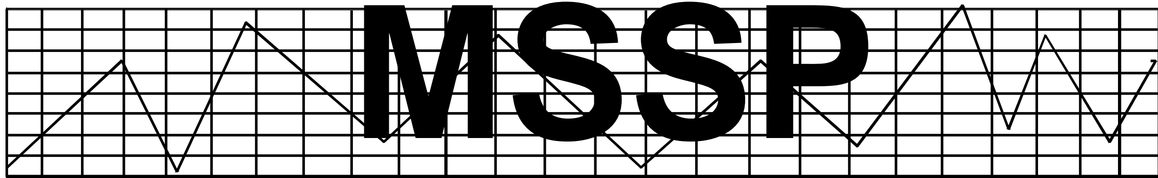

Market Segment Specialization Program

Auto Dealerships

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual.*

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

Department of the Treasury
Internal Revenue Service

Training 3147-120 (9/2000)
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Preface

One of the goals envisioned with this Audit Techniques Handbook is to achieve a high level of proficiency in the way we conduct our examinations of Automobile Dealerships. In addition, by establishing and maintaining close contact with other Industry Specialists, including the Motor Vehicle Industry Specialist, National Office, Appeals and District Counsel, we can maximize the effectiveness of our efforts.

This Guide is divided into five parts:

Part I leads the agent through the examination; from pre-audit through the Books and Records, concentrating on the fulcrum concept of "Financial Status."

Part II illustrates Inventory, concentrating on LIFO computations before and after the implementation of Rev. Proc. 97-38 I.R.B. 1997-33, 43 (July 31, 1997).

Part III discusses Aftersale Financial Products sold by auto dealerships. This includes consideration of Non Captive issues, including Rev. Procs. 92-97 and 97-38, Captive Issues and Producer Owned Reinsurance Companies.

Part IV considers "stand alone" topics, unique to automobile dealerships.

Part V is the Appendix which includes comprehensive case studies, legal authorities, issue analysis, and a glossary of terms.

In order to encourage technical contributions from agents across the country, this text was produced in accordance with the "Living Document" idea, which should allow for the inclusion of important technical ideas and opinions.

No material in this Guide, should be construed as representing the official position of the Internal Revenue Service. The reader is directed to the Internal Revenue Code, the Income Tax Regulations and other relevant official publications to obtain the official position of the Service and for further guidance, as deemed necessary. The scope of this guide is limited to assisting the revenue agent in the completion of Auto Dealership cases.

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Part 1
General Focus and Procedure

Chapter 1
Financial Status

Introduction

Many of us attended financial status training. The analysis suggested in these classes concentrated on cash as it affected the ultimate earner and end user of that cash. Irregularities discovered concerning this cash flow may lead to a finding that financial status does not exist. The scope of the audit would focus in this direction.

Financial Status Analysis

Note: The IRS Restructuring and Reform Act of 1998, Section 3412, prohibits the use of financial status examination techniques to determine the existence of unreported income unless the IRS has a reasonable indication that there is a likelihood of unreported income.

The financial status analysis applied to auto dealership examinations, though seemingly more complex, is in reality the same analysis. Complexities in this analysis arise when multiple related entities, common in the auto dealership context, are discovered.

If the dealership is owned or controlled by one or a few shareholders, one can classify dealerships into three categories for purposes of determining financial status. The three categories determined are:

Type A: Schedule C Used Cars
Type B: Single/Smaller Dealers of New Cars
Type C: Large Multi-Entity Concern.

The analysis presented may be diluted if the dealership has many holders of equity interest, but should be applied to large holders. A "large holder" is a question of fact. The MSSP Auto Dealership Study defined a large holder as one holding 50 percent. For example, if a dealership had five shareholders:

10% Holder A
50% Holder B
10% Holder C
10% Holder D
20% Holder E

Then, the agent would be required to apply some financial status tools to Holder B, and would have the option of analyzing holders A, C, D, and E. Remember that when dealing with multiple entities, indirect ownership may exist where grouping may be necessary. To illustrate, suppose A, C, D, and E were all owned by separate corporations who were all owned by some sixth party, F, then F would be considered a mandatory financial status focus individual.

Of the examinations conducted by the project group in Los Angeles, examiners did not encounter automobile dealerships having a large number of independent stakeholders, but the possibility does exist.

Type A Analysis

A Cash T performed with the help of Bureau of Labor Statistics (BLS) information can show an apparent initial understatement which may act as a flag that one should more fully develop the income issue. Used car dealers may not have all the controls the new dealers have and tend to use currency quite a bit in their business operations. Accordingly, income is a potential issue.

A comparative analysis can yield paradoxical information that signals either an understating of receipts, or an overstatement of expenses OR BOTH. In the scenario on the following pages, Gross Receipts rise rapidly but Gross Profit percentages decline. The two would appear to be inversely related, or negatively correlated. The paradox is that the taxpayer continues to grow when it does not seem in his best financial interests to do so.

A used car dealer’s revenues and expenses are usually tightly and positively correlated. With this in mind it is important to look at the Gross Profit Percentage (GP%) as an indicator considering such market fluctuations.

1. Type A Return Information

Schedule C
Used Auto Sales

Gross Receipts		$ 5,000,000
Cost of Goods Sold		$ 4,900,000
Gross Profit		$ 100,000
Expenses:		
Bad Debts	$ 10,000	
Car and Truck	$ 10,000	
Insurance	$ 5,000	
Interest	$ 5,000	
Office Exp.	$ 15,000	
Supplies	$ 15,000	
Travel	$ 5,000	
M and E	$ 5,000	
Utilities	$ 5,000	
Other	$ 20,000	
Total Expenses		$ 95,000
Net Profit		$ 5,000

2. Recommended Type A Dealership Analytical Tools

a. Cash T

CASH IN			**CASH OUT**		
Gross Receipts	$	5,000,000	Cost of Goods Sold	$	4,900,000 [2]
			Sch. C Expenses	$	95,000
			Sch. C Depr	<$	10,000 >
			Meals	$	1,250
			Bureau of Labor Statistics Data	$	40,000[3]
Cash In	$	5,000,000	Cash Out	$	5,026,250
Cash Out	$	5,026,250			
Understatement	$	26,250 [1]			

[1] The agent needs to determine how this taxpayer is operating a business and paying for living expenses with a $26,250 understatement. The taxpayer is either understating income, overstating expenses or has a nontaxable source of income that needs to be discovered.

[2] An assumption is made for purpose of this illustration that Cost of Goods Sold only constituted $4,900,000 expended during the year as purchases.

[3] $40,000 is not an actual figure and is used only for purposes of illustration.

Since the taxpayer is required to use the accrual method of accounting, the agent should make adjustments for accounts payable and accounts receivable before focusing on an understatement of income.

b. Comparative Analysis

	9112	9212	9312
Gross Receipts	$ 3,000,000	$ 4,000,000	$ 5,000,000
Cost of Sales	$ 2,800,000	$ 3,850,000	$ 4,900,000
Expenses	$ 180,000	$ 140,000	$ 95,000
Gross Profit	$ 20,000	$ 10,000	$ 5,000
Gross Profit %	.67 %	.25%	.10%

The agent needs to question why Gross Receipts have increased and the Gross Profit

Percentage has gone down. The increase to cost of sales and decrease to expense is curious. It will be necessary to determine which sub-accounts comprise the Cost of Sales Tax Account. These items should be a focus of questioning during the initial interview.

Type B Analysis

In addition to the Type A analytical tools, it may be prudent to examine a taxpayer who is involved in primarily one large controlled entity along broader and more encompassing guidelines. The Type B analysis focuses upon one, two or a few entities created for the benefit of the auto dealer.

Looking at only one tax return may be deceiving. Taxpayers involved with only one real business often form other entities "in order to clarify operations and distinguish activities." However, these additional entities can give some taxpayer flexibility to devise improper tax avoidance schemes that would not be possible without the additional entity layer and are difficult to detect because of it.

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

An entity chart is helpful in getting the big picture. It is important that all related returns are gathered. The one the agent may miss may be the one that sheds a great deal of light on the reality represented in these tax returns. It is possible that a separate entity will be established to hold the land owned by the shareholder and "rented" to the dealership as its operating site. An "insurance company" may be formed to "facilitate the paper flow" of extended service contract sales or a "management company" is formed to receive management fees that may represent potential unreasonable compensation. These are some of the related entities created by some auto dealers that need to be identified and understood by the revenue agent.

Again, the Cash T and a comparative analysis are necessary to make the Type B analysis, once these related entities have been identified. An obvious increase in costs without related increases in revenues indicates either a troubled market, where one would expect to see dealers exit, or a troubled tax return, where one would expect to see areas to be addressed through an audit. Additionally, regression analysis may be applied to forecast the taxpayer’s subsequent year’s position.

Type B Return Information

Gross Receipts		$ 10,000,000
Cost of Sales		$ 9,500,000
Gross Profit		$ 500,000
Other Income		$ 50,000
Gross Income		$ 550,000
Expenses:		
Advertising	$ 50,000	
Bad Debts	$ 50,000	
Car and Truck	$ 10,000	
Depreciation	$ 40,000	
Insurance	$ 50,000	
Interest	$ 50,000	
Office Exp.	$ 50,000	
Rent/Lease	$ 100,000	
Repairs	$ 50,000	
Supplies	$ 50,000	
Taxes/License	$ 25,000	
Travel	$ 25,000	
Utilities	$ 30,000	
Wages	$ 70,000	
Other Exp.	$ 25,000	
Total Expenses		$ 675,000
Net Profit/Loss		≤ $ 125,000 ≥

Type C Analysis

Often, a financial status analysis relevant to auto dealerships needs to encompass the multi-entity structure prevalent in many dealership groups. Such an analysis would focus on their capacity to conduct intercompany transactions. Specific information needs to be acquired to enable the agent to complete a Type C analysis. This analysis is based on methodology we have adapted to this purpose.

The methodology centers around a flow chart prepared from information obtained from the tax returns of related entities. The suggested definition of multi-entity financial status includes an analysis that considers the economic position of all related dealerships, other related entities and

the principal shareholders to finance losses incurred by the entities, to finance loans and other intercompany transfers, to justify the acquisition of assets, to justify the financial maintenance of particular business philosophies, debt service and the maintenance of the business and personal life styles.

To visualize this definition one needs to view all the business activities of the principal stakeholder, in conjunction with their personal return. Each separate business organization that has a separate tax filing requirement needs to be viewed as a "separate schedule" on the principal shareholders individual return.

The best analogy that can be made is to consider the dealership multi-entity situation as on a par with consolidated return multi-entity situations. It is submitted that there should be a tax return created that transcends individual business organization filing requirements where there is a multi-entity structure and one or a few principal owners. The reason there is a need to fill this void is that some auto dealerships will not be forthcoming in providing the necessary related return information and make this area of discovery very difficult for the revenue agent. Divulging this information may "hurt" the dealership and often the designated representative will not freely disclose this information.

With this knowledge in hand, once the necessary information was assembled, it would not be difficult for an agent to create a flow chart that serves the function of being the shareholders "tax return," with each separate entity taking significance only as a separate schedule.

The agent would want to determine the relationship of each separate entity to the principal shareholder and create the flow chart based upon this analysis. Then from each related return obtained determine and list the following for each related corporation or partnership:

Assets/Liabilities
Gross Receipts
Gain/Loss
Capital Account [1]
Retained Earnings [1]
Paid in capital [1]

[1] Remember, corporations and partnerships will set forth different equity information.

For each related individual return list:

Adjusted Gross Income
Taxable Income

As the agent completes this flow chart, a tangible pattern should emerge. The agent should be

able to tell at a glance whether there is sufficient equity to finance any dealership losses. The agent should be able to quickly add all equity accounts and compare them to losses reported to determine if these arrangements are feasible. Sure, there may be assets included in these equity accounts that may not be liquid, but this method will give the agent an idea where they stand in relation to financial status.

Taking this analysis one step further, determine if in having sufficient funds and equity to finance losses, there is sufficient cash or its equivalent to justify asset acquisition, to maintain the debt service stated or maintain certain life-styles.

A side benefit to this method of analysis is that it enables the agent to see the "big picture." For instance, previous flow charts prepared have shown a flow of funds from a related non-key entity to finance the losses of several dealerships. Reviewing the flow chart and corporate balance sheets an agent could determine that one entity had a $35 million increase to retained earnings. This was a material increase on this tax return. Questioning of the principal shareholder indicated this increase was due to the sale of various pieces of real property. The corporation then transferred $15 million to one dealership to finance the losses incurred.

The lesson here is the use of this method enables the agent to determine material areas to further pursue. Whether a material issue exists or not can be determined in a very short period of time. This type of analysis will steer the agent away from "verification audits" and prove more efficient and time effective. Probability of material adjustments can be determined quickly. If there is no issue the case can be closed with less time then is currently being experienced and the agent can move on to the next case, conserving the valuable resources of both the Government and the taxpayer.

1. Type C Return Information

Profit and Loss from Form 1120S

Gross Receipts		$ 100,000,000
Cost of Sales		$ 90,000,000
Gross Profit		$ 10,000,000
Interest		$ 50,000
Other Income		$ 50,000
Total Income		$ 10,100,000
Deductions:		
Officer Compensation	$ 100,000	
Salaries and Wages	$ 5,000,000	
Repairs/Maintenance	$ 100,000	

Rents	$ 500,000
Interest	$ 50,000
Contributions	$ 50,000
Depreciation	$ 300,000
Advertising	$ 1,000,000

Total Deductions	$ 7,100,000
Distributable Income	$ 3,000,000

Balance Sheet from Form 1120S

		Beginning of tax year		End of tax year
ASSETS				
Cash	$	1,000,000	$	3,000,000
Accounts Receivable	$	2,000,000	$	1,000,000
Inventories	$	5,000,000	$	7,000,000
Other Current Assets	$	4,000,000	$	5,000,000
Loans to Stockholders	$	3,000,000	$	4,000,000
Total Assets	$	15,000,000	$	20,000,000
LIABILITIES				
Accounts Payable	$	5,000,000	$	7,000,000
Notes and Mortgages	$	1,000,000	$	2,000,000
Loans from Stockholders	$	2,000,000	$	3,000,000
Capital Account	$	7,000,000	$	8,000,000
Total Liabilities and Capital	$	15,000,000	$	20,000,000

EXAMPLE OF DEALERSHIP OWNERSHIP

TYPE C AUTO DEALERSHIP

FINANCIAL STATUS

YEAR END

Dealership Make	Chevrolet	Ford	Subaru	Saturn	Infiniti	B M W	Porsche/Audi
Filing Form	1065	1120 S	1065	1120 S	1120 S	1120 S	1065
Assets	$3,000,000	$2,000,000	$1,000,000	$8,000,000	$20,000,000	$5,000,000	$1,000,000
Gross Receipts	$12,000,000	$10,000,000	$3,000,000	$5,000,000	$100,000,000	$15,000,000	$1,000,000
Profit/Loss	($1,000,000)	$0	$0	($1,000,000)	$3,000,000	($2,000,000)	($1,000,000)
Capital Account	($2,000,000)	$0	($1,000,000)	$1,000,000	$8,000,000	($1,000,000)	($1,000,000)

	Owners Asset Holding Corp.	Investment Corporation	Real Estate Corporation	Owner's Living Trust	Insurance Subsidiary
	Form 1120S	Form 1120S	Form 1120S	<non filing>	Form 1120PC
Assets/Liabilities	$30,000,000	$10,000,000	$15,000,000	$30,000,000	$35,000,000
Income	$1,000,000	$1,000,000	$1,000,000	$5,000,000	$25,000,000
Profit/Loss	($2,000,000)	($1,000,000)	($2,000,000)	$0	($5,000,000)
Paid in Capital/Stock	$15,000,000	$5,000,000	$1,000,000	$10,000,000	$20,000,000
Retained Earnings	$4,000,000	$1,000,000	$3,000,000	$5,000,000	$10,000,000

	Owner 1040
AGI	$2,000,000
TI	$1,000,000

Conclusion

"Financial status" is one of the keys to planning any auto dealership examination. Such preplanning will aid in enabling the agent to determine the scope of the audit. Work papers should clearly demonstrate answers to feasibility questions regarding the taxpayer's ongoing business.

The next section will offer guidelines on how this information can be obtained.

Chapter 2
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, influenced by financial status concerns, and to make the transition present in each examination from planning to the next step: where do we start our examination of the books and records.

In order to determine what focus the agent may take in the examination, it may be prudent to request copies of a few audit necessities even before the initial interview. These documents form the cornerstone of any auto dealership examination:

1. Unadjusted Trial Balance and Adjusting Journal Entries

2. Tax Classification Work Papers

3. Manufacturer's Statement

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

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. More on this in the next section.

Often in a dealership examination the liability accounts have special significance. If the dealer is "taking money out of the business" the agent may be able to spot the issue here. The recommended reconciliation will enable the agent to analyze liability accounts to determine if any issues exist regarding loans or intercompany 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.

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. Most representatives are forthcoming and do provide these work papers. If received, most of the reconciliation is completed and the agent has saved the up front time previously scheduled.

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.

Regarding the initial interview, our 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 shareholder be present at the interview. However, the dealer may not be "available" during the time frame designated by the agent to begin the examination. It is not uncommon for a representative to recommend that the dealer stay visible to discourage compensation related issues, but out of direct access of the agent. Additionally, and to that end, a liaison will typically exist that will "aid" the examiner in securing answers and documents.

Regardless of the availability of the principal shareholder, the agent should not delay the start of these examinations 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, schedule an interview with the dealer 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 it becomes apparent the shareholder's unavailability is not in good faith or the designated representative is attempting to serve as a courier by responding to every question with, "I will get that for you," the agent needs to let them know this is not acceptable. Where appropriate, the agent should take affirmative steps to curtail such activity. The resolution of this matter will be determined on a case by case basis.

Requests for information work best when a separate Information Document Request (IDR) is issued for each item requested. This is especially true if many items have been requested. When a specific request is not timely filled, reissue the original request.

Some representatives wish to test the examiner early on in the audit process to determine not only the technical aptitude of a particular agent, but also his or her resolve to do the job. The representative will form his or her strategy in dealing with this agent and the audit accordingly. The sample initial interview questions are included in the appendix and may prove to be of benefit for some agents.

The most crucial source of information the agent could garner at the onset of the examination regarding financial status concerns related entities. The financial status analysis, as previously discussed, cannot be made without full knowledge of all related entities. This point cannot be stressed enough. The agents' IDR should ask the dealership to list all related entities. 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 dealership will respond to this request as asked. Sometimes the dealership will make this particular information gathering difficult. The agent must be persistent and repeatedly ask for this information if they are not satisfied full disclosure has been made. Often the reconciliation will reveal related entities to the agent through intercompany 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 documentations 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 photocopies of all related returns for all years of relevance. If a related return cannot be provided for a valid reason, e.g., nonmaterial participation in a limited partnership with a low percentage of ownership, receipt of a Form K-1 may be appropriate. The key is to obtain verifiable information regarding the shareholder's equity interests in these related entities.

When the agent has this information in hand, a determination of whether there is financial status can be made.

Dealerships currently may avail themselves of specific revenue procedures. Rev. Proc. 97-36 relates to the election to use the Alternative LIFO Method. Rev. Procs. 92-97 and 97-38 relate to the amortization of related expense and deferral of mechanical breakdown service income. The agent should determine if such elections have been made and request a photocopy of the Form(s) 3115, Application for a Change in Accounting Method, or other statement or form used to make the election. The inner working of these Revenue procedures and their application to a particular dealership may take on significance as the examination proceeds. The effect of these Revenue procedures is addressed later in this Guide.

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 auto 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. As previously

discussed, sometimes the dealer may not be available or not provide specified information requested. However, most comply with requests for package audit information. 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.

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.

Review the case file for Service Center/District Information, prior audit information, Department of Motor Vehicle transcripts, and tax transcripts. Order and analyze this information as necessary. Remember the necessary Taxpayers' Bill of Rights II (TBOR II) requirements on third party contracts.

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, payor and payee master file information, documents relative to ownership entities. Also 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.

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. Real estate information showing real property in the names of the audit principles can be pulled from a service such as "Data Quick" or "Metroscan" where the Service subscribes to it.

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.

An area that seems to add unnecessary time to the examination is the reconciliation of the Payroll Tax Returns. Why? Because the cost accounting approach taken by the taxpayer means wages are paid from PROFIT CENTERS; different accounts and various source codes permeate a voluminous set of books and records which represent these departmentalized payroll costs. Agents generally ask the dealership to provide photocopies of the pertinent payroll tax returns for the applicable periods. They then try to reconcile these items to applicable expenses claimed on the tax returns. Practitioners seldom provide the agent with beginning and ending accruals necessary to complete the analysis. These amounts are usually fragmented through out the books. A complete reconciliation of payroll returns, however, is typically nothing more than a verification item. The agent may consider an assumption of correctness after "confidence in books" has been established in other areas.

To avoid time and aggravation the agent should ask the practitioner to perform the reconciliation and to provide photocopies of the work papers in the initial Package Audit Information Document Requests. Some practitioners will resist and say, "I will not do your work for you." The professional practitioners understand the situation and will do the necessary reconciliation or provide the necessary accruals up front.

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

The agent should be cognizant of TEFRA applications to Form 1120S and Form 1065 tax returns and ensure compliance with its provisions.

Perform pre-contact analysis by following the procedures covered in the financial status section of this Guide. Compare prior and subsequent years operations of this and related entities. Remember, it is not 1 year of one entity that is under audit. This 1 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.

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 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. Basically, unless there is an item in the area of assets, equity, income or expense that stands out and begs for further consideration, the scope should be limited.

On the other hand, as also previously stated, if financial status does not exist based on the methodology described above, then the scope of the examination should be expanded as circumstances warrant.

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Chapter 3
Standard Audit Index Numbers – SAIN

Automobile dealership audits tend to be ever expanding. It is recommended that Standard Audit Index Numbers (SAIN) be used when conducting an auto dealership audit. Any well organized system utilized by the agent, and understandable to others will work. However, the SAIN method has proven to be the most universal, reliable and expandable. This system gives the agent a framework around which voluminous and complex information can be organized and placed into usable form for both the agent and whomever else may be involved with the case file. SAIN contemplates traditional accounting concepts originating in the financial statement.

Using Standard Audit Index Numbers serves two purposes:

1. To establish a uniform approach to indexing examination work papers,

2. To provide discretionary audit procedures in specific areas.

Each SAIN account is identified by a 3-digit number. The first digit identifies where the tax account fits within the structure of the balance sheet or income statement, as listed below:

- 1 – Assets
- 2 – Liabilities
- 3 – Equity
- 4 – Income
- 5 – Expense
- 6 – Tax Computations, Special Deductions and Credits
- 7 – General
- 8 – Administrative, Case Planning

The second and third digits of a SAIN account relate directly to the line number on the income tax return. Cash is an asset and is located on line 1 of the balance sheet, therefore the SAIN is 101. This general scheme is followed throughout where it is practical.

The Other Deductions account is the only area which differs from this general scheme. The Other Deductions tax account showing as a line item on the income tax return is the summary comprised of many subaccounts shown on a schedule attached to the return. Other Deductions will generally be shown as a 526 account with a hyphen. The hyphenated account represents the subaccount. Using this method there is no need for a SAIN 526 account showing the total Other Deductions claimed.

SAIN Discretionary Audit Procedures are listed on many SAIN Leadsheets that have been distributed to revenue agents. They represent a grouping of audit procedures specifically associated with each SAIN item. These standardized procedures should serve as a guide to the agent and not as a substitute for their skill and judgment. Please see the IRM for more information regarding SAIN Leadsheets and SAIN Procedures.

