements for capital gain treatment are:
a. Disposition is a sale or exchange
b. The asset is a capital asset defined in Internal Revenue Code §1221.

Proposed ruling:
a. Amounts received by the dealer qualify as amounts received per Internal Revenue Code §1241 and Treasury Regulations 1.1241-1(c)
b. This applies to marketing or marketing/servicing agreements
c. The distributor must have substantial capital investment, i.e. the Oldsmobile dealership qualifies.
d. However, franchises qualify as an amortizable IRC §197 asset

i. §197 assets are NOT capital assets
ii. EXCEPTION to §197 is gain from sale or exchange for IRC §1231 assets (property used in a trade or business for over one year qualifies as §1231 property)

Conclusion

a. This ruling is for the Automobile industry only
b. The distributor agreement is a franchise under §1253(b)(1)
c. The dealer has substantial capital investment
d. The gain from cancellation is a capital gain.

GLOSSARY

Cost Segregation: The reallocation of building costs from 39 year to 5, 7 or 15-year MACRS property

Enrollment Fee – Generally, dealers must pay an enrollment fee to enter into an agreement to transfer notes to a finance company.

Finance Reserves: The manner in which Finance Income is reported. Ordinarily, the institution and the dealership establish an account called a "Dealer Reserve Account" that is credited, with the dealership's "commission" for arranging financing for the buyer, when the finance company determines the income allocation.

Holdback Charges: When dealers acquire their new car inventory from manufacturers usually the invoice includes a separately coded charge for "holdbacks"

Pool Capping Fee: When the finance company decides that the pool notes should be closed (usually at around 100 notes), the dealership may pay a nonrefundable fee to the finance company to cap the pools.

Shuttling service: To transport vehicles to and/or from the dealership; hence a car shuttler is a person who performs those services.

Servicing Fee: The Servicing Agreement between the finance company and the dealer will specify the fee charged by the finance company to the dealer to collect the receivables (servicing fee)

Service Techs: Also known as automobile mechanics, motor vehicle technicians; a person who services motor vehicles

Warranty Advances: An account established when dealerships perform work on vehicles, as a result of defective materials or workmanship at the time of manufacture. The manufacturer subsequently reimburses the dealership and charged against the account.

Other Sources of Information

IRC sections: § 62(c), 170, 179A, 197, 274, 446, 451, 475, 481(a), 483, 501 and 1001, 1221, 1241, 3121(a), 3306(b) and 3401(a).

IRM, Section 4.10.3, Examination Techniques

Revenue Ruling 70-337: explains salespersons are under direct control of the dealership, which performs the hiring and training functions and all common law rules apply at the dealership level

Rev. Rul. 72-326, provides that the dealer cannot include the $300 "Holdback" as an inventory cost.

Rev. Rul. 72-595 The amounts represented by the credit memorandum issued by the manufacturer are not includable in the gross income of the dealer, but merely represent a reduction of the dealer's accounts receivable for amounts due from the manufacturer for warranty work performed.

Revenue Procedure 99-49, 1999-2, C.B. 725, superceded by Rev. Proc. 2002-9 allows for the change using the automatic provisions set forth in the procedure

Revenue Ruling 2002-67 discusses the car donation issue: a privately owned car dealership administers a section 170(c)(2) charity's car donation fundraising program as its authorized agent.

COURT CITATIONS

*Avis Rent-A-Car System, Inc. v. United States, 503 F.2d 423 (2d Cir. 1974). T*he Second Circuit held that the workers that performed car shuttling services were employees and were improperly treated and designated as independent contractors under employment tax law.

Brooks-Massey Dodge Inc. v. *Commissioner* 60 T.C. 884 (1973). The amounts of an accrual basis dealer discount held back by the manufacturer under a plan agreed to by the dealer was taxable to the dealer in years the amount was credited to the dealership's account rather than in years received.

Commissioner v. *Hansen*, 360 U.S. 446 (1959), the Supreme Court held that the amount held back or retained by the finance company is taxable to the dealership at the time the installment note is sold and the dealership has a fixed right to the reserve account.

Leb's Enterprises, Inc. v US 2000-1 USTC 182 the court found that payments to the drivers performing the services were determined to be employees subject to employment taxes by the employer

Ren-Lyn Corp., 968 F. Supp the court determined that the law does not require that the workers performed identical job duties, only that they perform substantially similar job duties. The court found that the workers performed substantially similar work;

however workers for one client were designated and treated as employees, but the other workers were being treated as independent contractors. As a result, Leb's was not entitled to the safe harbor relief provisions under §530.

Shotgun Delivery, Inc. v. United States, No. C 98-4835 SC (January 20, 2000) (*Appeal pending* 9th Circuit), the United States District Court for the Northern District of California granted the government's motion for summary judgment and found that Shotgun's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of I.R.C. § 62(c)