Driven

NADA MANAGEMENT SERIES L32

A DEALER GUIDE TO

Federal Tax Issues

NADA NATIONAL AUTOMOBILE DEALERS ASSOCIATION

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A DEALER GUIDE TO

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INTRODUCTION

Franchised new-car and -truck dealers are subject to significant governmental regulation at all levels, and nowhere is this more evident than in the large body of rules and requirements contained in the Internal Revenue Code and Department of the Treasury regulations.

This guide attempts to familiarize dealers with many of the federal tax issues and considerations that confront their businesses. It introduces the issues without providing comprehensive analysis, which would require a much more lengthy publication. This guide revises NADA's former guide of the same name and is updated as of the date of this publication. Any thresholds noted in the guide apply to the year indicated. It is imperative that dealers consult their tax advisors on the thresholds applicable to earlier or subsequent years.

The treatment of the issues in this guide is based on the authors' extensive tax advisory experience, which includes the representation of hundreds of dealers before the IRS National Office. Any views or positions expressed in this guide are those of the authors, Bob Zwiers and Joe Magyar of Crowe Horwath LLP, and not necessarily those of NADA.

You should note that the rules applicable to the topics in this guide are constantly developing and changing. Thus, portions of the guide may be obsolete by the time you read it. Additionally, the particular facts and circumstances of each dealer's situation affect how the rules apply. This is not a do-it-yourself guide, but one that should be used in consultation with a qualified and knowledgeable dealership tax advisor. You also should consult other resources, including the IRS's *New Vehicle Dealership Audit Technique Guide 2004*.

For your convenience, the topics addressed in this guide are arranged alphabetically.

I. ACCOUNTING METHODS AND METHOD CHANGES

A. Overview

A dealership determines taxable income for a year based on the accounting methods it uses to report income and deductions. The accounting methods that a dealer adopts must be used in a consistent and predictable manner to determine the timing of income and expenses. A method of accounting determines when an item of income is taxable and when an expense is deductible. The IRS requires that the method of accounting clearly reflect taxable income. Generally, this occurs when the accounting method is an allowable method for the dealer to use, complies with IRS regulations and rulings, and is applied in a consistent manner from year to year.[1]

Accounting methods include an overall method of accounting and the accounting for any item of income or deduction.[2] A dealership is typically required to use the accrual method as its overall method of accounting. Specific methods of accounting include items such as the use of the LIFO method or lower of cost or market method for inventories.

Each separate and distinct trade or business is permitted to adopt different methods of accounting provided that a complete and separate set of books is kept for each trade or business.[3] Thus, a dealer with two stores that are run separately and have separate books may have different accounting methods even though the stores are not separately incorporated or otherwise separate business entities. The IRS provides flexibility and dealers should act carefully when determining distinct trades or businesses.

B. Adopting a Method of Accounting

Generally, a dealer should use a method of accounting that postpones income reporting as long as possible and accelerates business deductions as soon as possible. This method will result in the lowest current taxable income and the lowest current income tax payable. By deferring the payment of tax as long as possible, the dealer retains the use of the cash and benefits from the time value of money, either by reducing dealer debt and thus the interest expense, or by investing the funds and benefiting from investment gains until the tax is payable.

C. Accrual Method of Accounting

Most dealers are required by the IRS to use the accrual method of accounting for income and expenses because dealers are required to use inventories.[4] Under the accrual method, income must be reported when the dealer has the right to receive the income.[5] Thus, it is not the actual receipt of the income that determines when it is taxable but rather when the dealer has the right to receive it that determines the year that the income must be reported.

Business expenses are generally deductible for the year in which the dealer pays or incurs the expense. An expense is incurred when all events have occurred that establish the fact of a liability and the amount can be determined with reasonable accuracy.[6] Additionally, the expense must meet the economic performance rules.[7] These rules generally require that an expense, to be deductible, must not only be paid or incurred, but the product or services associated with the expense must have been provided either during the year or could reasonably be expected to be provided within 3½ months after the end of the year.[8]

Some expenses, even though they are paid or incurred, are not deductible in the current year because they are capital in nature and are subject to deduction through annual depreciation or amortization expense discussed in a separate section.[9]

The following expenses, which are subject to the economic performance and capitalization rules, must also meet additional specific rules: workers' compensation and tort claims[10]; property taxes[11]; interest[12]; services rendered to the dealer[13]; vacation pay[14]; other liabilities[15]; contested liabilities[16]; and employment taxes on accrued wages.[17]

Dealers can deduct an expense in the year paid if the benefit from the payment is for twelve months or less and will expire by the end of the next taxable year.[18] Payment of a one-year insurance premium for coverage that will expire before the end of the next taxable year, for example, is deductible in the current year when paid. The deduction would still be subject to the economic performance rules.