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Chapter 4
Books and Records

Characteristics

The books and records of a Type A dealership are very similar to other cash businesses and will not be the focus of our discussion. Dealership Type's A, B and C were discussed in the Financial Status chapter.

The books and records of a Type B and Type C 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. 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, embracing SAIN, 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 dissimilarities are made to conform to the same final form. As such, it is important to determine those characteristics which 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) Sales

      2) Purchases

      3) Cash Disbursements Journal

      4) Cash Receipts Journal

      5) Payroll

      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 15.

   c. 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:

   a. Reconcile (1): General Ledger to working papers.

   b. Group: Use accountant's papers to group accounts into return items.

c. Reconcile (2): Beginning Trial Balance and Adjusting Journal Entries to the tax return.

d. Reconcile (3): 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.

Journal Voucher Entries

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

1. Standard Entries

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

2. Errors

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

3. 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.

Sub-Journals

Although dealerships do vary from one another on the complete structure of books and records, they usually vary along similar lines.

1. 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 auto), etc.

d. Perpetual versus physical inventory listings.

2. Separate Folders

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

e. Fixed Assets

f. Prepaid Expenses

3. Other Dealership records to be aware of

g. 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.

h. 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 would probably look very much like the following:

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 quarterly books, for example:

Source Code – 7 New Vehicle Purchases

a. Quarter 1

b. Quarter 2

c. Quarter 3

d. Quarter 4

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

11/9X	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 199X 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 199X. Inspection of that book reveals entries that would resemble the following:

7 New Vehicle Purchases

Date	Invoice #	Description	Amount
11/1/9X	111111	New Car	$100.00
11/2/9X	222222	New Car	$200.00
11/3/9X	333333	New Car	$300.00
11/4/9X	444444	New Car	$400.00
		7	$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	Accountant's Work Papers
12	Prior Year Adjustments	Work papers and individual AJEs
13	Standard Entries	Usual substantiation
14	Warranty Credits	Car jackets, transaction statements
24	Payroll	Payroll company books and records

Conclusion

Although intimidating at first, the books and records of an automobile dealership are usually very complete. So much so that it would be easy to drown in a sea of paperwork without the aid of a structured audit plan and the knowledge of the accounting procedures employed by the dealership. In most audit situations, the taxpayer will set aside a room or "home" for the examining agent out of the mainstream of the business operations with all of the items requested on the original Information Document Request present until the examination is finished. 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 ingredients to get started.

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Chapter 5
Balance Sheet

Why do we care about a balance sheet audit? Balance Sheets are necessary where a corporation or partnership is the business organization of choice. Most new vehicle auto dealerships are corporations or partnerships.

As revenue agents we are concerned with doing balance sheet examinations in order to save time and ensure we do a thorough job.

Entries made to many, if not most, balance sheet accounts have corresponding entries to the income statement. Audit planning considering this duplication of entries will save an agent time, eliminating potential duplication of effort. Consider this analysis, remembering that partnership return balance sheets entries shown on Form 1065 are 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 wealth is accumulated or dispersed. If the wealth is not correctly accounted for in the books and records, this wealth may be accumulated or disbursed without ever hitting income. As a general statement, such wealth is taxable, unless a proper Schedule M-1 adjustment is made. The propriety of Schedule M-1 adjustments is addressed later.

The reason we do a 3 year comparative analysis at the beginning of an auto dealership examination is to allow us to identify such changes and fluctuations that may require examination in the audit planning stages. This analysis, coupled with financial status concerns, will aid in determining the scope of the examination. Be aware that some dealerships may create multiple entries which will not affect ending balances when netted together.

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.

The reconciliation also eliminates misfires. If an agent does not know which accounts comprise a tax account, a proposed adjustment may disappear if the designated representative can demonstrate the misclassification. Also, a viable adjustment may disappear in this context where

the agent has made the correct analysis, but applied it to an incorrect account. Unless the designated representative is forthright regarding his or her knowledge of these accounts, the adjustment will disappear. A little time spent up front will save time and perhaps embarrassment later. 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. The entry involving a corporation is:

Debit Retained Earnings
    Credit Loan to Shareholder

According to this entry: Retained Earnings is an Equity account and loans to shareholder is an Asset account. If the loan to shareholder account is an asset and it 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, they should be advised that 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 a place where deviations from reliable manufacturer statements may occur.

Please see the appendix section of this Guide for a compendium of audit techniques relative to specific balance sheet accounts utilized in the auto dealership context.

When an adjustment to a balance sheet account affects taxable income, a typical presentation of such a result is shown as follows:

Debit	1. Increase Assets = Increase to Taxable Income
Credit	2. Increase Liabilities = Decrease to Taxable Income
Credit	3. Decrease Assets = Decrease to Taxable Income
Debit	4. Decrease Liabilities = Increase to Taxable Income

	Assets	
Debit		**Credit**
I	Cash	D
N	Accounts Receivable	E
C	Inventories	C
R	Other Current Assets	R
E	Loans to Stockholders	E
A	Real Estate Loans	A
S	Other Investments	S
E		E

	Liabilities	
Debit		**Credit**
D	Accounts Payable	I
E	Short Term Loans	N
C	Other Current Liabilities	C
R	Loans from Stockholders	R
E	Long Term Loans	E
A	Other Liabilities	A
S		S
E		E

Equities

Retained Earnings
Paid in Capital

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Part 2
Inventory

Chapter 6
General – Non LIFO

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 exists confidence in the taxpayer's books and records, the verification of Cost of Sales can be modified. The scope of the inquiry 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. By revisiting our classification types from financial status, we can look at inventory issues as falling into one of three categories:

Type A – Schedule C Used Cars

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 a write down or may compute an ending inventory adjustment for the year. (See RR 67-107 and Treas. Reg. section 1.471.4)

Example 1

Fast Auto is a small used car dealership reporting income on Schedule C. In pre-audit it was noticed that inventory was small in comparison to Gross Receipts. An examination was initiated and a physical inspection of the premises revealed that there were about 20 older but completely restored cars for sale at high prices. Also at the lot was a large garage where cars were being restored and worked on. The taxpayer was asked about the operation and stated that vehicles were purchased at wrecking yards or from individuals at low prices and then were restored and sold as exotic automobiles. The taxpayer also stated that under the Lower of Cost or Market rules, inventory was maintained at cost without adjustment and that given low gross receipts, the UNICAP rules of IRC section 263A were not applicable. Market was not considered because the type of vehicles were so unique no comparison could be made for valuation purposes. All parts purchased to restore the vehicles were expensed in the period paid, as were associated wages.

Although the UNICAP rules do not apply to the taxpayer, all of the parts, labor and unique supplies (special paint, special bolts, etc.) increase the basis of the automobile to which they apply and therefore are contained in the cost accordingly. Although the industry is specialized, the dealer is in an area of expertise with others and given mainstream publications on exotic cars with advertisements, market value can be estimated. Most importantly, the owner's experiences and typical high markup show that cost is lower than market and therefore market is irrelevant to the dealer for inventory purposes. The roll over adjustment would be to increase ending inventory accordingly in the first open year and carry the adjustments forward to the current year.

IRC section 263A – Uniform Capitalization Rules

IRC section 263A, provides uniform capitalization rules that apply to the production of property and the acquisition of property for resale. Treas. Reg. section 1.263A-1 states, "all costs that are incurred with respect to real or tangible personal property which is produced, or property which is acquired for resale, are to be capitalized with respect to such property."

Treas. Reg. section 1.263A(d)(2)(i) provides the following regarding resale activities:

1. The rules apply to all wholesalers and retailers.

2. Average annual gross receipts must be over $10 million over the prior 3 years.

3. If the taxpayer corporation was not in existence for 3 years, the average is based on the number of years it has been in existence. The costs that must be capitalized in the ending inventory include certain indirect costs pertaining to:

   a. Costs incurred for offsite storage and warehousing

b. Purchasing

c. Handling, processing, assembling, re-packaging

d. An allocable portion of general and administrative costs attributable to the functions in (a) through (c) above ("mixed service costs").

For an illustrated example of applying this section and the Simplified Resale methods introduced, refer to Notice 88-86, 1988-2 C.B. 401.

The issue must be considered when circumstances warrant and a decision must be made regarding allocation of resources.

Type B – Smaller New Vehicle Dealerships: Schedule C, Form 1120-S or Form 1065

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.

Example 2

ABC Rider is a new motorcycle dealership that was purchased 4 years ago and has shown losses on Schedule C for each year since. In pre-audit it was noticed that "Other Expenses" of $400,000 seemed high in comparison to gross receipts of $5,000,000. A schedule of "Other Expenses" showed a miscellaneous expense of $20,000. When examined, the taxpayer showed a schedule detailing $20,000 in rebate income and $10,000 of interest income, both netted against an inventory write down of $50,000. When questioned, the taxpayer responded that inventory was valued at yearend by him personally and that he assumed there was a significant number of employee thefts. When prior years were examined, it was noticed that this practice was employed in all years.

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. Also, all prior writedowns should be disallowed under IRC section 481(a). This amount would then be rolled over into subsequent years up through the current year. The Miscellaneous expense of $50,000 should be disallowed in full, and $30,000 of Other Income should be reclassified as such.

Type C – Large Multi-Entity Dealerships: Form 1120, Form 1120-S or Form 1065

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. It is recommended that all inventories be scrutinized as they have a material impact on taxable income and could be used incorrectly.

Example 3

Jumbo Auto is a large new auto dealership (Form 1120S) that maintains a separate lot down the street for used cars and trucks. These vehicles are acquired through trade in by customers purchasing their new vehicles. The lot does not always have an attendant and the dealership typically sells about 30 percent of the used cars to walk-ons and the other 70 percent to auto auction companies. The books revealed a LCM write down in the year under audit of $100,000 entered as an Adjusting Journal Entry at yearend. Supporting information was requested which showed mark-downs conforming to "low" blue book. Car jackets were requested to sample the vehicles and it was noted that most of them were sold in early January to the auctioneer. The rest of the jackets were requested. Of the 50 vehicles in inventory, 40 were written down and 30 were sold in January of the subsequent year. The taxpayer stated that mark-downs were done in accordance with Treas. Reg. section 1.471-2(c).

Although the mark-down was computed at the end of the taxable year when the vehicles were in inventory, lower of cost or market from a valuation guide was used for the computation when better information was available. Namely, the sales price. Given that the vehicles were sold in an arms-length transaction, and that the sale occurred so close in proximity to the end of the taxpayer’s taxable year when "valuation" occurred, the sales price represents market, *California Canneries Co.,* 2 B.T.A. 109 (1925), *acq*., for the prior period given that the industry did not incur a major decline in the short period, *Estate of Charles Stearns* v. *Commissioner*, 8 B.T.A. 884 (1927); *Abbeville Cotton Mills* v. *Commissioner*, 10 B.T.A. 646, (1928) *acq*; *Willard Mfg Co.* v. *Kennedy*, (1940, CA2) 109 F.2d 83, *cert. denied*, (1940, S Ct) 311 U.S. 660 (1940). The LCM adjustment should be recalculated using the sales price in lieu of the "low" blue book amount for the vehicles sold in January.

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. 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.

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Chapter 7
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.

If LIFO is such a complex method of accounting, why do auto dealerships elect it? The benefits offered by the method 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 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, FIFO, recognizes 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

It appears LIFO was introduced to automobile dealers in the early 1970s. When there was a sharp increase in prices, they made their accountants aware of their wishes to elect the method for their particular dealerships.

The complexities of the application of dollar value LIFO concepts to the inventories of auto dealerships proved to be difficult for the revenue agent to work for both technical and practical reasons. Few agents knew how to deal with the subject. The few that did had to cope with extremes. Some were besieged with volumes of records making computation difficult for the single agent. Some taxpayers provide inadequate or no records and challenge the agent to find fault with their computations. Some auto dealers created LIFO reserves far in excess of what was appropriate for the method elected on their Form 970, "Application To Use LIFO Method."

In the mid 1980s, a group of revenue agents from the Los Angeles District established a methodology to compute the LIFO indices and reserves that would be effective as to accuracy and time applied would be acceptable to both the auto dealership industry and the Service. Their work was the genesis of a methodology that was put into practice by their successors culminating with Rev. Proc. 97-36. This Revenue procedure left the industry and the Service with a somewhat workable system to compute auto dealership LIFO.

Upon completion of their examination, these agents produced the draft Automobile Dealership Audit Techniques Guide (ATG), dated June 1990.

The successor to these agents was a formalized Auto Dealership Audit Techniques Group. Their goals included a desire to pick up where the prior group had left off promoting uniform conformity within the auto dealership accounting fraternity in relation to the manner in which dollar value LIFO was computed. It was felt this uniformity would be established if the method of index computation could be standardized. This would leave agents and auto dealers only discussing the inflation to apply to a specific vehicle.

Problems concerning the manner in which the auto dealership industry was computing dollar value LIFO revolved around two concepts, averaging within submodels and assigning inflation to new vehicles. By following these practices, some LIFO calculations distorted income.

The method used by many dealerships distorted the LIFO calculations by defining the item as the "make," model or sub-model. As quality increased, less expensive vehicles were replaced with more expensive vehicle. To distort income by averaging within submodels, a dealer would group vehicles with higher prices with vehicles of lower prices. Though these groupings entailed working within the same model group, this comparison of dissimilar submodels produces an index higher than would be attainable if the dealer compared 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. This is the true intent of the regulations.

The following example is offered to illustrate the preceding paragraph:

1. Averaging Within Submodels

Corolla	1985	1986	
1702	5,967	6,319	50,941 / 48,956 = 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	1985 Extended Cost	1986	1986 Extended Cost	
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	

The preceding example of "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 an unwarranted deferral of the tax on $20,000. As a decrease to gross profit this would produce an unwarranted $20,000 cost of goods sold deduction. This example was rather basic and involved only one sub model group. In practice, the distortion produced by averaging within many sub model groups becomes increasingly material with higher unwarranted indices.

The second manner in which some dealers were distorting income was by comparing newly introduced models to existing items. A new vehicle has no item which proceeded 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.

The distortion of income would occur because new items entering inventory were receiving

improper inflation through unwarranted "reconstructions" of supposed like kind vehicles. In some cases, there was no vehicle that previously existed which could be compared to a new vehicle. Recall the Suzuki Samurai as an example where no vehicle which preceded it could be compared. Such improper comparisons known as "reconstructions" would produce unwarranted higher indices, thus a higher unwarranted deferral in the reserve and an unwarranted increased annual cost of goods sold deduction.

There were other problems. The one concerned 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 midsized dealership to have this volume in ending inventory. Then the invoices were scheduled and a determination was made 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.

The methodology this solution offered formed the basis of Rev. Proc. 97-36 which was a response to the industry's and the Service's recognition there was a need to apply some practicality to computing LIFO indices.

Rev. Proc. 97-36 allows the auto dealer to compute indices by using the simplified method described above. 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 take advantage of the cut-off provisions and 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 8
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 and 97-36 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 compendium of information which follows is an attempt to unlock for revenue agents the mysteries that surround LIFO. This compendium not only addresses the technical principals 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 which 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. The layer is added to the reserve on an annual basis. The layer could be described as the difference between the FIFO value, (the out of pocket cost), and the LIFO value, (the inflation [or deflation]), assigned to the vehicles in ending inventory. By computing the index we can determine this inflationary rate, which is added to the FIFO (cost) value. The result of inflation being added to ending inventory creates the layer which 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:

   a. Double Extension Method

   b. Link Chain Method

   c. Index Method

   d. 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 then 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.)

      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 which 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 is 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."

Taxpayers have developed a number of techniques to make it easier or even sidestep the reconstruction burden. 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 new vehicles 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:

a. Comparable and non-comparable vehicles may vary in their characteristics and costs.

b. 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.

c. 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.

d. 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.

e. 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."

This method of reconstruction (arbitrarily excluding new items when double-extending the inventory to arrive at an index) is present in almost every LIFO case.

Develop the issue by first determining how the taxpayer computes its index for new items. Consider following these steps;

a. Interview 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.

b. 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.

c. 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.

d. 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.

e. Give the taxpayer the opportunity to demonstrate that the index derived for an existing item is comparable to a particular new item.

f. 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.

g. 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.

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. Whether or not a Ford had either of these features was determined by the manufacturer. 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.

While it may not be possible to compare all of the aspects of vehicles on hand at the end of 2

different taxable years because of 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 representative of the District Director, 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).

5. 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 of the annual change in IPI Method CPI or PPI for the index.

6. 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:

a. Cost based on the most recent purchases.

b. Cost based on the average cost of purchases during the year.

c. 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 which, 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 true theory of LIFO entails use of the earliest acquisitions method. This 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

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 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. 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 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.

Now that you have a better understanding of the importance of pooling under the dollar-value method let's study the 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).

We believe this provides an added reason for requiring pools for unlike items 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 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. Caution: not all of a car dealer's inventory falls into this one category. Car radios, car batteries, metal stampings, and engine components are some examples of dealer inventory that are in another PPI category.

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.

Recently, 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.

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 District Director 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) spells out 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 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 District Director's approval upon audit. See Treas. Reg. section 1.472-3(d). Furthermore, the taxpayer agrees to any adjustments the District Director 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.

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

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

Index

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	$23,000	$115,000
Car B	6	24,000	144,000
Car C	9	27,000	243,000
Current Year Cost 9212			$502,000

Model Year 1994 - December 31, 1993

Model	**Quantity**	**Cost**	**Extended Cost**
Car A	6	$24,000	$144,000
Car B	7	25,000	175,000
Car C	10	28,000	280,000
Current Year Cost 9312			$599,000

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 where comparison can be made and inflation (or deflation) is assigned.

The 1992 LIFO Index is 1.041. This was determined as follows:

Car Pool 9212

Model Year 1993

		Prior Year		Prior Year	
Model	**End Inv Quantity**	**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	$23,000	$115,000
Car B	6	23,000	138,000	24,000	144,000
Car C	9	26,000	234,000	27,000	243,000
	20		$482,000		$502,000

Car Pool Index: $502,000 / $482,000 = 1.041

The 1993 LIFO Index is 1.040. This was determined as follows:

Car Pool 9312

Model Year 1994

		Prior Year		Prior Year	
Model	**End Inv Quantity**	**As of 1992 Vehicle Price**	**As of 1992 Extended Price**	**As of 1993 Vehicle Price**	**As of 1993 Extended Price**
Car A	6	$23,000	$138,000	$24,000	$144,000
Car B	7	24,000	168,000	25,000	175,000
Car C	10	27,000	270,000	28,000	280,000
	23		$576,000		$599,000

Car Pool Index: $599,000 / $576,000 = 1.040

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 minute, or you can simply compare the taxpayer's indexes to the relevant BLS indexes. 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 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 over the end of the year inventory 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 be 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. The question may arise as to why a cumulative amount of reserve is maintained. Not only does it present the value of the inventories under the selected method of accounting, but if the dealer ever disposes of the franchise of the particular make of vehicles, 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.

The taxpayer elected Dollar 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	$23,000	$115,000	$22,000	$110,000
6	Car B	24,000	144,000	23,000	138,000
9	Car C	27,000	243,000	26,000	234,000
20			$502,000		$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 1.041:

LIFO INDEX = (TOTAL CYC / TOTAL BOYC)

$502,000 / $482,000 = 1.041

The 1992 Cumulative Index is 1.041:

(1992 LIFO INDEX x BASE YEAR INDEX)

1.041 x 1.000 = 1.041

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

$502,000 / 1.041 = $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	258,228	1.041	268,815
	$482,228		$492,815

The 1992 Increment at Base Year Cost ($258,228) is derived by subtracting the Base Year Inventory from the 9212 Ending Inventory at Base Year Cost.

9212 Ending Inventory at Base Year Cost	$482,228
- Base Year Inventory	<224,000>
1992 Increment	$258,228

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	$258,228 x 1.041 =	+268,815
1992 LIFO Value		$492,815

The 1992 LIFO Reserve

Total Current Year Cost	$502,000
Less: 1992 LIFO Value	<492,815>
1992 Reserve Addition	$9,185

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	$24,000	$144,000	$23,000	$138,000
7	Car B	25,000	175,000	24,000	168,000
10	Car C	28,000	280,000	27,000	270,000
23			$599,000		$576,000

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 1.040:

(TOTAL CYC / TOTAL BOYC)

$599,000 / $576,000 = 1.040

The 1993 Cumulative Index is 1.083:

(1993 LIFO INDEX x 1992 CUMULATIVE LIFO INDEX)

1.040 x 1.041 = 1.083

The value of the 9312 Ending Inventory at Base Year Cost is $553,093.

(1993 CURRENT YEAR COST / 1993 CUMULATIVE INDEX)

$599,000 / 1.083 = $553,093

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	258,228	1.041	268,815
1993 Increment	70,865	1.083	76,747
	$553,093		$569,562

The 1993 Increment at Base Year Cost ($70,865) 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	$553,093
1992 Increment	<258,228>
- Base Year Inventory	<224,000>
1993 Increment	$70,865

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	258,228 x 1.041 =	+ 268,815
1993 Increment	70,865 x 1.083 =	+ 76,747
1993 LIFO Value		$569,562

The 1993 Cumulative LIFO Reserve

Total Current Year Cost	$ 599,000
Less: 1993 LIFO Value	<569,562>
LIFO Reserve	$ 29,438

Current Year Addition to LIFO Reserve:

1993 Reserve	$29,438
Less 1992 Reserve	< 9,185>
Addition to Reserve	$20,253

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 dealers gross receipts are usually in excess of $5,000,000 and they want more than the 80 percent of the change in the BLS indices

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Chapter 9
Alternative LIFO for Auto Dealers

As you were reading the chapter regarding the LIFO Method of Inventory Valuation, it probably occurred to you that 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).

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 are 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. 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 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 Industry Specialization 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 an item in ending inventory was not stocked by the automobile dealer 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 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. See Chapter 8 for in-depth discussion. 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 ratio of the cumulative index preceding the year of change. In this example, the ratio 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).

Information to request when examining the Alternative LIFO Method

A pro-forma Information Document Request relating to this Revenue procedure appears on the next page.

Form 4564	Department of the Treasury - Internal Revenue Service INFORMATION DOCUMENT REQUEST

TO:	Subject:	
	SAIN No:	Submitted to:
	Dates of Previous Requests:	

Description of Documents Requested

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.

Information Due by _______________ At Next Appointment [ ]   Mail In [ ]

FROM	Name and Title of Requester:	Date:
	Office Location:	Phone Number:

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Part 3
Aftersale Financial Products

Chapter 10
Automobile Dealership Aftersale Financial Products

Introduction

The automotive aftermarket contemplates products, tangible and intangible, the consumer may add to the new vehicle during or after consummation of the sale. This aftermarket is substantial and includes, but is not limited to, products such as financing, wheels, extended service contracts and service.

This section focuses on the sale of Automobile Dealership Aftersale Financial 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. As a "Living Document" we would like to see others extend the discussion set forth in this Guide to include other aftermarket products.

The products discussed in this section are referred to as "aftersale financial products" to give clarity to the discussion. "Aftersale" is substituted for "aftermarket." Also, these products are not referred to as "insurance" products because such characterization denotes a legal conclusion that may be adverse to Internal Revenue Service interests. Some of the products discussed in this section are disguised and sold as insurance, but in reality are not insurance. The non-insurance aspect of these products is a basis of adjustment the Service seeks to establish.

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. 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.