Payments to related persons are subject to limitations. Generally, an expense owed to a related person must be paid and includible in the related person's income in order for the expense to be deducted.[19] The purpose of this rule is to match the timing of deductions with income. The rule prevents taxpayers from taking advantage of income and deductions between related tax entities with different accounting methods.

The most common related persons include: family members, including brothers, sisters, husband, wife, ancestors, and lineal descendants; and C corporations, S corporations and partnerships with a certain level of common ownership.[20]

D. Special Dealer Accounting Methods

In addition to the normal accounting methods that are available to taxpayers generally, there are many specialized accounting methods that dealers can adopt for unique dealer transactions or that will provide the dealer with an advantageous treatment of a specific type of income or expense. These methods include: LIFO Inventory—alternative methods for new- and used-vehicle inventory; extended service contracts—proper treatment of dealer obligor contracts and a specialized method for deferring income; depreciation—special lives for certain dealership property; and accounting for UNICAP and manufacturer advertising and interest assistance. These methods are discussed in separate sections.

E. Accounting Method Changes

After a dealer establishes a method of accounting, the dealer may change that method only by filing IRS Form 3115, "Application for Change in Accounting Method," and receiving IRS consent for the method change or by complying with the "automatic" procedures.[21] Except as otherwise allowed by the IRS Commissioner, advance permission is required to change any accounting method regardless of whether the method is proper or improper and a Form 3115 filed during a taxable year will be effective for that taxable year.[22]

F. Adjustments Required

When a dealer changes a method of accounting, the timing of reporting income or taking a deduction is changed. The method change is implemented for the year of the change by determining taxable income for the entire year under the new method of accounting. However, the dealer must make appropriate adjustments as if the dealer had used the new method of accounting for all prior taxable years. This adjustment is in the nature of a catch-up adjustment. The adjustment is made by comparing the balances in the various affected accounts at the beginning of the year of change under both the present method of accounting (old) and the proposed method of accounting (new). The adjustment is the net change in all of the affected account balances.[23]

If the catch-up adjustment reduces taxable income, it is a negative adjustment and is favorable to the dealer. Conversely, if the adjustment increases taxable income, it is a positive adjustment and is unfavorable to the dealer. Favorable adjustments are deductible in full in the year of the method change. Unfavorable adjustments are generally spread over four taxable years beginning with the year of the method change. If an unfavorable adjustment is less than $25,000, the dealer may elect to include the full adjustment in income in the year of the change.

Once a dealer properly requests approval from the Commissioner for a method change, the dealer generally receives "audit protection"—i.e., the terms and conditions of the change are not subject to the less favorable rules applied by IRS examiners.[24] Frequently, dealers expedite a request to change an accounting method in anticipation of an IRS examination. The dealer may believe that a particular method of accounting is improper and that, if the dealer is audited by the IRS, the IRS will require the dealer to change the accounting method. By filing a Form 3115 before an examination begins, a dealer may obtain more favorable terms and conditions for making the change than if the change is made by the IRS examiner.

G. Changes Initiated by the IRS

If the dealer is examined by the IRS, the agent may recommend a change from an improper accounting method. The agent may only recommend changes from an improper method to a proper method.[25] Changes made by agents are almost always in favor of the government. The change will be made normally in the first year under IRS examination. The agent will include the entire catch-up and current adjustments in the first year of the change. There is no provision for spreading the catch-up adjustment over several years.

If the dealer disagrees with the agent's recommended adjustments, the dealer may request a hearing with the IRS Appeals division. The Appeals agent is authorized to consider special settlement options.[26]

H. Automatic Method Changes

The IRS allows more than 150 changes using automatic provisions.[27] There is no user fee for automatic changes and the application may be filed starting on the first day of the year of change up until the due date of the tax return including extensions.[28] Thus, dealers can delay deciding whether to make these changes until after the end of the applicable tax year. This allows the dealer to do retroactive tax planning. The dealer may not use the automatic procedures if, within the current or previous four years, the dealer has made a change in the same method of accounting.

Common situations where dealers file Form 3115 using the automatic provisions include the following: depreciation to reclassify assets into shorter life categories after a Cost Segregation Study[29]; qualifying volume-related trade discounts (manufacturer interest assistance)[30]; change from LIFO inventory method[31]; alternative LIFO inventory method for retail automobile dealers[32]; used-vehicle alternative LIFO method[33]; safe harbor UNICAP changes[34]; and LIFO vehicle-pool method.[35]

I. Changes Requiring Advance Consent

For non-automatic changes, the dealer must send Form 3115 with the application fee ($8,600 for 2015) to the IRS during the year of change.[36] The IRS will review the application and, if there are no questions, issue a "consent letter" for the dealer to sign and return to the IRS. The dealer attaches a copy of the signed consent letter to the tax return for the year of change.[37]

J. Restrictions on Filing Form 3115

The filing by a dealer of a Form 3115 to change a method of accounting will normally not cause the IRS to raise the same issue in an earlier year with less favorable terms and conditions (audit protection).[38] However, if a dealer files a Form 3115 while being audited, the IRS may raise the issue in a prior year if certain conditions are not met. This could be especially harmful if there is a large adjustment that the dealer had hoped would be spread over several years to cushion the impact of the additional tax. There are some opportunities for dealers to avoid this situation.