Dealers may offer the contracts as principals or as sales agents of manufacturers, distributors, administrators, insurance companies, or another party. 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 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.

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.

Credit Life Insurance; Credit Accident and Health Insurance

Many consumers finance the purchase of a vehicle and 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 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 VSCs.

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Chapter 11
Extended Service Contracts

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 dealership often sells more than one type or brand of service contract and may be either the "principal" / "obligor" or an "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 may also be named in the contract.

If the dealer is the principal, the contract will contain language indicating that the contract is between the dealer and the vehicle purchaser. The contract may 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 too 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.

Agent versus Principal/Obligor

A dealer can market aftersale 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 contemplated 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.

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.

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.

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 in *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957) 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.

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

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 of 2 to 6 years. 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. *Higginbotham-Bailey-Logan Co.* v. *Commissioner*, 8 B.T.A. 566 (1927).

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."

In summary, the dealer obligor extended service contracts and insurance is purchased

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 provided 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."

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, 1992, @ $1,600 =	$8,000
5 Contracts Sold December 1, 1992, @ $1,600 =	$8,000
Total	$16,000

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

[1] From tables found in Rev. Proc. 97-38 based on term of years (5) and the AFR (10%).

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

	1992	1993	1994	1995	1996	1997
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				$6,390		
Non Deferred				4,000		
Additional Income				$2,390 [3]		

[3] 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.

Contract Construction

Generally, a dealership should be fully aware when they are a principal. Most contracts explicitly state the dealer is a principal or an obligor. Try to ascertain whether the dealer entered into this contract free of mistake or duress of the insurance company. Absent such a finding, the dealership should not be allowed to use parol evidence to interpret the contract, having it conform to the dealership's immediate needs.

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 surrounding circumstances and parol evidence of a transaction may be considered by the IRS if the contractual 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), that the surrounding circumstances and parol evidence of a transaction may be considered by the IRS if the contractual terms of an agreement are unclear or ambiguous. 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 not vague and ambiguous 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 agreements 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 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 most dealerships, only a "net" amount of the retail sale price of a 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 1 year 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.

Chapter 12
Extended Service Contracts – "Dealer Reserve Accounts"

When a dealership acts as obligor on an extended service contract it may chose to cover its risk through an arrangement other than insurance such as by placing a portion of the sales price in an "reserve" (also known as an escrow or trust account) maintained by an administrator. The dealer generally, establishes the selling price of the contract, retains a portion as "commission" and forwards the remainder to an administrator. The administration agreement may require the establishment of an "escrow" "reserve" or "trust" account to provide for the dealer's obligations under the contract.

The administrator acts as "trustee" of the funds and retains a portion of the funds submitted to it as a fee for its services. Funds in the "reserve" account are used to meet the obligations of the dealer including payment for repairs to covered vehicles. The amounts placed in reserve may be based on actuarial standards and the dealer may have certain sales requirements. When certain conditions are met, the dealer is entitled to a return of unused reserve funds at the expiration of the extended service contract. Unless the contract is cancelled, the retail customer does not receive any portion of the unused reserve funds, even if no repairs are made to the covered vehicle. Often the funds deposited in the reserve accounts earn investment interest that is deposited into the reserve. Funds placed in the escrow account do not constitute payments for insurance.

Sometimes the program includes a provision for purchasing "stop loss" or "excess loss" insurance that may pay for claims if the reserve or escrow account does not contain adequate funds. The payments for stop loss or excess loss coverage may constitute payments for insurance.

Dealership that sell service contracts and cover their risk under a reserve program must include the entire sales price of the extended service contract in income in the year the contract is sold. Payments to the reserve account do not constitute payments for insurance. The dealership may deduct payments for claims as incurred.

Reserve, escrow, or trust extended service contract plans do not qualify for the Service Warranty Income Method of reporting income.

The Tax Court addressed similar issues in *Hinshaw's, Inc.* above and *Rameau Johnson* et al. 108 T.C. No. 22, Affirmed by 8th Circuit Court of Appeal 84 AFTR2d. Par. 99-5073; No. 98-1324 (July 21, 1999).

In *Rameau Johnson*, 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 reasoning of *Commissioner* v. *Hansen*, 360 U.S. 446 (1959), controls.

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.

Chapter 13
The Producer Owned Reinsurance Company (PORC)

Introduction

It is common in the auto dealership industry for a dealer to own an insurance company whose primary function is to reinsure the related dealership's risks under aftersale insurance contracts.

Normally, a dealer who owns all or a significant portion of the dealership will own all or a significant portion of the reinsurance company. The dealer usually has a promoter form the reinsurance company. These companies may file a Form 1120-PC, a Form 1120-L or a Form 990. The reinsurance company is generally incorporated in a jurisdiction such as Arizona or the Turks and Caicos Islands due to less restrictive formation requirements. This corporation is generally not qualified to do business in the dealer's home state.

A company having these characteristics is known in the auto industry as a "Producer Owned Reinsurance Company" (PORC). The PORC may be referred to as a brother-sister "captive" because it is usually not owned by the dealership. However, since the dealer and not the dealership owns the reinsurance company, it may not technically be a true "captive."

Introduction to Reinsurance

Reinsurance may be found in all aspects of dealership aftersale insurance products. It is prevalent in the areas concerning credit life and credit health and disability products. In the dealership context reinsurance often involves dealer owned offshore reinsurance companies.

The primary function of a PORC is to reinsure the risks of business initially placed with an unrelated insurance company, known as the fronting company. Reinsurance is the transfer of risk from one insurance company to another. Reinsurance is common with dealership aftersale insurance products, primarily vehicle service contracts and credit life and disability insurance.

This arrangement allows the dealer an opportunity to maximize the earnings on these products through underwriting profits and return on investments. In return for processing the business to the PORC, known as ceding, the fronting company charges an administrative fee at a predetermined percentage or portion of the premium. When the fronting company cedes the business, it is permitted to reduce its reserves, subject to certain conditions, for that portion of the transferred risk.

It is as though there is not reinsurance until the reinsurer receives the profits. This alleviates the need for the reinsurance company to maintain a reserve.

Considerations for Forming a Producer Owned Reinsurance Company

Formation of a reinsurance company requires an assessment of several factors. Some of the more important include: capital requirements, the regulatory environment, financial reporting, formation costs, security of assets and the time needed to form the reinsurance company.

Capital requirements in the United States have increased over the years. Since a reinsurance company only assumes business from other companies, it may not have to meet the higher capitalization that would qualify it to write insurance in the dealership's state.

In addition to statutory financial accounting and investment restrictions, there are a few business constraints. Most states have set a maximum amount of risk on any one life, based on a percentage of the prior yearend capital and surplus. There are also limitations on stockholder dividends.

There is a type of reinsurance company called an "exotic." This structure allows dealers to participate in a reinsurance program with limited capital contributions and to diffuse the annual cost of operations.

In contrast to a domestic reinsurance setting, offshore reinsurance companies are typically more attractive to auto dealers 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. Some offshore sites allow all of the reinsurer's assets to be held in the United States. The level of financial reporting is greatly reduced. The Turks and Caicos Islands have become the location of choice in which to incorporate offshore.

The decision to incorporate offshore is rarely due to the differences in United States versus foreign tax laws. Most offshore PORC's elect to be treated and taxed under United States tax laws. IRC section 806 provides certain tax benefits attributable to a small life insurance company. In addition, IRC section 831(b) provides an election for a non-life insurance company, known as a small casualty company, to be taxed only on investment income if premiums are between $350,000 and $1,200,000.

Typically, dealers sell dealer obligor extended service contracts as part of their sales of new and used vehicles. These contracts provide for the repair of any covered function of the vehicle during the term of the contract. The contract is between the customer and the dealer who is obligated to perform or pay for the repairs. The dealer may then arrange with an unrelated insurance company to provide insurance coverage for the risks covered by the extended service contracts sold by the dealer with the dealer being the insured party.

The dealer also establishes a reinsurance company for the sole purpose of reinsuring the risk insured by the unrelated insurance company for extended service contracts sold by the dealer. The reinsurance company is owned or controlled by the same person that owns or controls the automobile dealership. It does not maintain the staffing and facilities common to operating businesses. It is undercapitalized and/or the fronting company is indemnified from loss by another entity in the economic family, e.g. the dealership or the dealership's owner. Its business is

administered by the fronting company and/or the automobile dealer. The fronting company retains a fee for its services.

For each extended service contract sold by the automobile dealer, the dealer remits to the fronting company a "premium" from which the fronting company derives the fees for its services. The balance is remitted to the related reinsurance company. The fronting company administers the extended service contracts and charges the reinsurance company for the cost of all approved repairs. The reinsurance company's tax return is filed under the insurance company provisions of the Internal Revenue Code.

When an automobile dealer is the party obligated to pay for repairs under an extended service contract, the risk of loss rests on the automobile dealer. If the dealer purchases insurance coverage from the fronting company who then reinsures most, if not all, of the risk with the related reinsurance company, the risk of loss then rests with the reinsurance company. However, the risk remains the burden of the person who owns or controls both the automobile dealer and the reinsurance company.

There is no economic shifting or distributing of risks of loss with respect to the risks carried or retained by the reinsurance company. The economic consequence of the reinsurance arrangement is that those who bear the ultimate burden of loss are the same persons who suffer the losses.

The Service and the courts have long held that amounts set aside by a taxpayer as a reserve for self-insurance, though equal to commercial insurance premiums, are not deductible for Federal income tax purposes as "ordinary and necessary expenses paid or incurred during the taxable year." See Rev. Rul. 60-275, Rev. Rul. 57-485, 1957-2 C.B. 117, and *Pan American Hide Co.* v. *Commissioner*, 1 B.T.A. 1249 (1925). Even where a self-insurance fund is administered by an independent agent, such fact does not make payments to such fund deductible. See *Spring Canyon Coal Company* v. *Commissioner*, 43 F. 2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1930).

Rev. Rul. 77-316, 1977-2 C.B. 53 held that insurance arrangements between related corporations are not true insurance but "self-insurance." While there were a number of corporations that participated in the arrangement with one captive insurance company, there was no risk shifting since the corporations were one economic family.

Similarly, where the captive insurance company was under-capitalized and the losses were indemnified by the captive's parent, there was no risk shifting and the insurance premiums were disallowed. See *Malone & Hyde, Inc., et al.* v. *Commissioner*, 76 AFTR2d 95-5250, (6th Cir. 1995).

In situations where the owner of the dealership also owns the reinsurance company and personally uses the funds of the reinsurance company, the income of the reinsurance company is taxed to the owner. See *William T. Wright et al.* v. *Commissioner*, T.C. Memo. 1993-328.

The Reinsurance Transaction

To illustrate the nature of the dealership offshore reinsurance transaction, assume that a consumer purchases a credit life policy for $800. This form of insurance, credit life, is more prevalent in the dealership reinsurance arrangements.

The dealership, acting as an agent for a regulated United States insurance company, sells an $800 credit life contract to a consumer. The dealership retains $240 as commission income. The remaining $560 is sent to the regulated United States insurance company to purchase the credit life policy. The dealership reports commission income of $240.

The "insurance company" may be serving as a "fronting company." A fronting company is one which assumes the original risk in the policy and passes that risk to the reinsurance company. Normally, the fronting company charges a fee of, assume $35, for an arrangement similar to our example. The fronting company will then reinsure, by transferring the risk and the remaining $525, to the offshore captive reinsurance company owned by the dealer.

The insurance policy and the reinsurance agreement create the impression that business is being conducted "offshore." Upon request, the dealer will provide the agent with the reinsurance treaties and other documents that suggest foreign transactions. However, agents should follow the flow of the funds and will usually find that the funds never leave the dealership's hometown. The reinsurance company may in form be in the Caribbean but in reality carries on its "business" at the dealership's hometown bank. They usually do not have their own separate business location. Their address is usually the same as the dealership's or the dealer's residence. Usually, the bank account includes the name of the dealer who has control over it.

It is important to remember that most producer owned reinsurance companies often do not reinsure any risk other than that of contracts written by dealerships owned by the sole shareholder of the reinsurance company.

Any claims the consumer may make will be against funds collected by the fronting company and retained by the reinsurance company/hometown bank account. The dealer may have access to these funds. These reinsurance companies are not regulated, the dealer may hold these funds in any form; the dealer may invest, declare a dividend, or take a loan.

If a Form 1120-PC is filed, reserves calculated by representatives of the promoter may be used to reduce the reinsurance companies income under IRC section 832. The *William T. Wright* case, below, informs us of dealership offshore reinsurance companies who consistently overstated reserves. (Please see Appendix). The premium income earned by a non-life insurance company may be tax exempt if it remains below $350,000. With overstated reserves and paid out claims, companies would never pay taxes. Effectively, all income earned by these transactions was not taxed.

The dealers may tell the revenue agent they intended to recognize, as income, the amount remaining in the reserve when the contracts earn out. However, some dealers will have taken a loan against these funds that cannot be repaid for whatever reason, or have declared a dividend so there is nothing left to recognize when these contracts do earn out.

The dealer's control of the reserve is sufficient to allow them to time the liquidation of this reinsurance company, which may have a large capital loss, with a large capital gain from another source, using the loss to offset the gain.

These offshore PORCs often are off the dealership books. The amounts forwarded for the insurance contracts are going to regulated United States insurance companies. Other than the owner, the employees of the dealership may have no knowledge of this PORC. The revenue agent would not know of the existence of the PORC unless told by the dealer. At the beginning of the examination, the agent should ask about the existence of a PORC and reinsurance arrangements. Often determining whether the dealer filed a Form 1120-PC, a Form 1120-L or a Form 990 will lead the agent in the direction of the PORC.

We also recommend that, prior to questioning the dealership's shareholder(s) about related transactions and ownership interests, the initial IDR specifically request the existence of these related returns. If the dealer owns the PORC though, it is possible that the dealership tax return and books and records will not have any indication of the PORC (assuming no interaction whatsoever, e.g. loans, etc.). The agent may then have to request information about the PORC in relation to the dealer's own personal tax return.

Producer Owned Reinsurance Company Issues

Some dealers are treating these captive offshore reinsurance companies as organizations qualifying under IRC section 501(c)(15)(A). This section grants tax exempt status to insurance companies or associations other than life insurance companies * * * if the net premiums written for the taxable year do not exceed $350,000. Dealers now file Form 990 where they previously filed Form 1120-PC for the PORC. Form 990 is an information return for tax exempt organizations.

The Internal Revenue Manual requires revenue agents to refer the examination of a Form 990 to the Tax Exempt and Government Entities (TEGE).

If an agent finds a situation where the PORC is treated as a tax exempt organization the agent should become familiar with IRC section 845 which allows the Service to reallocate the income of a reinsurance arrangement to its true earner where any such arrangement is set up for tax avoidance purposes. The agent may also raise an issue that the Form 990 is an improper filing because the producer owned reinsurance company did not qualify as a tax exempt organization. If this argument can be made then the PORC would be taxed as an insurance company on a Form 1120-PC. A traditional sham argument as discussed in Chapter 12 and outlined below can be used to support the issue.

Excise Tax, of about 4 percent per contract, under IRC section 4371, may be due on each

insurance contract reinsured through the offshore PORC if no Subpart F election has been made to include this foreign source income as worldwide income. If the Subpart F election is made, this income would be taxed as United States income under IRC section 953(d), subject to the Foreign Tax Credit. The offshore PORC would be considered subject to Subpart F because it is a controlled foreign corporation as defined under IRC sections 951(b) and 953(a).

There may be an IRC section 482 pricing issue because the PORC is owned by the same shareholder who owns the domestic auto dealership.

The PORC may be considered a sham corporation if it has no reason for existence other than diverting or sheltering dealership income for the benefit of the dealer owner. Thorough analysis of these transactions may conclude that profits from the PORC are being channeled into a fund held effectively for the dealers personal use. This arrangement would fail the economic substance test found in the *Bail Bonds* case and be considered a sham. See *Bail Bonds by Marvin Nelson, Inc.* v. *Commissioner*, 820 F.2d 1543, (9th Cir. 1987).

In *Malone and Hyde, Inc.,and Subsidiaries* v. *Commissioner*, 76 AFTR2d Par. 95-5250, the United States Court of Appeals for the Sixth Circuit ruled that payments by a parent corporation to a subsidiary for "insurance" are not deductible. The court distinguished the case from *Humana, Inc.* v. *Commissioner*, 881 F.2d 247 in which the brother/sister corporations were allowed a deduction for such payments.

The ruling in *Malone and Hyde, Inc.*, above, has wide application to auto dealers. Producer Owned Reinsurance Companies (PORC) that reinsure dealer obligor extended service contracts should be examined carefully to see if they meet the tests outlined in the Court's opinion. Was the PORC adequately capitalized? Is there indemnification in excess of the capitalization amount? Is there a hold harmless agreement between the PORC and/or the dealership and the fronting company? If so, the risk of loss may not have shifted and the payments may qualify as non-deductible "self insurance."

PORCs that reinsure credit life and accident and health policies are more complicated. Since the risk is that of the vehicle purchaser rather than the dealer, it is more difficult to make the argument that risk did not shift. However, the Court began its opinion by stating that it must first determine if the reinsurance company was created for a legitimate business purpose or whether it was a sham. Dealers in states that have no commission cap or dealers who reduce their commission amount after formation of the PORC risk the characterization of the PORC as a sham. Other means may have been available for the dealership to increase its income from the sale of credit life coverage rather than the creation of an undercapitalized, off-shore reinsurance company.

The Courts also addressed reinsurance companies in *William L. McCurley, et ux.* v. *Commissioner* (T.C. Memo. 1997-371) the Tax Court held that the owners of two automobile dealerships received constructive dividends from a foreign corporation that reinsured credit insurance policies issued through the dealerships. The Court found that the reinsurance company never paid dividends, that it never demanded payment on the notes to the shareholders, that the advances did not bear interest, that the advances were made with reference to ownership interests,

that the advances had no fixed maturity date, and that the reinsurance company had demanded repayment on only two occasions. The judge determined that the reinsurance company was formed "to provide the shareholder with tax-free and interest-free access to profits attributable to policies issued through the shareholder's dealership."

Finally, the Court addressed a reinsurance company and supported the imposition of the fraud penalty in *William T. Wright*, T.C. Memo 1993-328. The Court agreed with the Service and characterized the transactions between the Wright dealerships and William Wright's reinsurance insurance company as sham transactions. The corporate form of the captive insurance company was disregarded and its income deemed received by Wright.

PORC issues are complex and require a thorough analysis of all documents and transactions. Depending on the facts and circumstances of each case, the amount paid as insurance premiums by the automobile dealership to the fronting company are not deductible under IRC section 162. The amounts ultimately remain under the practical control of the dealer who retains an economic stake in whether a covered loss occurs. The amounts paid as fees to the fronting company are deductible by the dealership based upon the principles of economic performance.

Since the amounts paid are not insurance premiums, the provisions of Rev. Procs. 92-97 and 97-38 do not apply.

The amounts received from customers for extended service contracts are income in the year the service contracts are sold by the dealership.

The dealership is entitled to a deduction under IRC section 165(a) for any losses sustained in connection with the extended service contracts during the taxable year.

The reinsurance company does not qualify as an insurance company for Federal income tax purposes.

All funds distributed to the shareholders by the reinsurance company are to be treated as distributions by the dealership(s) to its/their owner(s).

The Captive Transaction

Captive Insurance Arrangements

Some industry personnel believe captive insurance applies to PORC. IRC section 162(a) permits a taxpayer to deduct its ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Treas. Reg. section 1.162-1(a) provides that allowable business expenses include premiums paid to insure against losses from fire, storm, theft, accident or similar losses suffered by a business. A corporation is not entitled to deduct amounts set aside in a self-insurance reserve to protect against potential losses. *Spring Canyon Coal Co.* v. *Commissioner*, 13 B.T.A. 189 (1928), *aff'd*, 43 F.2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1931). See *Commissioner* v. *Lincoln Savings and Loan Assn.*, 403 U.S. 345 (1971), and *Steere Tank Lines, Inc.* v. *United States*, 577 F.2d 279 (5th Cir. 1978), *cert. denied*, 440 U.S. 946

(1979).

The Service's position is that a taxpayer has not bought insurance when it pays premiums to an entity it owns either directly or indirectly (or with whom it shares a parent) and is, therefore, not entitled to a deduction under IRC section 162. This position is set forth in Rev. Rul. 77-316, 1977-2 C.B. 53, *amplified and clarified*, Rev. Rul. 88-72, 1988-2 C.B. 31, *clarified*, Rev. Rul. 89-61, 1989-1 C.B. 75, Rev. Rul. 78-338, 1978-2 C.B. 107, Rev. Rul. 88-72, 1988-2 C.B. 31 and Rev. Rul. 89-61, 1989-1 C.B. 75.

In Rev. Rul. 77-316 the Service determined that there is no shifting of the risk from the parent and its subsidiaries to the captive to the extent of the risk retained by the captive because the premiums paid remain within the same"economic family," under the practical control of the parent and its affiliates. In addition, they are not expenses "paid or incurred" within the meaning of IRC section 162. Therefore, the amounts paid to and retained by the captive in the factual scenarios set forth in the revenue ruling are not deductible.

Until recently the Service had been successful in denying taxpayers a deduction for premiums paid to their wholly-owned subsidiaries on the theory that the parent has not truly shifted the risk of loss. See *Gulf Oil Corporation* v. *Commissioner*, 914 F.2d 396 (3d Cir. 1990), *aff'g* 89 T.C. 1010 (1987); *Clougherty Packing Co.* v. *Commissioner*, 811 F.2d 1297 (9th Cir. 1987), *aff'g* 84 T.C. 948 (1985); *Beech Aircraft Corp.* v. *United States*, 797 F.2d 920 (10th Cir. 1986), *aff'g* 1984-2 U.S.T.C. Para. 9803 (Kan. 1984); *Stearns-Roger Corporation* v. *United States*, 774 F.2d 414 (10th Cir. 1985), *aff'g* 577 F.Supp. 833; *Mobil Oil Corporation* v. *United States*, 8 Cl. Ct. 555 (1985). In each of these cases the courts concluded that a premium payment to a subsidiary is the functional equivalent of setting up a reserve for losses, and therefore not deductible. The one exception is *Crawford Fitting Company* v. *United States*, 606 F.Supp. 136 (N.D.OH.1985), in which the district court held that insurance premiums paid to a captive insurance company were deductible as ordinary and necessary business expenses because the taxpayer and the other shareholders of the captive were not so economically related that their separate financial transactions had to be aggregated and treated as the transactions of a single taxpayer. The *Crawford Companies* were not a parent-subsidiary group but were a group of separate corporations that were owned and controlled by a group of related individuals.

Although the Government has been mostly successful in arguing for disallowance, not all of the theories advanced by the Government have been embraced by the courts. In particular, the Tax Court has rejected the "economic family" theory though the economic family theory had been accepted by certain appellate courts. See *Stearns-Roger Corporation*, above, *Beech Aircraft*, above, *Carnation* v. *Commissioner*, 640 F.2d 1010 (9th Cir. 1981), *aff'g* 71 T.C. 400 (1978), *cert. denied*, 454 U.S. 965 (1981); and *Clougherty Packing Company*. In *Carnation*, the Ninth Circuit agreed with the conclusion set forth in Rev. Rul. 77-316 that there could be no shifting or distribution of risk where a parent enters what purports to be an insurance arrangement with a wholly-owned subsidiary. Similarly, in *Clougherty Packing*, the Ninth Circuit stated that Rev. Rul. 77-316 does not conflict with the recognition of the separate entity status of corporations doctrine set forth in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943).

Although the Tax Court has not embraced the economic family theory, the court has established a

three pronged test for determining whether amounts paid to a captive insurance company are deductible as premium expenses. See *Amerco* v. *Commissioner*, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); *Harper Group* v. *Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992), and *Sears* v. *Commissioner*, 96 T.C. 61 (1991), *modified*, 96 T.C. 671 (1991), *aff'd in part and rev'd in part*, 972 F.2d 858 (7th Cir. 1992).

In order for a payment between related entities to be considered a deductible insurance premium the payment must involve: (1) an insurance risk; (2) risk shifting and risk distribution and (3) it must be insurance in the commonly accepted sense. See *Amerco* v. *Commissioner*, 96 T.C. 18 (1991).

The first prong of the test, the presence of an insurance risk, was summarized by the Tax Court in *Amerco* as a situation in which "* * * an insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. * * *" *Amerco* v. *Commissioner*, 96 T.C. at 38-39. Factors which may indicate the lack of an insurance risk include an obligation on the part of the related corporations to pay the claims filed with the captive or to make additional contributions to the captive based on loss experience. See *Gulf Oil Corporation* v. *Commissioner*, 89 T.C. 1010 (1987).

The second prong, the requirement of risk shifting and risk distribution, has engendered a great deal of debate and confusion. The Tax Court and several appellate courts have found risk shifting to exist where the captive insures substantial amounts of unrelated business. The Tax Court's rationale for using the amount of unrelated business as the litmus test for risk shifting was expressed in *Gulf Oil Corporation*, in which the court stated, "If all of the insured are related, the insurance is merely self-insurance because the group's premium pool is used only to cover the group's losses. By adding unrelated insured, the pool from which losses are paid no longer is made up of only the affiliated group's premiums." *Gulf Oil Corporation* v. *Commissioner*, 89 T.C. 1010, 1026-27. The Tax Court thus concludes that risk shifting cannot occur between related parties without the presence of unrelated business. The Service's view, as expressed in Rev. Rul. 88-72, is that the absence or presence of third party insured is immaterial to whether the risk has been shifted. The critical inquiry is whether the economic risk of loss has actually shifted from the insured to the insurer. However, because the Tax Court and several appellate courts have placed significant weight on the amount of unrelated business, we recommend that cases raising this issue be coordinated with the Captive Issue Specialist.

Although the concept of risk shifting has been discussed by the courts, the risk distribution requirement remains unclear. As expressed in Rev. Rul. 88-72, the Service's position is that risk distribution requires the underwriting of statistically unrelated risks so that there is a reduced possibility that a single costly claim will exceed the amount taken in as a premium and set aside for payment of such a claim. The Ninth Circuit adopted the Service's view of risk distribution in *Clougherty Packing Company*. However, the Tax Court appears to have blended the concepts of risk shifting and risk distribution, assuming that when an insured shifts its own risk to an insurance company, it agrees to receive some of the risk of other insured. See *Amerco* v. *Commissioner*, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992); *Harper Group* v. *Commissioner*, 96 T.C. 45 (1991), *aff'd*, 979 F.2d 1341 (9th Cir. 1992), and *Sears, Roebuck and Co.* v. *Commissioner*, 96 T.C. 61 (1991), *modified*, 96 T.C. 671 (1991), *aff'd in part and rev'd in part*, 972 F.2d 858 (7th Cir. 1992).

While not all captive situations involve sham corporations or sham transactions, certain fact patterns do lend themselves to this analysis. In *Malone & Hyde Inc.* v. *Commissioner*, 62 F.3d 835 (6th Cir. 1995), *rev'g* T.C. Memo. 1993-585, CCH 49,463(M), the Sixth Circuit concluded that the captive was a sham and thus the payments made by the related corporation were nondeductible. The appellate court stated that the Tax Court should have determined whether the captive was a sham corporation before considering whether risk shifting and risk distribution were present. According to the Sixth Circuit, a taxpayer does not have a bona fide insurance transaction if it uses as its insurer "* * * an undercapitalized foreign insurance captive that is propped-up by guarantees of the parent corporation. The captive in such a case is essentially a sham corporation, and the payments to such a captive that are designated as insurance premiums do not constitute bona fide business expenses, entitling the taxpayer to a deduction under [IRC section] 162(a)." See *Malone & Hyde Inc.* v. *Commissioner*, 62 F.3d 835, 839.

In reaching its conclusion that a valid insurance arrangement did not exist, the appellate court distinguished the facts of *Malone & Hyde* from its decision in *Humana, Inc.* v. *Commissioner*, 881 F.2d 247 (6th Cir. 1989), *aff'g in part, rev'g in part and rem. in part* 88 T.C. 197 (1987). In *Humana*, the taxpayer's previous insurance had been canceled and the immediate need for alternative insurance led to the creation of the captive insurance company. In *Malone & Hyde*, however, the taxpayer had no problem obtaining comparable insurance from an unrelated party but instead organized the captive insurance company despite the ready availability of more conventional alternatives. See *Malone & Hyde*, 62 F.3d 835. In *Humana*, the captive was a fully capitalized domestic insurance company organized in Colorado and subject to the regulatory control of that state's insurance commission. In contrast, the taxpayer in *Malone & Hyde* organized the captive insurance company with only the thin capitalization required under Bermuda law. The *Malone & Hyde* court recognized that the *Humana* decision specifically characterized insurance schemes that involve undercapitalized captive offshore insurance companies to be without the requisite risk shifting element. See *Malone & Hyde Inc.*, 62 F.3d at 840.

It is important to note that the sham analysis is a limited concept. Therefore, cases which present fact patterns similar to *Malone & Hyde, Inc.* should be coordinated with the Captive Issue Specialist.

Insurance companies offer retrospective compensation ("retro") as a means of attracting more and better quality business. This form of c compensation is commonly accepted by auto dealers and may be associated with either credit life and disability insurance premiums and/or extended service contracts. In this context, retrospective compensation is an agreement with the insurer for the dealership to share in a portion of the underwriting profit, based on claim experience of the business placed by the dealership. This is a one sided arrangement in which the dealers shares no risk of loss. The retro is generally found in an addendum to the original agreement with the dealership.

Agents should take note of two very important elements of a retro. The first is the formula used to calculate the retro and the second is the timing of the payment.

Once the insurance company has established a reserve based o the dealership claim experience, the retro typically is calculated and payable on an annual basis, with a negative amount carried over and offset against a future positive amount. The percentage of the profit that is shared can be up to 100 percent. In this case the insurance comply retains an administrative fee and earns investment income, while the dealership receives all of the underwriting profit.

There are a number of issues that an agent could raise dependent upon the facts and circumstances a particular situation.

1. Is the underlying reason behind a retrospective arrangement to circumvent a state-imposed cap on commissions generated from the sale of credit life and disability insurance? If yes, consider reclassifying the arrangement as a commission contract.

2. Is the retrospective payment diverted from the dealership and not reported as income by the dealership or the dealer? In one situation, the retrospective arrangement was negotiated separately by the dealer. No one at the dealership was aware of the arrangement. All payments were sent individually to the dealer at his place of residence.

3. Is the timing of the retrospective payment properly accrued by the dealership, considering the all events test?

4. Is there an "oversubmitted" aspect of the original premium that is held in a related escrow or reserve account? How did the dealership treat this "oversubmit" and who ultimately receives it?

5. What access does the dealer have to the reserve? If any, is there corporate separateness between the insurance company and the dealership. See *Moline Properties*, 319 U.S. 436, 63 S. Ct. 1132.

6. Is the "retro" arrangement a disguised form of self-insurance?

The decision in *Malone & Hyde, Inc.*, above, greatly impacts this section. In addition to the issues developed above, the following is a listing of other recommended issues to consider with PORCs (dependent upon the facts and circumstances), developed jointly between the Motor Vehicle Industry Specialist and the Captive Issue Specialist (not in any particular order and note that some of these may be factors favoring assertion of one or more of the other issues to be raised):

1. Substance versus form (*Gregory* v. *Helvering*, 293 U.S. 465 (1935))

2. Assignment of income doctrine / IRC section 61 / *Lucas* v. *Earl*, 281 U.S. 111 (1930) 'to hang the fruit on the tree from which it came'

3. IRC section 845 tax avoidance

4. Recharacterization of a portion of ceded premiums as commission contracts - circumvention of statutory commission caps (credit insurance)

5. "Cash cow" - constructive dividend treatment for poorly documented and non-performing loans

6. Self-insurance arrangement (100 percent dealer obligor VSCs)

7. Oversubmits (funds in excess of a stated or required amount) -- dealership treatment and ultimate flow of funds

8. Undercapitalization (*Malone & Hyde, Inc.*)

9. Indemnification agreements (*Malone & Hyde, Inc.*) and any other form of contractual arrangement negating insurance risk

10. IRC section 481(a) and change in method of accounting

11. Violations to IRC section 806 small life insurance deduction

12. Validity of IRC section 953(d) election of foreign insurance company to be treated as domestic corporation

13. Inadequate reserves.

Reinsurance and Auto Dealership After Sale Financial Products

The owner may say the dealer owned captive offshore reinsurance arrangement as a legitimate reinsurance company which performs all the functions and meets all the requirements of regulated United States reinsurance companies.

If an agent was aware of the insurance industry reasons for reinsuring risk, irrespective of any taxation considerations, they may conclude these producer owned reinsurance companies do not perform functions or meet requirements as purported.

An insurance company will reinsure the risk on its liabilities, potential claims on existing policies, for two reasons. First, to distribute the risk held by the insurer. Second, to provide reserve relief allowing the insurer to write more business, to expand its client base, without adding to the surplus.

1. Risk distribution

   Reinsurance traditionally will be used where an insurance company is concerned that an adverse trend will develop with respect to a number of risks that may be on an individual basis

relatively small. Through reinsurance, the insurance company becomes less vulnerable to the adverse trend. The primary insurance company remains obligated to the consumer; the reinsurer is obligated to the primary insurer. Thus, risk is diversified.

2. Expand client base

   Policyholder surplus is the equity capital that may be invested by the insurance company shareholders, plus unappropriated retained earnings. Surplus in an insurance company is similar to shareholders equity in a corporation.

   The surplus serves as a backup to the reserves in case losses are greater than anticipated. Failure to maintain adequate surplus can inhibit future growth because there are insufficient funds for future policies to be written. Generally, a specific amount of surplus must be maintained for each insurance contract written.

   Reinsurance is used by insurance companies to address a need for additional surplus to write future policies by allowing the first insurer to shift liabilities off its balance sheet and onto the reinsurers balance sheet. Reinsuring credit life and credit accident and health contracts, even with related party reinsurers, is a common practice in the insurance industry.

   One reason that can be argued by the reinsuring auto dealer, is the reinsurance arrangement allows the dealer to increase the commission of the insurer. By funneling ceded contracts to the reinsurance company, the dealer’s net commission is increased above state caps when the contracts earn out and the dealer may have access to these reserves.

   Applying traditional insurance standards to these arrangements may lead to the conclusion that this is reinsurance in form, not substance. The arrangements do not achieve the usual benefits associated with reinsurance, namely risk distribution and surplus relief. The only recognized benefit that this arrangement produces is to increase commission income originally capped by state statutes.

The Future

As we analyze the facets of dealer Aftersale Financial Products, we see that we have encountered changes emerging that may establish a formula to apply to future analysis of true insurance situations. We have seen the law evolve, from *Humana*, to the point where, as in the *Ocean Drilling* case, outside risk and true insurance were determined to exist where 27 percent of sales were to non-related parties. See *Ocean Drilling, Inc.* v. *Commissioner*, 24 Cl. Ct. 714 (1991).

Consider also the *Malone & Hyde, Inc.* decision discussed, above, in Chapter 12 of this Guide, which distinguishes the *Humana* decision. See *Malone & Hyde, Inc.*, 62 F.3d 835.

Will the dealer aftersale financial products issue go away now that Rev. Procs. 92-97 and 92-98 are in effect? In some cases this may be true. Remember, these revenue procedures only apply to mechanical breakdown contracts for which the dealership purchases an insurance policy from an unrelated third party to insure its obligations under the contract. As discussed throughout this

section, seemingly compliant arrangements may actually turn out to be anything but.

Part 3
Stand Alone Issues

Chapter 14
Advertising Associations

Introduction

The Stand Alone Issues incorporated into this text are the ones that are considered to be most relevant. This is not to imply that there are no other issues that can be discussed. Inherent in the "Living Document" process is the need for others to extend the scope of the discussion set forth in this Guide.

Advertising Associations

An advertising association is a separate entity whose main purpose is to obtain effective advertising beneficial to all of its members. The activities of such associations are a catalyst for sales of manufacturers, dealerships and auto centers.

An association typically takes three forms, all of which operate by using primarily dealership funds. Dealerships deduct their payments to the fund as advertising expense or, in some cases, cost of goods sold. The association will use the funds at some future date to advertise on behalf of the group members. The three forms are:

1. By make

   As a part of their franchise agreement, most dealerships are required to participate in an advertising association. Amounts for this expense may be stated on the face of the vehicle invoice. Thus, stated advertising charges are expensed by the dealership when the automobile hits the flooring account. These funds are used by the advertising association for both local and national purposes.

   According to the dealer agreement with the manufacturer, the dealership is required to join the advertising association. The dealerships are members which own the corporation. The advertising association may be a "non-profit" organization and as such there are no shares of stock issued. The corporation is operated by a Board of Directors. This Board decides how the funds are to be spent and usually meets every quarter. The Board is made up of dealership owners. They are voted in by all the association members. The amount charged for advertising from each invoice can be a flat amount or a percentage of the purchase price of the vehicle including options. The amount is set by the association and/or manufacturer.

2. By owner

   A dealer may own dealerships in different locations of the same region (e.g. different cities of Southern California) and may promote the dealers name even though different makes of automobiles are sold. Typically, advertising will be solicited that best aid the growth and sales of any dealership attached to that name. An advertising association may be created that receives payments from all related dealerships and then uses the funds as stated. Such advertising is in addition to manufacturer sponsored programs described above.

3. By geography

   In the last several years, auto centers have been the option of choice for establishing dealerships. The theory is that by placing competing dealerships in one large auto park, many potential customers will be lured that will help sales of all auto center tenants. Additionally, cities may offer attractive land leases and perks to increase their sales tax revenue. Centers may be owned by the tenants, completely independently owned, or jointly owned. The tenants of the auto park will typically pay fees to an association that will advertise the park as a whole. Again, this advertising form will be in addition to the manufacturer's programs.

   Regardless of the form of the dealership you are examining, chances are advertising is structured in one of the aforementioned advertising methods. The key to determining the correctness of expenses taken at the dealership level lies in the answer to questions related to the advertising entity, as follows:

   a. Was the money actually spent on advertising?

   b. Who ultimately spent the money on advertising?

   c. When was the money spent on advertising?

   It is paramount in the examination of advertising expenses that these simple questions be answered thoroughly. However, obtaining simple answers often becomes a complex process. Many structure variations can be used which cloud the issue. For example, advertising associations typically deal with large dollar amounts. Errors by the association in the processing of this money may result in either "unreported income" or "double deductions" making it necessary for the Service to verify the correct tax treatment of the fund.

Association Tax Returns

The tax returns filed by the associations are usually not complicated, but may not show all of the years activity. They may reflect the following:

1. Gross receipts less rebates to the dealerships which are reflected as sales returns and allowances. A "schedule" may be attached reflecting the same. "Other income" is usually interest. The remaining income is offset by advertising expense and other deductions which

reduces taxable income to zero or negative taxable income.

2. The face of the tax return shows a "schedule" with little else of any consequence. The schedule will list amounts received from the dealers less amounts disbursed for advertising.

Potential Issues

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

1. Diversion of income

   A portion of the advertising funds are spent, the remaining balance is sent back (diverted) to the dealership or shareholder via a straight distribution, management fee, travel and entertainment reimbursement, or some other vehicle.

2. Double deductions

   Double deductions may occur when the dealership is expensing the vehicle purchase invoice amount under Cost of Goods Sold. Each purchase invoice is charged an amount for advertising which the manufacturer collects, then forwards to an advertising association. The advertising association will then spend the dealership funds to advertise for themselves which a dealership might deduct as an expense for the same amount.

3. Timing of deductions

   The agent should ensure the dealership advertising expenses are deducted considering economic performance. See IRC section 461(h). Also see the chapter on Extended Service Contracts in this Guide.

4. All events test

   An issue may arise where the dealership accrues advertising association rebates prior to "all events" having transpired under IRC section 451.

5. Segregation into member and nonmember categories

   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, may be deducted with respect to nonmember income such as interest income. IRC section 277 member and non-member income and expenses.

   Thus, it is typical for advertising fund amounts to go from entity to entity to entity, being partially used, rebated or reused. It is important to follow the dollars.

Rules and Regulations

Many rules regarding the treatment of advertising amounts on both the manufacturer and dealership level exist as brought out by Revenue Rulings, Court cases, Internal Revenue Code sections and Treasury Regulations. The current rules are paraphrased below:

1. IRC section 446(b): If the way the taxpayer is treating the income/expense relating to the advertising association distorts income, a new method that does not distort income can be employed.

2. IRC section 481(a): Prior period adjustments resulting from a change in accounting method should be used to compute the open year deficiency. Also see the chapter on Extended Service Contracts in this Guide.

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

4. 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.

5. 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.

6. 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. See the chapter on Extended Service Contracts in this Guide.

7. Association expenses are deductible after applying the rules of IRC section 277 which requires the division of items into member versus non-member categorization, i.e., portfolio income is reported and taxed.

8. The dealership can expense amounts paid to the manufacturer for advertising, if the amount is listed on the invoice, given to a local ad association for the sole purpose of advertising and the excess is refunded to next years charges.

Under current law, if the dealership does not include the advertising fee in the cost of the vehicle and the amount is not listed on the invoice then the agent is correct in applying Treas. Reg. section 1.461-4(d)(7), Example 5 and Treas. Reg. section 1.461-4(g) by adhering to the economic performance occurrence theory. Taxable income is recomputed giving an expense when and where monies are paid or owed to bona fide advertising media. Additionally, where reserves exist that are not truly restricted from the use of the shareholders, the reserves should be recaptured into current year income and considered a constructed dividend.

The advertising association issue may not be easily identifiable and demands developmental efforts on behalf of the agent. It should be noted, however, that as potential tax avoidance, the issue is important and should be audited and resolved.

Audit Techniques

During the interview, ask if the dealership belongs to any advertising associations. If they do, ask if they are required to belong to the association or if they formed the association along with any other dealership in the surrounding areas. Ask if the dealer belongs to the Board of Directors which handles the association funds.

Analyze the advertising account to see the components of the accounts and types of advertising expenses incurred.

Analyze how the rebates are booked into income or credited as a liability or other expense.

Contact the association and request info on dealership rebates, refunds or funds forwarded to the dealership for any reason. Consider auditing the association.

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Chapter 15
Covenant Not to Compete

A covenant not to compete between the seller of a business and the purchaser for a specified period after the sale may be valid under certain instances. However, this issue often arises in the auto dealership context as a form of disguising the full purchase price of the dealership or as a means to ensure the furtherance of the business goodwill built up over the years by the seller. If this is the case, the entire sum received by the seller represents the proceeds from the sale of the business, including goodwill, and the purchaser would not be entitled to amortize the corresponding amount paid out for this covenant.

Resolution of this issue is laid out in the judicial test found in *Forward Communications Corporation* v. *United States*, 608 F.2d 485 (Ct. Cl. 1979). The following four tests may be applied to determine whether any part of the purchase price may be separately allocated to a covenant not to compete:

1. Whether the compensation for the covenant is separable from the price paid for the goodwill?

2. Whether either party is trying to repudiate an amount fixed by both parties as allocated to the covenant?

3. Where there is no precise allocation in the agreement, did both parties nevertheless intend that some portion of the price be allocated to the covenant?

4. Whether there was economic reality behind the covenant?

    a. Rev. Rul. 77-403 expands the economic reality analysis:

        1) Whether in the absence of the covenant would the seller actually desire to compete with the purchaser?

        2) The ability of the seller to actually compete effectively with the buyer.

        3) The feasibility of the seller effectively competing with the buyer considering the business and market within the time and area specified in the covenant.

Case Study

Consider the following factual situation and the application of these principles to determine if the designated covenant not to compete being amortized by the dealership was nothing more than a non amortizable disguise of a portion of the sales price paid for the seller's assets:

Buyer was in the auto business for many years but was new to this area. Seller began his dealership in the same area over 30 years ago. Buyer and Seller entered into an agreement to purchase all of Seller's assets and assume certain liabilities.

One of the assets specifically identified in the sales instrument was the purchase of goodwill, namely "all of seller's goodwill, all of seller's existing telephone numbers, all costs and sales records and data, customer lists, mailing lists, files, invoices, advertising material and methods, warranty records, licenses to conduct the business and any files required to be retained after the closing by law or regulation for a purchase price of $250,000."

Subsequent to the agreement to purchase and concurrent with the closing of this transaction, Buyer and Seller enter into a Covenant Not to Compete and Consulting Agreement. The agreement was for 5 years and covered a 50 mile radius from the site of dealership. Seller was to receive $300,000 each year for 5 years on the anniversary date of the closing of this sale.

As a consultant, Seller agreed to provide the Buyer with "technical assistance, advice, and consulting with respect to the management and operation of the dealership, business principles employed, introduction to key executives of the dealership and outside the dealership, analysis of market employee relations, and other matters pertaining to the profitable operation of the business for 5 years from the date of the closing of this sale."

The agreement further stated that if seller died or was to become incapable of performing these consulting duties during the term of the agreement for any reason he shall be deemed to have earned the full amount of compensation payable to him under the terms of this agreement.

Facts brought out during the examination:

> Seller did provide management of the dealership with advice on how to market in this particular area. He provided advice on competitors in this market. He provided through his presence and advice for a smooth transition at the time of purchase.
>
> There was no appraisal of the covenant not to compete. Its valuation was based on assumptions that seller would take 5 percent of the dealer's business if he competed and this would be more than $1,500,000 for the 5 years after the sale. Buyer had no objective criteria on which to base such an opinion.
>
> The covenant was separately negotiated by the buyer and seller.
>
> Seller was 69 years old and in poor health. The Buyer approached the Seller who had no intention to stay in business and compete. Buyer was aware of Sellers intentions.
>
> The net worth of the dealership per financial statements just prior to the sales closure was $6,000,000. The sales price was stated in the closing memorandum to be $7,750,000.

Applying the principles found in *Forward Communications Corporation*:

1. Whether the compensation paid for the covenant is separable from the price paid for the goodwill?

   The presence of separate goodwill existed in this transaction as shown by the inclusion of

goodwill as a stated asset in the sales agreement with a specific price of $250,000.

2. Whether either party is trying to repudiate an amount fixed by both parties as allocated to the covenant?

   This test concerns pre-1986 sales when there was a conflict between purchasers and sellers as to the classification of an asset as ordinary income or capital gains. Currently, the weight of this element is lessened.

   There is no proof that either party tried to repudiate an amount fixed by both parties as allocated to the covenant.

3. Where there is no precise allocation in the agreement, did both parties nevertheless intend that some portion of the price be allocated to the covenant?

   The actions of the parties tend to show some portion of the price be allocated to the covenant. The balance sheet showed the assets to be $6,000,000. The price was $7,750,000.

   The covenant makes no provision for breach upon part of seller and appears to vest in seller at closing date.

4. Whether there was economic reality behind the covenant?

   Economic reality in this context concerns reasonable buyers who have a genuine concern with their economic future to bargain for a covenant not to compete with the seller.

   The dealership's financial statement shows net worth of $6,000,000. The purchase price was $7,750,000 and an additional $1,500,000 for covenant and consulting agreement.

   a. Use factors in Rev. Rul. 77-403 for post-1986 acquisitions to determine whether this agreement has any economic merit.

      1) Whether in the absence of the covenant the seller would desire to compete with the buyer?

         Unlikely. The seller was 69 years old and in failing health. The buyer knew of sellers intention not to compete.

      2) The ability of the seller to compete effectively with the buyer in the activity in question.

         Seller has expertise to compete, but likelihood of doing so in light of his age and health is extremely improbable.

3) The feasibility in view of the business and market in question considering the time and area specified of effective competition by seller.

Where a covenant may be enforced it must contain two items; a limit on time and a limit of the geographic restrictions. If one or both of these conditions are not stated or are unreasonable, the covenant is unenforceable.

Applicable State (California) law allows a limitation of 10 miles on such covenants. State law also allows existing dealerships to protest against a like kind manufacturer from entering this radius. A hearing will be held and the new franchise may be refused by the State Motor Vehicle Department upon a finding of good cause.

The manufacturer in question will authorize dealership locations based on studies. Manufacturer will not allow a new dealership to open if it jeopardizes an existing one.

Intangibles Settlement Offer

IRC section 197 of the Omnibus Budget Reconciliation Act of 1993 allows the amortization of intangibles, including goodwill and going concern value, over 15 years on a straight line basis if purchased after August 10, 1993. Except for limited application to intangibles purchased after July 25, 1991, the legislation is not retroactive.

Prior to *Newark Morning Ledger Co.* v. *United States*, 113 S. Ct. 1620 (1993), the IRS maintained that certain intangibles, such as covenants not to compete, were inseparable from goodwill, also known as going concern value, and could not be amortized. The decision in this case rejected that position and held an intangible could be amortized if the taxpayer could establish both a value and a useful life. The burden placed on a taxpayer to make such a showing is significant.

The settlement offer is applicable to those intangible acquisitions for which the IRS had begun an examination before April 1, 1994. The settlement will not cover any intangible issues raised in an audit begun after this date.

The settlement was offered because Section 197 of the 1993 Act changed the tax treatment of these intangibles for future years and court cases would have little precedential value. The settlement was also offered because Congress, in the legislative history to the 1993 Act, suggested the IRS do something to save litigation cost for both the Government and affected taxpayers.

For further information, refer to the Intangibles Settlement Initiative, the IRS National Office publication (March 29, 1994), known as "the Greenbook," which discusses the handling of Covenants Not To Compete.

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Chapter 16
Related Finance Companies

What is it?

Issues concerning Related Finance Companies refer to the self-financing arrangement pursued by some dealerships, new and used, where individuals for whom financing cannot be obtained through normal channels. The customer is required to make payments usually at the dealership's location.

How does it work?

Dealerships involved in this practice establish a financing entity, typically an S-Corporation, which acts as the financial institution in the dealership's selling arrangement. Determining dealership involvement is done by looking at the:

1. Amount of advertising expense (high)

2. Form of advertisements ("Guaranteed credit")

3. Production and sale of notes by multiple financial institutions/entities

4. Market value of trade-ins (low).

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 as the lender. Then the note is sold at significant discount to the controlled (IRC section 267(b)(3)) entity 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 and the finance entity accrues income as it becomes earned, of course subject to IRC section 162 deductions.

If the dealership is an S-Corporation qualifying as a member of a controlled group under IRC section 267(b)(3), it will be entitled to loss deferral under IRC section 267(f). If, however, an S-Corporation is treated as related to another S-Corporation only under IRC section 267(b)(11) or as related to a C-Corporation only under IRC section 267(b)(12), the S-Corporation does not qualify for loss deferral under IRC section 267(f). Instead, such losses would be disallowed under IRC section 267(a)(1).

Adjustment

Not all Related Finance Company arrangements require an audit adjustment. Only those that lack economic substance warrant such an adjustment. Where an arrangement lacking such economic substance is found the taxpayer will:

1. Spread income over a number of years

2. Take a current period "loss" deduction for what should be just another sale.

If the transaction has the requisite economic substance the transaction may dictate that:

1. Income is booked in the current period

2. There is no loss creation and deduction.

If the Related Finance Company exists only in form and the transactions lack economic substance, the losses on the sale of receivables to the Related Finance Company should be disallowed to the dealership. IRC section 482 also permits the reallocation of income and expenses between related taxpayer's to clearly reflect income. *Lucas* v. *Earl*, 281 U.S. 111 (1930).

Possible applicable legal assertions

1. IRC section 267: No deduction shall be allowed for any loss relating directly or indirectly to property exchanges between related parties.

2. IRC section 446(b): The issue has been raised as to whether there has been a change in method of accounting where a related finance company is used to defer dealership income. This issue is under active consideration by National Office.

   The issue arises from the following two divergent views of a dealership's use of related finance companies to defer income:

   a. Those who believe that an auto dealership's use of a related finance company to defer income results in a change in method of accounting suggest that the aggregate income for the owner of both the dealership and related finance company is the same. Therefore, because only the timing of the income is affected as to the owner, the use of the related finance company results in a change in method of accounting.

   b. Those who believe that the use of a related finance company to defer income does not result in a change in accounting method argue that the dealership's income shifted to the related finance company will never be reported by the dealership. Therefore, because the shift of income as to the dealership is permanent rather than temporary, there is no change in method of accounting.

3. IRC section 453(b)(2): An installment sale accounting method cannot be applied to disposition of inventory of the taxpayer.

4. IRC section 482: The examining agent can attribute income among related entities in a manner that clearly reflects income.

5. IRC section 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.

Can Your Related Finance Company Meet the Test?

There are several valid business purposes for establishing Related Finance Companies (RFC). An RFC enables dealers to sell cars to customers with marginal or non-existent credit. Individuals who can afford car payments but who have poor credit history were an untapped market prior to Buy-Here Pay-Here (BHPH) lots and RFCs.

An effective RFC removes the collection burden from the dealership, allowing dealership personnel to focus on what they do best, sell cars.

Some RFCs are so well managed that 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 and the dealership may be more selective when it offers credit. An RFC may allow a dealership to free itself from any restrictive regulatory and licensing requirements to distance itself from adverse publicity resulting from collection activity.

Even when there are valid business purposes for forming an RFC, care must be taken to perfect the form and operations of the business. The RFC must be operated as a separate entity from the dealership and in a business-like manner. Among other things, an RFC should have separate books, a written contract with the dealership(s), its own location and employees (Additional items are included in the checksheet at the end of this section).

It is clear that some BHPH lots and RFCs are legitimate and were established for valid business purposes. The MSSP Independent Used Car Audit Technique Guide (ATG) contains an excellent section on related finance companies. It was prepared with the assistance of the National Association of Independent Auto Dealers (NAIA) and includes many characteristics of a valid RFC.

If the finance company exists only in form and the transactions lack economic substance, the losses on the sale of receivables to the RFC should be disallowed to the dealership. IRC section 482 also permits the reallocation of income and expenses between related taxpayers to clearly reflect income. As the Supreme Court ruled in *Lucas* v. *Earl*, 281 U.S. 111 (1930), the income is taxable to the earner.

The following checksheet can provide a quick test of the validity of your BHPH lot and RFC. If the answers to the questions below are no, the issue probably merits further analysis.

RELATED FINANCE COMPANY CHECKSHEET

ORGANIZATION	YES	NO
1. Is the RFC a separate, legal entity from the dealership?		
2. Does the RFC meet all state licensing requirements?		
3. Does the RFC maintain all required, local business licenses?		
4. Does the RFC comply with title and lien holder laws in its area?		
5. Does the RFC have adequate capital to pay for the contracts?		
6. Does the RFC have its own address and operate from separate facilities?		
7. Does the RFC have its own telephone number?		
8. Does the RFC maintain its own books, separate from the dealership(s)?		
9. Does the RFC have its own employees?		
10. Does the RFC compensate the employees directly?		
11. Does the RFC pay its own expenses?		
12. Does the RFC maintain its own bank accounts, separate from the related dealership(s)?		
OPERATION	**YES**	**NO**
13. Does the lien holder on the finance contract change from the dealership to the finance company?		
14. Does the dealership notify customers that the contracts were sold?		
15. Does the RFC pay the dealership for the contracts at the time of purchase?		
16. Does the RFC purchase any contracts from unrelated companies?		
17. Does the RFC have written agreements with the dealership(s)?		
OPERATION, Continued	**YES**	**NO**

18.	If so, does the agreement state how he discount rate was determined?		
19.	Does the discount rate approximate the actual loss experience?		
20.	Are the finance contracts non-recourse?		
21.	Does the RFC handle repossessions?		
22.	Does the dealership sell any finance contracts to unrelated finance companies?		
23.	Does the RFC report income on a pro-rata basis?		
24.	Did the profit reported on the initial sale of the vehicle exceed the loss on the sale of the finance contract?		
25.	Does the RFC have a business purpose?		
26.	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 FMV of the note?		

Conclusion

An adjustment is appropriate where the note is not discounted at fair market value to a "controlled financier" or where the Related Finance Company arrangement is an economic sham. If such is the case, then adjustments should be made to assign income to the proper year it was incurred in connection with the rules aforementioned.

See MSSP Used Car Audit Techniques Guide (ATG) for additional discussion of Related Finance Company Issues.

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Chapter 17
Passive / Non-Passive Considerations

Introduction

In the attempt to be good tax planners, it is possible that a taxpayer involved with auto dealerships will overlook the complexities of passive loss rules and regulations of IRC section 469. 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 paramount that the agent look at the individual and related entity returns and see the "big picture" to determine if the taxpayer may be manipulating passive characterization rules. Please also see the chapter on Financial Status in this Guide. Simply see if any of the individuals are securing a benefit by using flow through entities.

The Typical Scenario

The taxpayer, who is also a shareholder in a large C-Corporation auto dealership, is somewhat wealthy and 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 which 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 recognized 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, a 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)).

   Note: There are material participation relief provisions under IRC section 465(c)(7)(C) for closely held C-Corporations.

   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 through the lense of financial status. Also see the chapter on Financial Status in this Guide. Did the taxpayer through some device 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 and often productive.

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Chapter 18
Voluntary Employees' Benefit Associations

The tax treatment of contributions to funded welfare benefit plans changed with the enactment of IRC sections 419 and 419A. It is important to keep the rules regarding deductibility of contributions in mind as the larger automobile dealerships tend to employ such plans. If an examination of such a plan is initiated, the agent will want to verify that payments are not strictly being expensed per IRC section 162.

This section is included in this Guide for agent awareness only.

What is a VEBA to which IRC sections 419 and 419A apply?

A VEBA is a "voluntary employees' benefit association" that is tax exempt under IRC section 501(c)(9). It is a "welfare benefit fund" to which IRC sections 419 and 419A apply if it is part of a plan of an employer through which the employer provides welfare benefits to employees and their beneficiaries. A "welfare benefit" is a type of benefit exclusive of those to which IRC sections 83(h), 404, and 404A apply.

What do I need?

In order to examine this issue, first question the taxpayer (representative) as to the nature of the plan and what benefits are provided. Determine if the plan is subject to collective bargaining. Secure any agreements or contracts at the taxpayer's disposal. Secure a full list of participants. Also, secure copies of forms filed in substantiation of the Plan (5500) and the VEBA trust (990).

Whenever an agent encounters a VEBA situation it is suggested they contact the VEBA Issue Specialist. The VEBA Issue Specialist has spent a significant amount of time developing VEBA issues and is the best source for information regarding this topic.

Audit Potential

Prior to IRC section 419, employers often deducted funded amounts for employees, care providers, administrator payments, and insurance company distributions fully per IRC section 162. Subsequent to IRC section 419, deductions for such funded amounts were limited in accordance with certain rules and formulas. Audit potential exists when these rules are not followed.

Technicalities

Under the provisions of IRC section 419/419A, the employer is only allowed to deduct in a given fiscal year the lesser of: 1) Cash PAID to the fund, 2) "Qualified Cost" amount, or 3) "Eat-up Rule" amount.

1. Cash PAID to the fund is just that, irrespective of the method of accounting employed by the employer, only the amount substantiated as cash paid to the fund is considered.

2. Qualified Cost is defined by the following formula:

	Qualified Direct Costs (QDC)
+	Qualified Asset Account Addition (QAAA)
-	After tax income (ATI)
	Qualified Cost

   The subcomponents of Qualified Cost are further defined:

   (QDC) = Benefits paid through the fund for the year calculated on a cash basis.

   (QAAA) = Additions to certain reserves: The only amounts permitted as additions to reserves are amounts for a) incurred but unpaid claims and b) post-retirement life and medical benefits. These are described in IRC section 419A.

3. The "Eat up rule" amount is described in detail at Treas. Reg. section 1.419-1T, Q/A 5(b).

Exceptions

There are two major exceptions to the 419/419A rules:

1. Collectively Bargained benefits per IRC section 419A(f)(5)(A)

   Per Treas. Reg. section 1.419A-2T:

   a. Arms-length negotiations

   b. Benefits must be negotiated

2. Certain 10 or more employer plans per IRC section 419A (f)(6)

Sources of Information

For an explanation of how IRC sections 419/419A work, a reading of the *General Signal* case is suggested. See *General Signal Corporation* v. *Commissioner*, (103 T.C. No. 14). Again, the

best source for information regarding the VEBA issue is the VEBA Issue Specialist who should be contacted if it appears a VEBA issue may exist in a case.

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Chapter 19
Other Prevalent Auto Practices

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. Audit Technique

   The agent needs to compare the dealer's invoice with the purchases Journal and the General Ledger to determined whether dealer is correctly reporting the "Holdback" amounts. 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.

Warranty Advances

Dealers perform work on vehicles, as a result of defective materials or workmanship at the time of manufacture, for which the dealer is reimbursed by the manufacturer. 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 warranty bill is processed by the manufacturer.

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. 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.

2. 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.

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 typically 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).

1. 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 who 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.

2. 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(ies).

   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 accrual method was being used by the taxpayer.

3. 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 have traditionally been issues involving Form 941 and Form 940 that are unique to the auto industry.

Fringe Benefits

Determine whether the dealership permits its employees, shareholders, or directors to use its automobiles or purchase them at a discount. If such a practice exists, the benefit is presumed to

be 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 section 132(b); qualified employee discounts, defined in IRC section 132(c); and working condition fringes, defined in IRC section 132(d).

1. 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 the rules of IRC section 132(c) are satisfied. The exclusion applies whether the property or service is provided at no charge or a reduced price or whether 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.

   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.

2. Working Condition Fringes

   a. General Rule

      Subject to the special rules for qualified automobile demonstration use and product testing below, 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 relates 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).

      See Treas. Reg. section 1.132-5(b).

For purposes of this rule, 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).

Qualified Automobile Demonstration Use

IRC section 132(j)(3)(A) deems "qualified automobile demonstration use" to be a working condition fringe. "Qualified automobile demonstration use" is any use of an automobile by a full-time automobile salesperson in the sales area in which the automobile dealer's sales office is located if:

1. Such use is provided primarily to facilitate the salesperson's performance of services for the employer, and

2. There are substantial restrictions on the personal use of the automobile by the salesperson.

    a. Substantial restrictions on the personal use of a demonstration automobile exist when all of the following conditions are satisfied:

        1) use by individuals other than the full-time automobile salesperson, such as family members, is prohibited;

        2) use for personal vacation trips is prohibited;

        3) storage of personal possessions in the automobile is prohibited; and

        4) the total use by mileage of the automobile by the salesperson outside the salesperson's normal working hours is limited.

    See Treas. Reg. section 1.132-5(o)(4). The value of the use of a demonstration automobile may not be excluded from gross income as a working condition fringe, by either the employer or the employee, unless with respect to these four restrictions, the substantiation requirements of IRC section 274(d) and the regulations thereunder are satisfied. See Treas. Reg. section 1.132-5(o)(6).

    This exclusion applies only if the automobile is currently in the inventory of the dealership and is available for test drives by customers during the normal business hours of the employee. See Treas. Reg. section 1.132-5(o)(3). Note that these rules apply only to "full-time automobile salesmen" per Treas. Reg. section 1.132-5(o)(2). For rules that may apply to individuals other than full-time automobile salesmen, see the discussion of the general working condition fringe rules above and the product testing rules below.

    The value of the use of a demonstration automobile not meeting the requirements of Treas. Reg. section 1.132-5(o) must be included in the employee's gross income. The rules provide that two of the four methods for determining the value of personal use, the annual lease value

and the "general" method are generally available to dealers. The other two are available only in limited circumstances.

Unreasonable Compensation

Most auto dealerships are closely held corporations with one to two shareholders. In addition to being a closely held corporation, the majority shareholder will often spin-off operations of the dealership and form other related entities. The existence of multiple corporations may create a situation in which compensation may be split between two or more related corporations, and which in the aggregate, may be considered excessive.

The general manager (sometimes, the minority shareholder), is the person who runs the day-to-day operations of the dealership. His/Her duties may include: hiring, training, promoting and supervising personnel; maintaining relations with the manufacturer; developing advertising policy and 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. Sometimes, the majority shareholder is also involved in other business activities such as other dealerships. If this is the case, the total time devoted to each of the businesses compared to the total amount of compensation paid by all entities should be considered in determining the reasonableness of the compensation. The agent should also be aware that 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 augmented by the aforementioned bonuses. See *Good Chevrolet* v. *Commissioner*, T.C. Memo. 1977-291, CCH 34,606(M).

1. Reasonableness of Compensation

   a. IRM Factors

      The Internal Revenue Manual list the following factors to be considered in deciding whether compensation is reasonable [See the current IRM]:

      1) nature of duties,
      2) background and experience,
      3) knowledge of the business,
      4) size of the business,
      5) individual's contribution to profit making,
      6) time devoted,
      7) economic conditions in general, and locally,
      8) character and amount of responsibility,
      9) time of year compensation is determined,

10) relationship of stockholder-officer's compensation to stock holdings,
11) whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired, and
12) the amount paid by similar size businesses in the same area to equally qualified employees for similar services.

b. Judicial Factors

The factors generally considered relevant by the courts, which are set forth in *Good Chevrolet* v. *Commissioner*, T.C. Memo. 1977-291, CCH 34,606(M), include:

1) the employee's qualifications,
2) the nature, extent and scope of the employee's work,
3) the size and complexities of the business,
4) a comparison of salaries paid with the gross income and the net income,
5) the prevailing general economic conditions,
6) comparison of salaries with distributions to stockholders,
7) the prevailing rates of compensation for comparable positions in comparable concerns,
8) the salary policy of the taxpayer as to all employees, and
9) in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

2. Pre-Audit

During pre-audit the agent can use the following ratios in considering the merits of raising the issue:

a. compensation to gross sales,
b. compensation to gross profits,
c. compensation to taxable income,
d. compensation to that of other employees within the corporation, and
e. taxpayer's compensation to that of similar officers within the industry.

Such ratios can be obtained from third party publishers, e.g., "Dun and Bradstreet, Robert Morris Associates, Almanac of Business and Industrial Financial Ratios, NADA Data, etc."

3. Examination

The IRM advises to be alert for any officer's compensation claimed under headings other than officer's salaries, such as manufacturing salaries, supervisory salaries, labor, contributions to pension plans for the officers, payments of personal expenses, yearend bonuses, etc. It also advises to be alert to closely held multiple corporation situations in which compensation may be split between two or more related corporations, and which in the aggregate, may be considered excessive.

4. Agent development of issue

   a. Obtain documentation of salaries and wages (paid and accrued) for the managers of the various departments by inspection of the Forms W-2 and the payroll registers. Yearend bonuses are reflected as accrued salaries and a detail of the employees would reflect amounts paid to the managers.

   b. Through a review of the corporate minutes and the minutes of the board of directors meetings for the authorization of salaries and bonuses, the agent can determine the formality and timing of the corporate actions. The minutes may also reveal the method of determining salaries and bonuses (i.e., a formula), economic and financial concerns of the corporation, and the dividend history of the corporation.

   c. Dividends paid during the current year should be reflected on the schedule M-2 of the tax return and as a reduction to the retained earnings account.

   d. Review of prior year tax returns (4 years) would indicate whether the officers had been underpaid in prior years and establish a salary history for the officers.

   e. Examine the travel and entertainment expense with the intent of scheduling the officer/shareholder's activities (business and non-business) throughout the year.

   f. 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).

   g. Other factors concerning the officer-shareholder that need to be developed are:

      1) Specific qualification of the employee (i.e., educational level, experience).
      2) Salary history of the individual (i.e., increased salary and corresponding changes in responsibility or productivity).

      3) Contribution(s) of the officer-shareholder to the success of the business; growth of the business.

      4) Comparison of officer's salaries with other comparable dealerships in the industry.

      5) Economic conditions of the automobile industry and of the nation as a whole.

5. Legal Authority

   IRC section 162(a)(1) allows a deduction for all ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. To be deductible, salaries and bonuses must be both reasonable in amount and in fact payments

purely for services. See Treas. Reg. section 1.162-7(a).

Treas. Reg. section 1.162-7(a) compensation for personal services states the following:

> There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

The test of deductibility mentioned in paragraph (a) above is illustrated in Treas. Reg. section 1.162-7(b)(1):

> Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part in payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

Treas. Reg. section 1.162-7(b)(2) deals specifically with contingent compensation arrangements.

> The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate * * * [If] contingent compensation is paid pursuant to a free bargain between the employer and the individual before the services are rendered it should be allowed as a deduction.
>
> Regulation Section 1.162-8 describes the treatment of excessive compensation if the amounts correspond or bear a close relationship to stock holdings, and are found to be distribution of earnings and profits, the excessive payment will be treated as a dividend. Rev. Rul. 79-8, 1979-1 C.B. 92 states that the failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends on its stock is a very significant factor to be taken into account in determining the deductibility of compensation paid by the corporation to its shareholder-employees. Conversely, where after an examination of all of the facts and circumstances (including the corporation’s dividend history) compensation paid to shareholder-employees is found to be reasonable in amount and paid for services rendered, deductions for such compensation under Section 162(a) of the Code will not be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock.

Good Chevrolet v. *Commissioner*, T.C. Memo. 1977-291, CCH 34,606(M), held that the compensation paid to the officers in this case was reasonable. The compensation policy of the corporate officers had been set prior to when the officers became shareholders and members of Board of Directors. The officers had always been paid a fixed salary and a monthly bonus. The court pointed out that "* * * the volume of the new car sales was not due solely to

general economic conditions, but must be attributed to the efforts of the employees * * *" in particular its shareholders. Much of their success is due to their development and implementation of the program to increase fleet sales. The court went on to state that "* * * experts familiar with the automobile business in the area found the compensation paid to [its shareholders] to be in line with the compensation paid to officers of other dealerships even though those dealers were less successful than the petitioner."

City Chevrolet Company v. *Commissioner*, 228 F.2d 894 (4th Cir. 1956). The redetermination of reasonable compensation paid to the two officer-shareholders of the corporation was based upon the facts in the particular case. Although the large increase in profits in 1946 upon which the bonuses were based was due partly to the efforts of the shareholders, the general economic conditions at the time were also a contributing factor.

University Chevrolet Company, Inc. v. *Commissioner*, 16 T.C. 1452 (1951). The Court determined that the compensation paid to the sole owner of the corporation 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. The Court stated that "* * * for a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense * * * any contract between him and the corporation would not be a contract at arm's length between two persons with different interests, each dealing for his own best interest * * * the petitioner benefits little, if any, from the incentive contract in meeting its burden of proof." In its decision, the Court also considered other factors such as the relationship of his compensation to net income, to capital, to compensation to others, and to other significant figures; the dividend record of the corporations; evidence of salaries paid elsewhere; and salaries paid in earlier years. Upon filing a claim with the U.S. District Court in Florida, the jury redetermined the "reasonable" compensation.

Ernest Burwell, Inc. v. *United States*, 113 F.Supp. 26 (W.D. SC. 1953). The salary paid in 1941 to the president and general manager of an automobile sales corporation which was owned by him and his wife was held to be reasonable. The gross sales, the net income, and the new units sold for the taxable year were the highest during the 5-year period from 1938-1942. The increase in the volume of business in 1941 was due to the manager's efforts, since he, though on a special assignment in the Navy, was permitted and was able to actively supervise and direct the business. The salary paid was considered reasonable in the trade. Although no dividends were paid in 1941 or in the several preceding years, there was no attempt to channel off corporate earnings as salary.

Mullen Chevrolet Co. v. *Commissioner*, T.C. Memo. 1950-682, CCH 18,469(M). During the "war years" (1941-1944), the taxpayer had engaged in innovative methods of selling new and used vehicles and increased its service department activities by initiating a following-up system for servicing. The court stated that the taxpayer's capital as well as services was an essential income-producing factor in the business. Although dividends were actually decreased in what was petitioner's most profitable year, the court determined that the amount deducted as compensation was reasonable.

Howard Sole, Inc. v. *Commissioner*, T.C. Memo. 1953-238, CCH 19,503(M). The compensation paid to the officer was a reasonable allowance for personal services rendered. In this case, the petitioner's board of directors voted its principal officer a fixed salary plus a bonus based on a percentage of corporate earnings. The board of directors was composed of two directors, each representing families owning one-half of the issued stock. One of the directors was the principal officer who received the salary; the other director was not related to the principal officer and took no active part in the operation of the business. The inactive director was in the automobile finance business and was familiar with salaries paid to automobile distributors.

Lorenz Bros. Inc. v. *Commissioner*, T.C. Memo. 1946-567, CCH 15,277(M). The court held that the bonuses that were paid by the taxpayer to its two shareholders did not appear to bear a realistic relationship to the actual value of the services rendered where one was in charge of the sales activities and one was in charge of servicing and repairs. On the contrary, the record indicates that the income from sales were quite considerable in 1940 and 1941, but dropped sharply in 1942 due to wartime restrictions. The case further states that by computing the bonuses on percentages of net income in excess of 10 percent of the outstanding capital stock indicates that the bonuses had no relation to reasonable compensation but were essentially a means of distributing profits.

A.M. Chandler, Inc. v. *Commissioner*, T.C. Memo. 1950-380, CCH 17,624(M) states that in determining whether salary is reasonable in any particular case no single factor is decisive, but the situation should be considered as a whole. In this case, Chandler's duties as the president and general manager "* * * were burdensome and his services vital to the success of the business during the period involved. He could not have been replaced by an employee at a lesser salary and [he] was largely responsible for the entire income realized by the petitioner." Therefore, the determination was made that the salary paid to Chandler during the taxable years, by comparison with those paid officers of similar establishments in the locality during the same years, was held to be reasonable.

Skyland Oldsmobile, Inc. v. *Commissioner*, T.C. Memo. 1972-17, CCH 31,220(M). Based upon the "expert" testimony of the assistant zone manager for the Oldsmobile division of General Motors, the owner-dealer has the ultimate responsibility for the departmental and overall operation of the dealership. And in this case particularly, the petitioner provided evidence that indicated that the shareholder worked long hours and was responsible for all phases of the business: advertising, sales (new cars and old cars), financing, customer relations, and promotions.

Lloyd Schumacher Chevrolet-Buick, Inc. v. *United States*, 80-2 U.S.T.C. (CCH) Paragraph 9576, (DC-IL 1980). "* * * The court determined that [the] amounts paid to an employee solely responsible for the overall operations of the taxpayer['s] automobile dealership during the years in issue constituted a reasonable allowance for compensation paid for personal services actually rendered and were deductible in full by the taxpayer business." As the employee-owner, he was responsible for the direction of product line stock, the balancing of inventories, for the direction, stimulation and encouragement of salesmen for new and used

cars and trucks, setting objectives and sales rules, purchasing and planning a two acre addition to the business facility, negotiating with the business's suppliers and negotiating with Chevrolet for a heavy-duty truck franchise. He also had the responsibility for warranty problems and banking, including maintenance of proper cash flow, working capital and various other administrative matters.

S & R Chevrolet Co., Inc. v. *Birmingham*, 93 F.Supp. 950 (N.D.IA1950). The Commissioner determined that the compensation paid to the shareholders and their sons was excessive and unreasonable. The finding of the Court was that the taxpayer had not sustained the burden of proof otherwise. Their decision was based on these factors: deductions for compensation to the officers of the corporation and their sons which included a percentage of profits as well as straight salary; the taxpayer realized a return of 6 percent on its invested capital, an inadequate return of capital considering the general business conditions prevailing in the automotive industry for the year in question; and the fact that the taxpayer did not pay dividends to its stockholders from 1941 to 1946, inclusive.

Castle Ford, Inc. v. *Commissioner*, T.C. Memo. 1978-157, CCH 35,117(M). The court redetermined the amount of salary payments deductible as reasonable compensation that were paid to its officer-shareholder. The "* * * petitioner [had] failed to introduce any evidence (other than unsupported assertions * * *) as to [the] compensation paid by comparable business[es] to executives with responsibilities comparable to * * *" the petitioner's. The fact that there was "* * * agreement between [the] petitioner and [the shareholder that] contemplated the possibility that a portion of the salary might be disallowed as unreasonable * * *" was an element that had some bearing on the decision made by the court.

Van's Chevrolet, Inc. v. *Commissioner*, T.C. Memo. 1967-172, CCH 28,583(M). The amount of reasonable compensation of the principal officer-owner of an automobile dealership was redetermined. In determining the amount that was reasonable, the court used its best judgment in comparing the amounts being paid in prior years for the services being rendered.

Superior Motors, Inc. v. *Commissioner*, T.C. Memo. 1974-187, CCH 32,689(M). The Tax Court found that the auto agency's success was due largely to the officer's efforts and that it was the general practice in the car sales business to compensate the dealer-owner by both salary and a bonus based on a percentage of the net profits after salary and before taxes. However, the Court reduced the amount of reasonable compensation deductible by a corporation for an officer who was the sole owner of an auto agency who set his own salary.

Osborne Motors, Inc. v. *Commissioner*, T.C. Memo. 1976-153, CCH 33,826(M) stated the compensation, in the combination of salary and bonuses, paid to officer-stockholders based upon a percentage of net profits were reasonable and deductible as business expenses.

Childers & Venters Motors Inc. v. *United States*, 62-2 U.S.T.C. (CCH) Paragraph 9825 (DC-KY 1962). The jury redetermined the amount of reasonable compensation to each of the top four officials of an automobile agency. The fixed reasonable compensation amounts ranged from $7,000 to $13,500.

Milford Motor Co. v. *United States*, 56-1 U.S.T.C. (CCH) Paragraph 9477 (DC-NH 1956). The decision by the jury was that the amount paid by the taxpayer to its stockholding president of $37,500 as salaries was reasonable. The court considered the following factors in determining the reasonableness of the compensation paid: Compensation paid in prior years; the nature of and extent and scope of the president's work; the president's competency; the availability of others to do the same sort of work; and any special relationships between the officer and any other person who is in a position to furnish business to the company or to the officer.

Key Buick Company v. *Commissioner*, T.C. Memo. 1976-303, CCH 34,036(M). The Tax Court redetermined the amount considered to be reasonable compensation to a part-time president stating that "* * * Although the services of the president were valuable to the dealership because of his knowledge of the business and his contribution to routine business decisions, his services were not as valuable as those of a full-time president * * *."

East Tennessee Motor Company v. *United States*, 453 F.2d 494 (6th Cir. 1971). Jury decision in which it was determined that the compensation paid to the six officer-shareholders was unreasonable and, therefore, not deductible.

See decisions where the reasonable compensation issue was addressed in the auto dealership context:

a. *Automotive Investment Development, Inc.* v. *Commissioner*, T.C. Memo. 1993-298, CCH 49,140(M);

b. *William Wright and Lynne L. Wright* v. *Commissioner*, T.C. Memo. 1993-328, CCH 49,174(M).

Sub-Prime Issue

For tax purposes, how should a vehicle dealer report the transfer of a sub-prime finance contract (retail installment agreement) to an unrelated finance company?

What Is a Non-prime or Sub-prime Finance Contract?

Many potential vehicle purchasers cannot obtain financing through traditional means like banks, credit unions or manufacturers' finance companies because of poor credit. These individuals are referred to as "non-prime" or "sub-prime" consumers, depending on their credit rating (non-prime having a higher credit rating than sub-prime). To tap into this large market, many vehicle dealerships (particularly used car dealerships) offer their own retail installment agreements to these customers. These contracts are known in the industry as "non-prime" or "sub-prime" financing.

How a Non-prime or Sub-prime Plan Works

To facilitate cash flow and to avoid collection responsibilities, the dealerships often transfer non-prime or sub-prime installment contracts to an unrelated finance company shortly after the deals are consummated for an up-front cash advance and the possibility of additional cash payments in the future. Dealerships may do business with several finance companies, and may have paid a fee and entered into a servicing agreement with each finance company prior to transacting business with it. Servicing agreements vary among finance companies, and one finance company may have a variety of programs, but the basic premise of most programs is the same. Upon transfer of the installment contract, the finance company pays the dealership an advance which may range from 50 to 75 percent of the contract, depending on the credit rating of a particular customer or the dealership's aggregate pool of contracts. The advance can be based on the face amount of the contract without interest, or the total contract amount including interest. After paying the advance, the finance company collects the installment payments from the vehicle purchaser for a fixed percentage of each payment, often 20 percent. In addition, the finance company will be reimbursed for any out of pocket collection cost incurred. Only after recovering the fixed percentage fee, out of pocket collection costs, and the advance, will the finance company begin to pay the dealership for the remainder of the contract, known as the **BACK-END DISTRIBUTION.**

To summarize, the finance companies apply the collections on the installment contracts in the following order:

1. To pay the fixed percentage collection fee
2. To reimburse out-of-pocket collection costs (e.g. repossessions related expenses)
3. To repay the advance from the finance company to the dealerships, and
4. To remit any remaining funds to the dealer (back-end distribution)

Assuming a 20 percent fixed collection fee, and if the finance company has no out-of-pocket collection costs, the dealer has the potential through the advance plus back-end distributions to receive 80 percent of the installment contract (either the face amount of the contract or the face amount of the contract plus interest, depending on the servicing agreement). However, because of the order in which the collections are applied, dealers may not receive any back-end distributions because the collections received will be subject to a high default rate and may never exceed the sum of the 20 percent service fee, out-of-pocket costs, and the repayment of the outstanding advances.

The chances of receiving back-end distribution are further diluted because the finance companies aggregate the installment contracts rather than carry them individually. For example, if a dealership transfers 20 non-prime or sub-prime contracts, the advances from the finance company for all 20 contracts will be aggregated, and only after collections are received that exceed the cumulative advances on all 20 contracts will any back-end distribution be made. Thus, as long as the finance company keeps issuing advances, the cumulative advance balance increases and the collections received may never be enough to cover this ever-increasing advance balance.

To rectify this, some finance companies offer pool capping. Under this arrangement, the dealership may pays an additional fee to cap off one pool (or group) of contracts and to create a

new pool for additional, subsequent, contracts. Pool capping speeds up the time in which the dealer receives back-end distributions because it segregates a group of contracts, and collections received on those particular contracts are applied exclusively to those contracts. The collections on those contracts are not used to repay advances on contracts not in that pool. Once the advances on the contracts in that specific pool are repaid and the 20 percent collection fee and any out-of-pocket costs are covered, the dealership will begin to receive back-end distributions on those contracts. The same process would apply to all pools of the dealer that had been capped. The terms of pool capping arrangements must be carefully analyzed, however, since cross collateralization of pools may occur (payments made on contracts in one pool may be applied to another pool), diminishing the benefits of capping.

Non-prime and sub-prime arrangements are continuously proliferating and permutating, so it is difficult to provide a "one-size fits all" description of these products. Agents should consider all the facts and circumstances pertinent to a particular servicing agreement when examining these issues.

What Are the Issues?

The discussions in this audit technique guide are directed toward dealership reporting. No conclusions should be made or inferred from this document about the treatment of these contracts by finance companies.

There are several dealership issues associated with the tax reporting of non-prime and sub-prime contracts, including the following:

Is the transfer of the contract from the dealership to the finance company a loan, an assignment, a sale or a pledge to collateralize a loan?

- How should the cash advance be reported?
- How should the payment of the fixed percentage collection fee be reported?
- Are back-end distributions contingent payments?
- When should the back-end distributions be reported?
- How should the back-end distributions be valued?
- How should interest be computed and reported?
- How should enrollment fees and capping fees be reported?
- Are adjustments to this issue changes in method of accounting?

Income Tax Treatment

Since inventory is a material income-producing factor, vehicle dealerships are required to use the accrual method of accounting. Often, however, dealers use the cash method to report the transfer of installment contracts to the finance company. They report only the customer down payment and the advance received from the finance company as current income. Back-end distributions are often reported in a later tax period, when received. The primary reasons these transactions are reported in this manner are because 1) they follow the actual cash flow, or economic reality, of the transactions, and 2) it is difficult to assign a value to money which the dealership does not know if, when or how much will be received.

It appears clear that transactions associated with non-prime and sub-prime financing must be reported on an accrual basis. However, it is important to understand all facets of the transactions in order to properly account for them.

Two separate transactions occur. First, the vehicle is sold to the customer. Second, the installment contract is transferred from the dealer to the finance company.

The Tax Reform Act of 1986 repealed the installment method of reporting for dealers in personal property. Thus, the initial sale of the vehicle by the dealer to the customer must be reported in full the year the sale occurred. The total sales price of the vehicle must be reported even if an Installment agreement was executed. The dealership's basis in the vehicle offsets the total sales price to determine the gain or loss on the sale.

To determine the appropriate tax treatment of the second transaction, it must be determined if the transfer of the installment contract to the finance company by the dealer is a sale or an assignment of the contract or even a loan to the finance company. No matter what the character or tax treatment of the second transaction, however, the initial sale of the vehicle to the customer must be reported in full in the year of the sale.

Sale, Assignment, Loan or Pledge to Collateralize a Loan

Whether the transfer of an installment contract is a sale, assignment, loan or pledge to collateralize a loan depends on the facts and circumstances. Many of the servicing agreements or other arrangements between the dealerships and finance companies are worded in form like they are assignments or loans. However, a close review of the provisions of these agreements often reveal that in substance they are sales.

The following factors tend to indicate the transfer is a sale. The number of factors applicable to a particular dealership, or the relative importance of one factor to another, must be considered in determining whether a sale has occurred, or some other type of transaction:

1. The terms of the transfer are nonrecourse; i.e. the dealership is not responsible for payment of any defaulted notes or payments (often after 90 days). This is an important distinction from full recourse cases like *Hansen* v. *Commissioner*, 360 US 446.

2. The transfer gives the finance company unilateral power to dispose of the note

3. The dealership's security interest in the financed vehicle was transferred to the finance company.

4. The finance company receives all files and paperwork related to the customer note.

5. The finance company handles all collections and other administrative actions on the customer note.

6. The finance company is entitled to endorse the dealership's name on any payments made to the dealership and any other instruments concerning the installment contract and the financed automobile.

7. The finance company determines whether the note is in default.

8. The finance company can waive any late payment, charge or any other fee it is entitled to collect.

9. The finance company can repossess and sell or otherwise liquidate the financed vehicle if default occurs.

10. The dealership's customers are notified the note will be assigned to the finance company.

11. The finance company may or does pledge the customer notes as security for its own indebtedness.

12. The finance company bears the credit risk on the customer notes.

13. The dealership is not required to provide financial statements to the finance company in a manner normally associated with a line of credit or other loan arrangement.

14. There is no state interest rate, maturity date, or other specific details normally associated with a line of credit or other loan arrangement.

Treatment of a Loan, an Assignment or a Pledge of Collateral

Whether the transfer of the installment contract to the finance company from the dealership is determined to be primarily in the nature of a loan or an assignment, the tax treatment is similar. There is no income to the dealership upon receipt of the cash advance and no gain or loss is recognized at the time of the transfer of the contract. The cash advance is considered a loan. Collection by the finance company are treated in a dual manner since they must be applied to both the original installment contract between the purchaser and the dealership (which the dealership still owns), and the outstanding cash advance loan between the dealership and the finance company.

Dealership Note Receivable (from vehicle purchaser): Each collection by the finance company is applied against the outstanding installment note receivable still owned by the dealership. A portion of each collection is interest income to the dealership, and a portion is applied against the principal balance of the purchaser's note.

Dealership Note payable (to finance company): Since the amounts collected are actually retained by the finance company to apply against the cash advance balance outstanding, a portion of each amount collected is considered interest expense to the dealership, and the remainder applied against the advance principal balance. The fixed percentage collection fee

retained by the finance company is current expense to the dealership. Due to the front-loading of interest expense in this scenario, back-end distribution payments would be unlikely since the repayment of the loan principal (the up-front cash advance) is protracted.

It is anticipated that few, if any, of these transactions are likely to be true loans, under the terms of the arrangements between the dealerships and the finance companies.

Treatment of a Sale

If the transfer of the installment contract to the finance company is deemed to be a sale by the dealership, the amount realized on the sale is compared to the dealer's basis in the contract to determine the dealer's gain or loss. Per IRC section 1001(b), and as amplified in a number of TAMs, the amount realized from the sale is the cash plus the fair market value of any other property received. This formula appears simple, but is actually difficult to apply. It is made more complex by the impact of IRC section 483, which requires deferred payments to be recharacterized in part as a payment of unstated interest.

The dealer receives cash in the form of advance payments. That is easy to quantify. However, the dealer also receives the right to back-end distributions, which pursuant to IRC section 1001(b) is "other property received." The fair market value of that right is difficult to determine, since these contracts relate to non-prime and sub-prime customers who do not have good credit and the back-end distribution payments are upon the recovery of the up-front cash advances, collection fees and out-of-pocket costs. Thus, it is difficult to determine the amount realized from the sale of the installment contract by the dealer to the finance company.

There is significant debate over the appropriate valuation of the amount realized upon the sale of the contracts. Some argue that the full face value of the installment contract should be reported in the year of the transfer. Others maintain that although some back-end payments may be made, they will be *de minimis* and almost never match the remaining balance in the contract after cash advances and fixed percentage collection fees. Yet others insist that the possibility of receiving any back-end distributions is so remote it is almost moot, and the fair market value of the right to receive the back-end distributions is zero.

If the dealership primarily does business with customers having very poor credit and/or there is no historical receipt of back-end distributions, it MAY be reasonable to assign a $0 fair market value to potential back-end payments.

If the dealership does have a history of receiving back-end distributions, these amounts should be determined from the monthly statements received from the finance company. A rolling average or some other type of methodology may be utilized to determine the fair market value of sales occurring in the tax years under examination and for the future.

The amount of back-end distribution recharacterized as unstated interest may also be difficult to determine. The regulation requires this amount to be determined by discounting the back-end distribution at the applicable federal rate from the time the applicable installment contract was sold until the back-end distribution is made. The regulations do not explain how to apply this rule

when the back-end distributions are made on a pool of installment contracts. Similarly, the portion of a back-end distribution that is not unstated interest is a recovery of basis received from the sale of the installment contract. When the back-end distributions are made on a pool of installment contracts, it is not clear to which installment contract the recovered basis should be attributed.

The following facts and circumstances pertinent to each dealer should be considered when determining the value of the right to back-end distribution payments includable in the amount realized on the sale:

1. Has the dealer received any back-end distribution payments?

2. What is the amount of back-end distribution payments received?

3. How long has the dealer been involved in the program with the finance company?

4. Has the dealer capped any pools of contracts?

5. Are the pools collateralized?

6. Has the dealer's involvement in the program with the finance company been terminated?

7. Has the finance company changed the dealer's collection rating since joining the program?

8. What is the historical rate of default for the dealer's customer base?

9. Has the current customer base changed?

10. How does the taxpayer value the right to back-end distribution payments?

11. Have the terms of the servicing agreement between the dealer and the finance company changed?

This list is not all inclusive. The examiner will need to probe further to develop the facts in each case.

Audit Techniques

1. Initial Interview

   At the initial interview, ask the taxpayer if any retail installment agreements for the customer purchases of vehicles are transferred to any unrelated finance companies. The taxpayer may use more than one finance company or switch from one finance company to another. Almost any finance institution may be involved with non-prime or sub-prime paper, including major banks and financing arms of major vehicle manufacturers.

If you interview the accountant or preparer, he/she may not be aware that the dealer is transferring any finance contracts since the audit plan may not include reviewing vehicle jackets or supporting documentation. It is imperative that the dealer is directly asked.

2. Records

   Ask the dealer to provide the vehicle jackets. These jackets are usually an envelope (or sometimes a file folder) for each vehicle, which includes all of the dealer's documentation related to that vehicle such as the sales invoice, purchase invoice, copy of the title, and repair receipts. The outside of the jacket also lists detailed information about the vehicle's purchase and sale, including the dates, amounts, and individuals or companies involved. These jackets also may contain the dealer's records pertaining to the transfer of the installment contract to the finance company.

   Look through the jacket for a retail installment agreement specifying how the customer will pay for the vehicle. Sometimes the retail installment agreement specifically states that it will be transferred to a finance company. In addition, the dealer usually receives a payment voucher from the finance company that shows the customer's name and amount received, and these vouchers may be in the vehicle jacket. The dealer also prepares other paperwork as required by the finance company, copies of which have been kept and retained in the jacket or a separate finance file. This includes the non-prime or sub-prime customer's verification of employment and utility bills to show the home address, the computation of the advance to be received from the finance company, the insurance information form, and the notice of security interest.

   If it is determined that the dealer transferred finance contracts to an unrelated finance company, additional information will need to be requested for each company:

   a. Servicing Agreement – The Servicing Agreement defines the responsibilities of the dealer and the finance company. It provides definitions, explains the advances and how the collections will be applied, and shows how the agreement can be terminated. In addition, if the finance company changes the advance computation or other provisions of the agreement, an addendum or other notification of the changes may be provided to the dealer by the finance company.

   b. Dealer Manual and Other Literature – The dealer Manual may contain various items of information, including a sample of customer paperwork with detailed advance computations. The finance company may also send the dealer literature on new programs or new features such as pool capping.

   c. Monthly Statements – The finance company sends monthly statements to the dealer summarizing advances, collections, fees, and other pertinent information. The summary may also show detail by customer of the last payment date, amount of payment, and if the account was written off as a bad debt.

<u>Example of Accounting Entries</u>

The transfer of the installment contract to the finance company may or may not be recorded in the dealer's books. You should not rely on the presence or absence of accounting entries to determine if the transactions have been reported properly. The following provides representative examples of how you may find the transactions to be reported and how they *should* be reported:

FACTS:

Sales Price	$5,000	Sale Price by Dealer to Purchaser
Cash (Down Payment)	$1,000	Down Payment from Purchaser to Dealer
Accounts Receivable	$4,000	Installment Contract Recorded on Dealer's Books
Cash (advance)	$2,000	Advance to Dealer from Finance Company
Cost of Goods	$2,500	Dealer's Cost of Vehicle Sold
Monthly Payments	$250	Monthly Payment per Contract
Interest Rate	10%	Rate of Interest Charged to Purchaser and by Finance Company to Dealer
FMV of BE Distribution	$450	Potential Max Back-End Distribution of $1200, Actual Distribution of $600 (recharacterized under IRC section 483 as Interest in part)
Section 483 Interest	$150	Estimated IRC section 600 Interest on FMV of BE Distribution

Report as a Loan or an Assignment… ***(What You May Find on the Dealership Books)***

Sales	**$5,000**
COS	**2,500**
Net Profit	**$2,500**

	Account	Debit	Credit
I.	Note Receivable	$4,000	
	Cash (down payment)	$1,000	
	Sale		$5,000
	To record the sale of the vehicle		
II.	Cost of Goods Sold	$2,500	
	Inventory		$2,500
	To record the cost of the vehicle sold		
III.	Cash	$2,000	
	Advance Payable to Finance Company		$2,000
	To record advance received from the finance company		
IV.	Advance Payable to Finance Company	$250	
	Notes Receivable		$250
	To record collections received and applied by the finance company to offset the advance		
V.	Cash	$100	
	Accounts Receivable		$90
	Interest Income		$10
	To record back-end distribution payment from finance company. Amounts and interest rate estimated.		
VI.	Service Fee	$20	
	Accounts Receivable		$20
	To record collections received by finance company applied to the service fee.		

Report as a Loan or an Assignment… ***(How it Should Be Reported)***

		Debit	Credit
I.	Accounts Receivable	$4,000	
	Cash (down payment)	$1,000	
	Sale		$5,000
	To record the sale of the vehicle		
II.	Cost of Goods Sold	$2,500	
	Inventory		$2,500
	To record the cost of the vehicle sold		
III.	Cash	$2,000	
	Advance Payable to Finance Company		$2,000
	To record advance received from the finance company		
IV.	Advance Payable to Finance Company (250 - (17 + 50))	$183	
	Interest Expense (Dealer to Fin. Co.) (2000 x (10% / 12))	$17	
	Collection Fee Expense (250 x 20%)	$50	
	Notes Receivable (250 - 33)		$217
	Interest Income (Dealer held note) (4000 x (10% / 12))		$33
	To record collection of first $250 payment		

Reported correctly, the dealership must include ordinary interest in its taxable income rather than applying all the payments as an offset to notes receivable.

Reported as a Sale… ***(What You May Find on The Dealership Books)***

Gain on Sale of Vehicle (5000-2500)	**$2,500**
Loss of Sale of Contract (4000-2000)	**(2,000)**
Net Profit	**$ 500**

		Debit	Credit
I.	Note Receivable	$4,000	
	Cash (down payment)	$1,000	
	Sale		$5,000
	To record the sale of the vehicle		
II.	Cost of Goods Sold	$2,500	
	Inventory		$2,500
	To record the cost of the vehicle sold		
III.	Bad Debt Expense	$2,000	
	Cash (advance)	$2,000	
	Note Receivable		$4,000
	To record the sale of the finance contract		

Note that instead of assigning value to the right to receive future back-end distributions and interest, a bad debt expense was taken to write off the dealer's remaining basis in the installment contract. This has a significant impact on the net outcome of the transactions, as shown above.

Reported as a Sale… ***(How it Should Be Reported)***

CASH FLOW ANALYSIS

Tax on Profit (Sale of Car) ($2,500 x 30%)	**$750**
Tax on Loss (Sale of Contract) ($1,400 x 30%)	**($420)**

		Debit	Credit
I.	Note Receivable	$4,000	
	Cash (down payment)	$1,000	
	Sale		$5,000
	To record the sale of the vehicle		
II.	Cost of Goods Sold	$2,500	
	Inventory		$2,500
	To record the cost of the vehicle sold		
III.	Cash	$2,000	
	Back-end Distributions Receivable	$450	
	Section 483 Interest Receivable	$150	
	Loss on Sale of Installment Contract	$1,400	
	Note Receivable		$4,000
	To record the sale of the finance contract		
IV.	Cash	$600	
	Back-end Distributions Receivable		$450
	Section 483 Interest Receivable		$150
	To record back-end distribution and interest payments		

Reported properly, the correct loss is $1,400, not $2,000.

Other Issues

1. Enrollment Fee – The dealership may pays a nonrefundable fee to the finance company to join the program. Pursuant to a TAM, this fee is an IRC section 263 capital expenditure and may not be currently deducted 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.

2. Pool Capping Fee – The dealership may pay a nonrefundable fee to the finance company to cap the pools. 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 Section 197 of the Code because it is 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.

3. 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, rather it is deductible based on economic performance. The fee should be deducted as the services are provided by the finance company.

4. Mark to Market – Section 475 of the 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 were determined to be a sale, Section 475 would not apply since the dealer no longer owns the receivable. The IRS Restructuring and Reform Act of 1998 amends Section 475. The mark-to-market accounting rules were not intended to be used by dealers in non-financial goods and services to obtain a loss deduction that otherwise would not be available. Mark-to-market no longer can 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 non-financial goods and services.

5. 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, a Section 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 Section 446. The facts and circumstances of each situation must be considered to determine if a change in method has occurred.

Other Sources of Information

IRC sections 446, 475, 483 and 1001
Hansen v. *Commissioner*
Resale Mobile Homes

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Part 4
Appendices

Appendix A
Initial Interview

NOTE: These are suggested initial interview questions and concepts. They are not to be construed as being totally exhaustive of the subject matter nor would it be productive to ask each question listed here. Their purpose is to serve as a memory jogger to enable the agent to frame the questions necessary for their specific examination. Many of these concepts can be utilized to frame questions on Information Document Requests.

1. How long have you been involved in this business? What are your duties?

2. What is your personal background? (Brief biography including education; training; or special skills.)

3. Who are the officers/general partners in the dealership?

4. Who are the shareholders/partners in the dealership?

5. Please provide an organizational chart, to be retained by the agent, of all entities, business organizations, associations, or individuals related in any degree or manner to the dealership and any officers/shareholders or partners of the same corporation/partnership.

6. Are any of these entities, business organizations, associations, or individuals involved in any degree or interest with any of the following activities:

    a. Insurance Companies

    b. Warranty Companies

    c. Advertising Companies or Associations

    d. Trucking Companies

    e. Wholesale Auto or Parts Sales

    f. Leasing

    g. What dealer associations do you belong to? (Look for political contributions; political action committees.)

7. Financing

   a. How is the corporation/partnership financing the $xxx,xxx loss incurred by the dealership during the year of audit?

   b. Are there any loans made between any related entities, business organizations, associations, or individuals?

   c. Are there any transfers of any assets between any related entities, business organizations, associations, or individuals?

   d. Are there any transactions, (i.e., a lease; management agreements) between any related entities, business organizations, associations, or individuals?

   e. Are there any financing and investment interests entered into between any related entities, business organizations, associations, or individuals?

   f. What does the increase in short term loans represent?

   g. What does long term loans represent?

   h. Do any of the related entities, business organizations, associations, or individuals engage in the financing of consumer purchases of automobiles or any aftermarket product whether it be tangible or intangible? (i.e., Vehicles, Mechanical Breakdown Extended Service Contracts, any form of Credit Life Insurance.)

   i. Could you please provide a list of all bank, financing or investment accounts maintained by all the related entities, business organizations, associations, or individuals?

   j. Do any of the related entities, business organizations, associations, or individuals maintain any foreign bank accounts?

   k. Are any reserve, trust, or annuity accounts maintained by anybody, related or not, for any of the related entities, business organizations, associations, or individuals?

8. Books and Records

   a. Could you please provide a photocopy, to be retained by the agent, of all manufacturers' yearend statements for all related auto dealerships for the year of audit?

   b. Could you please provide access to the Manufacturers' Accounting Manual?

   c. Please provide photocopies, to be retained by the agent, of the following:

      1) Trial Balance

2) Adjusting Journal Entries

3) Tax Classification

4) Chart of Accounts

5) List of Source Codes.

d. Determine the adequacy of internal controls.

e. Determine the accounting system maintenance cycle:

1) Is the General Ledger prepared monthly?

2) Which subsidiary ledgers are maintained? (i.e., AR, Inventory, CDJ, CRJ, etc.)?

9. Assets

a. Did this corporation/partnership acquire any assets during year of audit, other than inventory or other recurring purchases? (i.e., other business, entities, or associations; real estate; exotic autos; boats; planes; club memberships; intangible assets)?

b. Could you please provide a photocopy, to be retained by the agent, of the Fixed Assets schedule for calendar or financial year of audit?

c. What assets do you personally own?

1) House or houses

2) Club Memberships; Sport Franchises

3) Planes; Boats; Exotic Cars

4) Cash; Other Valuables; Intangibles.

d. Do any entities or associations own like kind assets that are made available for your use or that of another officer/partner or significant other participants use?

e. Do any officers/partners or other significant participants own any of the assets described above?

f. How was the franchise agreement treated?

10. LIFO

a. Please provide a photocopy, to be retained by the agent, of all Forms 970 filed by the dealership or any related entity.

b. Have you filed a Form 3115 to avail yourself of the Alternative LIFO Election?

c. What method do you use to compute new car LIFO?

   1) Unit?

   2) Dollar-Value?

      a) External Index (CPI or PPI)?

      b) Internal Index (Double-Extension; Index Method; Link-Chain)?

         (a) If an internal index is used how do you derive that index?

         (b) If actual invoices are used how far back are they retained?

d. How do you value current-year cost?

   1) Earliest Acquisitions?

   2) Latest Acquisitions?

   3) Average Cost?

   4) Other?

e. Which pools do you maintain?

f. How do you treat new items?

g. How do you treat options?

h. Please provide a photocopy, to be retained by the agent, of LIFO reserve computations from the inception of the election.

i. How do you value inventory for financial reporting purposes? (If LIFO on return and FIFO on the B/S, possible termination.)

j. How do you account for dealer holdbacks?

k. Do you receive rebates from anyone? If so, how are these items treated (i.e., tires, cost of sales, banks)?

11. IRC section 263A

a. Is there any off site storage?

b. Who does the purchasing?

c. How are prep costs handled?

d. Please provide to agent a photocopy of the IRC section 263A organizational chart identifying job positions and descriptions.

12. Warranties; Credit Life

a. What type of extended service and credit life contracts do you sell?

b. How do you record sales and expenses? Which accounts are used?

c. Whose contracts do you sell? Are you a principal or do you sell as an agent?

d. Is the extended service contract between you and the customer or between the customer and another entity? If another entity, who?

e. Are any related entities, business organizations, associations, or individuals involved in any manner or degree with a captive insurance company?

f. Are any related entities, business organizations, associations, or individuals involved in any manner or degree with any offshore insurance company?

g. Are any related entities, business organizations, associations, or individuals involved in any manner or degree with any reinsurance agreements?

h. Does any related entity, business organization, association, or individual have any involvement in any manner or degree with any retrospective arrangement?

i. Does any related entity, business organization, association, or individual have any involvement in any manner or degree with any administrator in regard to the sale of any extended service or credit life contract?

j. Does any related entity, business organization, association, or individual have any involvement in any manner or degree with any reserve, trust, or annuity account in regard to the sale of any extended service or credit life contract?

k. Does any unrelated party or person hold any reserve, trust, or annuity on behalf of any

related entity, business organization, association, or individual in regard to the sale of any extended service or credit life contract?

l. Did you file any Forms 3115 to elect the Service Warranty Income Method (SWIM)?

m. Did the corporation/partnership, any related entity, business organization, association, or individual file a Form 1120-L or Form 1120-PC?

n. Please provide a copy of all contracts related to all extended service contract plans.

13. Advertising

a. What type of advertising do you do?

b. Do you belong to an advertising co-op, pool, or association?

c. Does this co-op, pool, or association file a tax return?

d. Do any funds revert to officers, shareholders or partners or related parties?

e. Who determines the per car advertising amount for the co-op, pool, or association? Is participation mandatory or voluntary?

14. Demonstrator vehicles (Since 1989), need IRC section 274(d) substantiation.

a. Do you have demonstrator vehicles available for use by any officer, shareholder, partner, relative of these same or any employees? If yes, provide a list of individuals who have demonstrators and their relationship to the dealership.

b. Do you maintain agreements for such use? Provide copies.

c. Sample the substantiation.

15. Items to request or remember

a. Get copies of all related returns affecting all years of examination.

b. Is the current year dealership return filed?

c. What Federal returns is the dealership responsible for? Are these returns filed? Excise Tax, 720? Small casualty or life, Form 1120-L or Form 1120-PC?

d. Ask for copies of Forms 940, 941, W-2, 1099 and the appropriate state tax returns, i.e. California's Form DE-3. (Determine how shareholder is compensated.)

e. Corporate minutes; by-laws.

f. Employee Benefits

1) Form 5500?

2) Determination letter?

3) Payment?

g. Rent: Related parties? Disguised dividends?

h. Forms 8300

1) Did you receive any payments over $10,000, as defined for purpose of compliance with the requirements of Form 8300, for the years in question?

2) Did you file all necessary Forms 8300?

3) Are you aware of the definition of cash? (Cash, traveler's checks, cashier's checks. "Any monetary instrument whether or not in bearer form." Form 8300 instructions.)

i. Prior audits; individuals; entities? Get copies of relevant correspondence, RARs, etc .

j. Copies of all Forms 3115 filed by the dealerships or any related entity.

16. Additional questions to cover the following areas and associated issues should be developed where appropriate:

a. LIFO conformity (manufacturer statements, creditors, owners)

b. Extent and degree of LIFO comparability (coordinated issue)

c. IRC section 263A organizational chart identifying job positions and descriptions

d. Write downs (accuracy and validity per Treas. Reg. sections 1.471 et. al., *Thor Power*, Rev. Rul. 67-107)

e. Existence and economic substance of intangibles, e.g. Covenant not to compete

f. Existence and sale of receivables to a related finance company

g. Existence and flow of funds to a producer-owned reinsurance company (does not have to be offshore)

h. Types and tax treatment of all sales transactions (deferrals, liabilities)

i. Sources of other income (commissions, referrals, money held back, rebates, warranty, etc.)

j. Existence of reserves (not limited to extended service contracts or credit insurance) in varying forms (self-insured, escrow and trust accounts, finance, etc.)

k. Treatment of lease capital cost reduction payments

l. Employment tax treatment of salesperson incentive programs established by the manufacturer

m. Economic performance of advertising expenses and accrual of rebates

n. An understanding of all insurance and financing arrangements and any money received as a result of these arrangements

o. An understanding of all related party and entity transactions and arrangements resulting in deferrals, losses, at less than arm's length sales, loans, diverted funds, etc.

p. Did the taxpayer file any Form(s) 3115 to change any method of accounting?

Appendix B
Balance Sheet Section – Examination Specifics

Below are Balance Sheet items related to the auto industry.

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

1. Cash

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

What's a Contract in Transit?

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). When the financing institution "makes the loan," proceeds are forwarded to the dealer who then acts on the note executed by the buyer and subsequently an entry is made:

DR Cash in Bank
    CR Contracts in Transit

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

These sources 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 company transfers.

c. Reviewing Adjusting Journal Entries, standard entries, and Journal Vouchers affecting the cash accounts.

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
- Other
  - -- Driver education receivables (paid by Mfg.)
  - -- Manufacturer rebates (paid by Mfg.)
  - -- Other claims

a. Sales

Only a portion of these receivables actually deal with vehicle sales. 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. This could be a potential flag as the obvious question comes to mind: Why wasn't this financed by a bank? If the bank wouldn't take it, why should the dealer who has far less collectibles power? 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.

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. Some dealerships report income when a payment is received instead of when it is earned in accordance with the note which may lead to a timing adjustment.

The terms of the note must be reasonable. The note should call for full payback to occur evenly within a 1 to 5 year window. There may be issues 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).

c. Note Transfers

It would be prudent for the examiner to scrutinize any trend of dispositions of notes, either gains or losses, as related or unreported transactions could be occurring.

In the event that 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 auto buyer defaults the bank CAN NOT look to the dealer for payment. Notes sold "without recourse" are discounted to a significant degree.

A note sold "with recourse" means that if the auto buyer 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. 77 sets forth conditions, all of which must be met, in order for the transferor to record a sale. These include: the transferor’s surrender of control of the economic benefits associated with the receivables; the transferor’s ability to make a reasonable estimate of its obligations to the transferee under the recourse provisions; and the transferee’s inability to require the transferor to repurchase the receivables, except in accordance with the recourse provisions.

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 note is signed by the customer.

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). 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 section in Chapter 19.

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 Reserve Holdbacks

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 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 them [dealers] to finance companies, which 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.

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. Parts and Accessories
d. IRC section 263A
e. LIFO reserve
f. Demonstrators
g. Body shop materials
h. Sublet repairs
i. 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 workpapers on the 263A allocation, and the used vehicle valuation sheets.

a. New Vehicles
Many dealerships use LIFO to value new car and truck inventories. LIFO was previously discussed in a separate section due to its complexity.

b. Used Vehicles
The auditor should verify that any used vehicle valuations are not arbitrary or incorrectly computed. Used vehicles are usually kept separate from new vehicles, both physically and in the books. They are most commonly accounted for using Lower of Cost or Market (LCM).

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. 52 (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.

Official valuation guides may be consulted to determine the inventory valuation and any overallowance should be adjusted through cost of sales at the time of trade-in. Reconditioning expenses are inventorial and added to the cost of the applicable vehicle.

Rev. Rul. 67-107 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.

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 in order. Yearend write downs are subject to compliance with Treas. Reg. sections 1.471-2 and 1.471-4 and the *Thor Power Tool* case.

4. Loans to and from Shareholders

The corporate balance sheet should be reviewed for the existence of loan accounts either to or from the shareholder. However, no entry on the balance sheet for shareholder loan accounts 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 examiner 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 examiner should request copies of the loan documents. If loan documents exist, they will show the terms which the examiner can then validate. If loan documents are not available, the examiner 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 examiner must inspect the payables accounts for a possible deduction of the interest owed which the shareholder which has not been paid. IRC section 267(a)(2) states the corporation and the shareholder (who hold 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 but 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)(4) 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 retransferred 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:

1) The foregone interest is characterized as additional compensation to the employee.

2) The corporation has deemed interest income in a like amount.

3) 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.

4) After the 1990 year, the employee will only be allowed a deduction for the interest deemed paid to the corporation if the employee can demonstrate the expense is not a personal expense.

When a below-market interest rate loan is made between otherwise related entities, or a shareholder makes a loan to his or her corporation, the adjustments resulting after imputing the interest are:

1) The shareholder receives interest income in the amount of the foregone interest.

2) The corporation has deemed interest expense in a like amount.

3) The foregone interest will treated as a capital contribution by the shareholder. See Treas. Reg. section 1.7872-4(d) (Proposed).

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.

b. Thin Capitalization

Upon reviewing the loans from shareholder and the common stock accounts, a thin capitalization issue may exist. Thin capitalization may be at issue where there is little or no common stock and there is a large loan from the shareholder. IRC section 385 was enacted for the purposes of determining whether an interest in a corporation is to be treated as stock or indebtedness. Under this code section, there are five factors which need to be considered. In addition, the agent should consider relevant court cases.

The objective concerning a thin capitalization issue is to convert a portion, if not all, of the loans from the shareholder to capital stock. By performing this conversion, an adjustment to the interest expense will be necessary because the loans at this point will be considered non existent. The interest paid by the corporation, which has been disallowed by the examiner, will now be classified as a dividend at the shareholder level to the extent of earnings and profits.

The courts have not always supported the government's pursuit of this issue as shown in *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694 (3d Cir. 1968). This opinion considered equity to be high risk. Monies loaned are considered low risk. Thus, to loan money to one's corporation is in effect limiting their risk because equity is only allowed a capital loss, but loans can be afforded the benefit of being classified as ordinary losses under IRC section 166. In addition, the court stated a shareholder would not loan their corporation money at extraordinary rates because this would be self-defeating as it would damage their own corporation.

If this issue is present the adjustments would be:

1) Increase to the common stock account.

2) Decrease to the loans from shareholder account.

3) Disallowance of a portion of the interest expense.

4) Reclassification of the interest income at the shareholder level to a constructive dividend.

5) The repayment of debt would be recharacterized as a redemption of stock and may be a dividend.

5. Building and Equipment

In an auto dealership, it is common for the dealership to rent the land and building from a related entity. Where this occurs, building and equipment will not be one of the larger balance

sheet accounts. The main issue should be the arms length nature of the rent paid by the dealership to the related entity for the property. The examiner may wish to determine Fair Rental Value to disallow excessive rent and expand on a constructive dividend issue.

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

a. Large, unusual, or questionable items

b. Like kind exchanges

c. Potentially personal items

d. "Imaging Payments"

   1) 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, *aff'g* 55 T.C. 729, the court ruled that the payment was includable in income.

6. Accounts Payable, Other Current Liabilities and Other Liabilities

   When auditing a payable account, the examiner 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.

   When auditing the liability accounts, the following steps are recommended:

   a. Have the taxpayer search for unrecorded liabilities by reviewing the Cash Disbursements Journal for disbursements after the yearend.

   b. Review unpaid liabilities after the close of the taxable year.

   c. Review balances due to officer's and shareholder's; ascertain business purpose, trace to the

corporate minutes if material.

d. Look for liability amounts owed to other related entities.

Auto industry specifics:

a. 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.

b. 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.

c. Transfer of funds. Items 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

Due to the nature of dealerships, it is recommended that the capital accounts of all entities be looked at. Auto dealerships tend to be family ventures that may pass from generation to generation and may expand to incorporate more and more dealerships in different areas. The economic reality analysis for capital is useful as it gives a full picture of who owns what and how much. Possible issue areas include the transfer of ownership from one family member to another. These transfers should be examined to ensure that there is no unreported gift tax or capital gain tax.

Flow through entities should be analyzed with their related Forms 1040 to determine that Forms K-1 match ownership percentages and that 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.

Appendix C
Definition of an Item Coordinated Issue

INDUSTRY SPECIALIZATION PROGRAM

MOTOR VEHICLE INDUSTRY

COORDINATED ISSUE

July, 1989

DOLLAR-VALUE LIFO

DEFINITION OF AN ITEM

ISSUE

Whether an item, 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.

FACTS

Motor vehicles are manufactured with a wide variety of makes, models, body styles, colors and options. These factors are specified on the order prepared for each vehicle by a consumer, a dealer, a distributor, or the manufacturer. Additionally, each vehicle is designated as to its model year.

Manufacturers have traditionally made annual changes to vehicles to enhance their marketability and to meet Federal and State requirements. These include interior and exterior trim, minor exterior body parts, major structural design and styling, drive train, and body family, or platform as it is called in the industry. These changes may or may not be directly reflected in the price of the vehicle. Trim changes usually occur every year and include the interior trim, exterior bumpers, paint, and front and rear styling. Minor changes to exterior body parts occur every 2 to 3 years and include fenders, hood, and trunk lid, but, not to any body structural part. A major change to structural design and styling may occur every 4 years and includes distinctive changes to exterior body parts which may change the dimensions of the vehicle, but not the drivetrain. Changes to the drivetrain occur every 2 to 3 years and include engine displacement, type of engine, transmission, and drive wheels. The change to the body family or platform occurs when an entirely new vehicle is designed and involves a design of most of the parts of a vehicle. The new vehicle may take over the name of a previous model or be given a new name. For 1988, there were 42 body families for domestic passenger cars, that included 254 different models. There were also 337 models of import passenger cars sold in the U.S.A.

Usually, manufacturers change the price of vehicles when the model year changes, and occasionally during a model year. These changes may include the base price, the price of the options, the options that are included in the base price, the warranty provisions and the sales incentives that are offered to the distributors, dealers, or consumers.

Most taxpayers in the motor vehicle industry file tax returns on a calendar year basis. The model year for the industry, however, generally changes on October 1. Consequently, the majority of vehicles on hand at the end of a taxable year are 1 model year newer than those on hand at the end of the previous taxable year. In order to encourage the sales of vehicles that are on hand when the model year changes, manufacturers normally give a cash rebate to the distributors and dealers for each prior model on hand. Since this allowance is a reduction to the cost of the vehicle, it is possible that a taxpayer may have on hand at the end of 1 taxable year, a vehicle whose cost, after deducting the allowance, is less than the cost of a vehicle of the same model year that was comparably equipped and on hand at the end of the preceding taxable year.

LAW

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. Whether or not a Ford had either of these features was determined by the manufacturer. Their cost was never separately stated on the dealer’s invoice. The court decided the entire car was the item and not the individual components or parts.

DISCUSSION

Throughout this discussion it is assumed that any vehicle being discussed is not a new item. Whether a vehicle is a new item will be a separate coordinated issue.

The LIFO regulations were written under the assumption that every taxpayer can determine what "items" are in inventory at the end of a taxable year, and that a comparable "item" was in inventory at the end of the base-year, or the preceding year for taxpayers using link-chain. The regulations state that no adjustments are to be made to the cost of an "item" if the "item" is on hand at the end of the base-year, or the preceding year if the taxpayer has elected link-chain. When the list of optional equipment for cars is combined with the more than 600 different passenger car model, there is a tremendous number of differently equipped cars that could be on hand at the end of the year. Additionally, yearly changes are made to body style, standard equipment, options, rebates, warranties, features, and other factors. These differences and changes must be considered in making LIFO computations to avoid gross distortions. The cost of

two cars of the same model can vary by thousands of dollars depending on how they are equipped.

The tax court decided in *Wendle Ford* that the "item" to double-extend is the entire car as it comes from the factory, and that minor differences from one year to the next did not cause cars to be different "items." While the court did not specifically address the issue of factory-installed options, it appears that it is reasonable to conclude that the cost of factory-installed options are to be included in the cost of the "item" being double-extended.

Finally, there is no case law on whether to compare the cost of a current model with a current model of the preceding or base-year, or whether to compare the cost of a prior-year model on hand with the same model in the preceding year. For example, a taxpayer on December 31, 1988, may have on hand a 1988 model car whose inventory cost has been reduced by a manufacturer's allowance, as well as a 1989 model of the same car whose cost has not been reduced by an allowance. Similarly, the taxpayer on December 31, 1987, may have had on hand a 1988 model not reduced by a manufacturer's allowance and a 1987 model whose inventory cost has been reduced by an allowance. Should the cost of the 1988 model on hand on December 31, 1988, (which has been reduced by a manufacturer's rebate because it is a prior-year model) be compared with the cost of a 1988 model car on hand on December 31, 1987, comparably equipped (which has not been reduced in cost by manufacturer's rebate), or should the 1989 model be compared with a similar 1988 model? The intent of the LIFO regulations would require the cost of the 1989 model to be compared with a 1988 model, both being current models at the end of each year.

CONCLUSION

While it may not be possible to compare all the aspects of vehicles on hand at the end of 2 different taxable years because of 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 percentage of the base vehicle cost.

An example follows:

The standard equipment on the 1987 and 1988 Buick Electra Estate Wagons is the same except for the following:

1. A 6-way power driver's seat was an option on the 1987 model that cost the dealer $179 but was standard on the 1988 model.

2. Third seat was an option on the 1987 model that cost the dealer $187, but, was standard on the 1988 model.

The dealer cost for the 1987 model, including destination charge but with no optional equipment, was $15,773. The 1988 cost was $16,837. The 1987 cost should be increased to $16,139 for the cost of the items that were made standard in 1988 ($15,773 + $179 + $187 = $16,139).

Appendix D
An Analysis of the *Wright* Case

No discussion of the dealer owned offshore reinsurance company would be complete without an analysis of the *William Wright and Lynne L. Wright* v. *Commissioner* case, Docket Nos. 18407-90, 27968-90, 26402-91. T.C. Memo. 1993-328, CCH 49,174(M), amended by order dated October 29, 1993, 67 TCM (CCH) 3095 (1993).

Wright is the first case that addressed the concept of dealer owned reinsurance companies. Previously, the concept was addressed through case law in a piece meal approach. Even if the case may be distinguishable from what your dealer entered into, the transaction analysis contained within this case should be considered whenever the revenue agent finds a similar issue. The court sided with the IRS.

The overriding issue concerned allocation of income. Specifically, should income of a closely held offshore small life reinsurance company be allocated to the (sole) controlling shareholder? The subsidiary issues concerned allocation of annuity interest, reasonable compensation, estimated warranty expense, and penalties.

Dealer (D) owned multiple automobile dealerships (DLRS). (D) was an active participant in the management of (DLRS). (DLRS) sold single premium credit life and credit (accident and health) disability insurance in connection with loans extended by (DLRS). (CBL) was the direct insurer.

(DLRS) also sold extended warranty service contracts administered by various entities. (DLRS) retained the amount paid by the consumer over the amount required to be forwarded to the administrator (ADM). The price paid to (ADM) was fixed. The price paid by the consumer was subject to negotiation.

During 1983, (D) decided to enter into reinsurance agreements. It was brought out during trial that (D)'s reasoning for involvement with these schemes was to avoid tax and to create a liquid fund which he could use to "retire" on. (D) used (M) as his reinsurance promoter. (D) nor (M) had formal training or experience in the areas of insurance or reinsurance. (M) represented to (D) that "minimizing or deferring the tax event is the cornerstone of his operational plan." (M) recommended that (D) incorporate a small casualty company (FIR) in the Turks and Caicos Islands. Being offshore would allow (FIR) to escape state regulation and capital requirements. (M) also recommended that (FIR) become authorized to do business in the state of Nevada to avoid state corporate income taxes.

(D) was advised by his retained C.P.A. and attorney, who indicated a lack of expertise in these areas, to obtain a formal tax opinion from a "Big 8" firm to ratify or deny the validity of and tax consequences surrounding these contemplated reinsurance agreements. (D) declined and went forward.

(CBL) was involved in the credit life reinsurance plans because it desired to retain its volume of business with (D).

(FIR)'s capital contribution was a $1,000 receivable from (D).

(M) set up (FIR) in an "office" that was no more than a prop. (FIR)'s actual presence in Nevada was nonexistent.

The reinsurance agreements structured for (D)'s benefit by (M) allowed (D) to "avoid tax and prepare for his retirement" in three distinct areas:

1. Credit Life Contracts

   (M) had reinsurance agreements drawn up between (CBL) and (L). (L) was a company controlled by (M). Then (M) had a reinsurance agreement drawn up between (L) and (FIR). Each agreement provided for payment to the reinsurer of 100 percent of the premiums. Modifications to this arrangement needed to be in writing.

   A reinsurer assumes the risk of the ceding company who gives up the risk. This principle applies to the case as follows:

   Agreement [1] - Contract between (CBL) and (L)

   (CBL) cedes (gives up risk) to (L)
   (L) re-insures (assumes risk) of (CBL)

   Agreement [2] - Contract between (L) and (FIR)

   (L) cedes (gives up risk) to (FIR)
   (FIR) re-insures (assumes risk) of (L)

   (CBL) charged (L) a ceding fee of 10 percent for reinsuring (CBL)'s original business. (L) charged (FIR) a total fee of 11 percent, retaining 1 percent on the (L) and (FIR) reinsurance agreement. (L) also received a 10 percent "float" because (CBL) ceded monthly to (L), whereas (L) ceded to (FIR) quarterly.

   State law required (CBL) to hold reserves for payments of future claims. Under the agreements, (CBL) required (L) to maintain reserves on deposit. (L) required (FIR) to maintain reserves on deposit. The reserve requirements were "met" through a $500,000 letter of credit from (DLRS). Per statements of (D), (DLRS) had no connection with (FIR).

   (FIR) deducted from income, reserves required by (L). (D) expressed a goal to establish "reserves in an amount necessary to cover the projected income of (FIR)." (M) intervened on (D)'s behalf.

   (M) had no prior training or expertise to compute the separate reserves needed for both credit life and credit disability. (M) erroneously overstated the reserves for both. The effect of these erroneous computations was a negative surplus (i.e., (FIR) owes more than it is worth) and understated (FIR) income.

(D) also moved (DLRS) income to be under reported by arranging with (CBL) to pay (DLRS) less than the maximum amount for commissions. This reduction increased the net premium to (CBL), increased the premium ceded to (L), and ultimately, increased the portion ceded to (FIR). (DLRS) deduction was overstated. The increased (FIR) income was already "protected" against taxation by erroneously overstated expenses.

2. Service Contracts

(D) diverted monies to (FIR) that should have been reported as income by (DLRS) through "over-submits" to the service contract administrator (ADM). (D) would pay to (ADM) an amount in excess of (DLRS) cost of the contract. (D) had exclusive control over where these excess payments, "over-submits," were sent. Checks equal to the amount of these "over-submits" were forwarded by (ADM) to (D). These amounts were then deposited to the (FIR) bank account, over which (D) had exclusive control. (FIR) did nothing to earn these monies.

(DLRS) under reported its income by taking an inflated expense for the"over-submits." The amounts includable in (FIR) income were "protected" against taxation by erroneously overstated reserves.

Personal commissions of (DLRS) employees were decreased, because cost, including the "over-submit" amounts, were subtracted from the consumer price to arrive at commissions.

3. Annuities

In later years, service contracts sold by (DLRS) were administered by (N). Under this program (DLRS) would have no continuing liability on service contract claims. The remittance by (D) to (N) was spread as follows:

(N) retained a portion as an administrative fee. A portion is used to purchase stop-loss insurance for potential consumer claims from licensed insurance companies. Another portion is used to invest in an annuity. The amount deposited in the annuity was intended to be equal to anticipated consumer claims based on actuarial studies conducted by (N).

Under terms of the annuity, funds functioned as a reserve out of which consumer service contract claims were paid.

(N) filed bankruptcy. The receiver found the true owner of the annuities was (DLRS).

(D) wanted to ensure the success of his retirement plan. The goal is to build up a large principal and have the interest pay the consumer claims. The plan is successful if all outstanding claims over the life of the individual service contracts can be paid without touching the principal. Upon termination of the last service contract (D) would have been able to appropriate the principal to his own use without inclusion in income.

The court laid out a simple, but potent rule as the governing principle in this case: Money diverted to a sham is taxable to the true owner.

The court held that the corporate form of (FIR) should be disregarded and the income of (FIR) should be deemed received by (D).

The court felt (D) was engaged in sham transactions. The court cited several factors concluding the transactions lacked economic substance:

a. Reduction of Commissions - This served no normal business purpose. The activity wrongfully reduced (DLRS) taxable income and improperly allocated income to (FIR).

b. "Over-submits" - (D) knew (FIR) did nothing to earn this income. (D) knew this arrangement was risky for tax purposes. The court felt (D) knew these overpayments constituted a large portion of the "principal" for his retirement plan, and as constituted, over inflated (DLRS) expenses; wrongfully allocating income to (FIR).

c. The insurance contracts do not demonstrate any risk shifting or distribution. The court felt the agreements constituted a captive insurance arrangement. The dealership who took out the $500,000 letter of credit makes that related corporation, not the offshore reinsurance company, at risk in the insurance arrangement. There is no unrelated business.

d. The carelessness in which (FIR) was formed denotes a sham insurance relationship. The court specifically cited, among other factors; organizing offshore to escape regulation, lack of capitalization, the erroneous and undocumented computation of reserves shows a disregard for standard insurance practices. Additionally, modifications were not entered into, and the $500,000 letter of credit from (DLR) to establish mandated "reserves" were cited.

e. The court did not address the issue of constructive dividends because all income was allocated to (D).

The court felt the interest earned by the annuities was taxable to (D). There was no risk shifting involved. The intent of the arrangement was to use the annuity interest to pay claims and to forward the principal to (D) upon termination of all service contracts. The annuities, in essence, were self-insurance reserves and the evidence shows they were owned by (D).

4. Reasonable Compensation

Concerning the reasonable compensation question, the issue was basically one of compensation versus dividend. The court sustained the government's disallowance of (D)'s compensation as an expense stating (D) did not establish his formula for determining compensation was valid.

The court did not allow (D)'s claim for estimated warranty expense for subsequent years because he did not establish that he was entitled to it. The only offer of proof was a completed income tax return.

The court sustained the negligence, fraud, and substantial understatement penalties as they applied to the reallocation of income.

Whenever a revenue agent encounters a PORC they should review the *Wright* case which held: income wrongfully diverted to an offshore reinsurance company is allocated to the (sole) controlling shareholder where he engages in sham transactions, and the corporate form of the offshore company is disregarded.

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Appendix E
Glossary

The following terms have been used in the Audit Techniques Guide and are defined in a summarized format. Some are terminology/jargon and are well known in the Auto Dealership Industry or Service.

13TH MONTH JOURNAL ENTRIES: Correction of errors and adjustments to yearend account balances typically are made at the end of the fiscal year and prior to the preparation of the Trial Balance. These 13th Month entries are prevalent in the auto industry and are usually identifiable by a unique source code on the General Ledger.

AGENT: An agent is one who represents and acts for another, whose function is to bring about, accept performance of, or terminate contractual obligations between a principal and third persons.

BASE MODEL CODE NUMBER: Identifies an item of inventory which is determined by using the entire manufacturer's base model code number that represents the most detailed description of the base vehicle's characteristics under the Alternative LIFO.

BASE VEHICLE COST: The cost of a vehicle for Alternative LIFO Method computations that is not adjusted for any options, accessories or other costs. The pool index computed from only the base vehicle cost of vehicles is applied to the total vehicle cost, including options, accessories and other costs of all vehicles in the pool at the end of the taxable year.

BASE-YEAR: The year in which LIFO was adopted for a pool.

BASE-YEAR COST: The aggregate of the cost of all items in a inventory pool, determined as of the beginning of the taxable year for which the LIFO method is first adopted using the current-year quantity. The base-year cost of an item is the cost at the beginning of the base-year valued at its average cost. For items entering a pool for the first time, their base-year cost is either the current-year cost of the item or its reconstructed cost at an earlier date.

BEGINNING-OF-YEAR COSTS (BOYC): Using LIFO, the costs of inventory items at the beginning of the year.

BUSINESS PLAN: In the context of a Producer Owned Reinsurance Company, a plan usually prepared by a professional outside the auto dealership setting forth domicile, capitalization, and types of insurance subject to reinsurance.

CAR JACKET: A separate folder for each new vehicle sold which contains documentation pertaining to this particular transaction.

COMPARABILITY: The basic concept of LIFO required by the regulations for computing an index for items in a LIFO pool. This is the foundation of any LIFO computation.

CPI-CONSUMER PRICE INDEX: A measure of change in consumer prices (inflation) as determined by a monthly survey conducted by the Bureau of Labor Statistics.

CUMULATIVE INDEX: In the LIFO "Link Chain Method," the product of all annual indices dating back to the year of election. It is used to restate current-year cost to base year costs. This index is also used to value increments of base-year cost.

CURRENT YEAR COST (CYC): Total current-year cost of items, using LIFO, may be determined in one of four ways:

1. by referring to the actual cost of the items most recently purchased;

2. by referring to the actual cost of the items purchased during the taxable year in the order of acquisition;

3. by the application of an average unit cost equal to the aggregate cost of all goods purchased during the taxable year;

4. any other proper method which clearly reflects income.

CUT-OFF METHOD: A method of changing a method of accounting on a prospective basis without an adjustment under IRC section 481(a). In the context of Alternative LIFO, there is no change to prior LIFO indices or layers.

DECREMENT: A decrease in a LIFO pool for a year when the end of the year quantity of the pool at base-year cost is less than the beginning of the year quantity of the pool at base-year cost.

DOLLAR VALUE METHOD: The dollar-value method of valuing LIFO inventories is a method of determining costs by using base-year costs expressed in terms of total dollars rather than using the quantity and price of specific goods as the unit of measurement.

DOUBLE EXTENSION METHOD: A method of computing the LIFO value of a dollar value pool. Under this 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 cost.

EARLIEST ACQUISITIONS: This is one of three methods specifically mentioned under dollar-value LIFO to determine the current-year cost of the ending quantity of inventory. This method involves repricing all of the items on hand at the end of the year at the earliest price paid for the item.

EXPRESSED WARRANTY: Specifically stated in contract, controlled by conditions attached to it.

EXTERNAL METHOD: A method of computing a dollar-value LIFO index where the indices are generated by information taken from any source other than the taxpayer data.

FIFO: An inventory cost flow assumption where, regardless of the actual physical flow of goods, the earliest inventory costs of the period are treated as having been sold first and the latest inventory costs are those remaining in ending inventory. It may be used when "* * * Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices * * *" See Treas. Reg. section 1.471-2(d).

FINANCIAL STATUS ANALYSIS: A determination of whether what is represented on tax returns as true actually has economic merit and substance.

FLOORING STATEMENT: Statement issued by lending institutions reflecting amount of credit extended to a particular dealership for vehicle purchases. Other information, such as identification of specific vehicles being financed, can also be found on these statements.

IMPLIED WARRANTY: A warranty "implied" in law. Usually it involves a warranty of merchantability and fitness for a particular purpose.

INCREMENT: An increase in a LIFO pool for a year when the end of the year quantity of the items at base-year costs exceeds the prior year's quantity at base-year costs.

INDEX: A statistical composite that measures changes in the economy or in financial markets, often expressed in percentage changes from a base-year or from the previous month.

INDEX METHOD: Under the LIFO index method an inventory price index is computed with reference to the consumer or producer price indices for specific categories of inventory items published by the Bureau of Labor Statistics, or an alternative pricing method to the double-extension method where a taxpayer computes a price index by double extending a representative portion of the inventory.

INTERNAL METHOD: A method of computing a dollar-value index where the indices are generated by information derived and maintained by the dealership.

INVENTORY PRICE INDEX (IPI): A measure of change in government indexes for eligible small businesses, particularly, non-department store retailers. Beginning in 1981, the Service allowed certain taxpayers to adopt indexes issued by the Bureau of Labor Statistics in calculating their LIFO inventories. However, the measure of inflation for LIFO purposes is limited to 80 percent of the relevant BLS index. This is also known as the simplified dollar value LIFO method.

JOURNAL SOURCES: Traditional books are journalized by auto dealerships into, sometimes, several sub-journals. Using source codes, particular transactions and the particular source book to which it was journalized, can be identified.

JOURNAL VOUCHER STANDARD ENTRIES: Journal entries which are normally made on a monthly basis for adjustment or correction purposes.

LATEST ACQUISITIONS: This is one of three methods specifically mentioned under dollar-value LIFO to determine the current-year cost of the ending quantity of inventory. This

method involves repricing all of the items on hand at the end of the year at the most recent price paid for the item.

LEMON LAWS: The term given to state regulations which control durable good sales in order to protect the consumer.

LIFO: An inventory cost flow assumption, where regardless of the actual physical flow of goods, the most recent inventory costs of the period are treated as having been sold first and the earliest inventory costs are those remaining in ending inventory.

LIFO INDEX: A measure of inflation that has occurred for the taxable year.

LIFO RESERVE: A tax deferral resulting from the difference between the LIFO and non-LIFO values of an inventory.

LINK CHAIN METHOD: An alternative LIFO pricing method where all of the items in a pool are priced at their current-year cost, restated in terms of the prior year's cost, and indexed back to the base year through the use of a cumulative price index.

LIQUIDATION: A liquidation of a LIFO pool occurs when the pool has a decrement.

LOWER OF COST OR MARKET (LCM): Method of valuing inventory.

MANUFACTURER'S STATEMENT: A financial report issued to the manufacturer on a monthly basis, reflecting all business activities. In some instances, a 13th month report will be prepared, in order to take into consideration all closing entries for the year. These statements are standardized per the factory manual and should be reconciled to tax returns.

MOST RECENT PURCHASES: This is one of the three methods specifically mentioned under dollar-value LIFO to determine the current-year cost of the ending quantity of inventory. This method involves repricing all of the items on hand at the end of the year at the most recent price paid for the item.

NADA: The National Automobile Dealers Association. Is an organization whose purpose is to serve as a network catalyst of information which is disseminated to member dealers and as an advocate in Washington for dealership interests.

NEW ITEM CATEGORY: A new item category as defined for Alternative LIFO, is an item category not considered in existence in the prior taxable year, is one of the following (i) any new or reassigned manufacturer's model code, as described in IRM section 4.02(3), that is caused by a change in an existing vehicle or (ii) a manufacturers model code, as described in IRM section 4.02(3), created or reassigned because the classified vehicle did not previously exist. 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 track width or wheel base, whether or not the same model name was previously used by the manufacturer's, a new item category is created. New items are found in all LIFO computations, not just in Alternative LIFO.

PLATFORM: A vehicle platform is the main structural element or backbone of a vehicle to which the suspension, powertrain and body are mounted. In older vehicles, it was traditionally the frame. In newer unibody vehicles, it is the lower, horizontal sheet metal stamping.

POOLING: A central point of LIFO valuation. The dollar value method allows for a combination of like kind items into a group where inflation is computed on these items.

PRODUCER PRICE INDEX (PPI): A measure of change in wholesale prices (formerly called the wholesale price index), as released monthly by the U.S. Bureau of Labor Statistics.

PRICE GUIDE: A compilation of vehicle models, standard and optional equipment, and current year prices.

PRINCIPAL: The obligor of a contract who assumes the risk of the transaction and derives compensation from the profit built into the product sold. As it relates to a dealership, the term is most commonly used in an analysis of a vehicle service contract.

PROFIT CENTER COSTING: Or Activity Based Costing (ABC), is the practice employed by taxpayers where operational departments of the business are maintained in order to determine the profitability of the overall concern as a function of the profitability of each department.

REPORT OF SALES BOOK: A record kept by auto dealerships of all sales made and reported to the Department of Motor Vehicles, as required by state law. For example, in California, all sales must be reported within 5 days of sale in order for the vehicles to be registered.

RESTATEMENT (rebasing): The revaluation of all of the LIFO layers remaining as of the beginning of the year of a change, as required under IRC section 263A and Rev. Proc. 97-36.

RETAIL METHOD: An inventory valuation method designed to allow a retailer to take physical inventory at retail selling prices and then deduct an amount determined to reflect gross profit. The retail LIFO method is an adaptation of the dollar-value LIFO method, using retail sales values in addition to cost in recording inventory input and output, and can be combined with the use of government prices indexes published by the Bureau of Labor Statistics.

SELF-INSURANCE: A method where by one pays monies into a reserve created by the payor.

WARRANTY OF FITNESS FOR A PARTICULAR PURPOSE: Product represented by seller to function in a specific manner for a particular purpose. The product must meet that standard.

WARRANTY OF MERCHANTABILITY: The product is made in a manner considered proper for that type of good. "Lemon Laws" originate with this type of warranty.

YEAR OF CHANGE: It is the taxable year in which a change in method of accounting is made.