II. ADVERTISING

A. Overview

One of a dealer's largest expenses is advertising. New-vehicle advertising may be paid for by the dealer, the manufacturer, or an area advertising association. The manufacturer may assess an advertising amount to the dealer either as a separate line item on the invoice or as a part of the base price of the vehicle. How these assessments are used by the manufacturer determines whether and when a dealer can deduct them as an expense. If they are treated as an inventoriable cost of the vehicle, the dealer deducts the assessment for each vehicle when the vehicle is sold. In some cases, the assessments are deductible sooner, when the dealer purchases the vehicle.[39]

B. Manufacturer Programs

If the manufacturer uses the assessments to pay for advertising in the dealer's local or regional area, the dealer should deduct the assessments when the dealer purchases the vehicle. Thus, the portion of the amount paid for the vehicle as shown on the manufacturer's invoice that is allocable to advertising should be deducted as advertising expense and not included in the inventoriable cost of the vehicle.[40] A dealer can obtain information from the manufacturer to determine the amount of advertising cost, if any, that is assessed to the dealer and included in the base price of the vehicle.

If the manufacturer remits some or all of the advertising assessment to the dealer's area advertising association and the association uses the assessment to provide local or regional advertising, the dealer may deduct the assessment as an advertising expense when the dealer purchases the vehicle. The advertising assessment should not be included in the inventoriable cost of the vehicle.[41]

In some cases, the manufacturer or the area advertising association rebates all or a portion of the assessment back to the dealer. In these cases, the assessment should not be treated as an advertising expense. Rather, it should be treated as a receivable when the vehicle is purchased.

Some manufacturers sponsor co-op advertising programs that reimburse dealers for approved advertising up to 125 percent of the amount assessed to the dealers. These assessments also should not be deducted, but should be treated as a receivable when the vehicle is purchased.

C. Accounting Method Changes

Dealers who have been treating these assessments as an inventoriable cost may file a Form 3115 to obtain consent from the Commissioner to change the method of accounting to expensing the assessments. In certain situations, the change may be filed using the automatic provisions.[42.]

D. Economic Performance Rules

Deductions for advertising are subject to the economic performance rules. Under these rules, economic performance occurs as the advertising is provided. Dealers can use the recurring item exception for advertising performed by the manufacturer or an advertising association under the assumption that economic performance occurs no later than within a reasonable time after the close of the taxable year.[43]

III. AIRPLANE

The topic of airplane expenses is addressed at nada.org/regulatoryaffairs.

IV. CASH REPORTING

A. Form 8300

Every dealership that receives more than $10,000 in cash in one transaction or in two or more related transactions must file IRS/FinCEN Form 8300, "Report of Cash Payments Over $10,000 Received In a Trade or Business," with the IRS by the 15th day after the date on which the cash transaction occurs.[44] Dealers also must notify customers in writing that a cash report was filed with the IRS. This notice must be given by January 31st of the year following the calendar year in which the cash was received.[45] A "Cash Reporting Sample Notification" is available for this purpose at nada.org/regulatoryaffairs. Form 8300 may also be filed electronically via the FinCEN E-filing system[46] and the IRS has informally indicated to NADA that such electronic filing will be deemed to meet the IRS requirements.

Any transactions conducted between a customer (or agent) and the dealer in a 24-hour period are related transactions. Transactions are considered related even if they occur over a period of more than 24 hours if the dealer knows, or has reason to know, that each transaction is one of a series of connected transactions. Dealers should closely consider cash sales of vehicles to the same wholesaler. Depending on the facts, the sales may be related and subject to the Form 8300 filing requirement. For example, if on one day a dealer sells three vehicles to the same wholesaler, who pays cash for one of the vehicles on the day of the sale and two days later pays cash for the other two vehicles, and the total cash received is over $10,000 for the three vehicles, a Form 8300 is required. However, the IRS Motor Vehicle Technical Advisor has previously explained in informal guidance that if that wholesaler buys one car with cash on each of three non-consecutive days, and no single transaction exceeds $10,000, the transactions are not considered to be connected and are not required to be reported even though the dealer received more than $10,000 for the three cars combined.[47] This information can also be found on www.irs.gov here.

B. Penalties

A dealer may be subject to civil penalties for failure to file a complete and accurate Form 8300 on time if it cannot be shown that the failure was due to reasonable cause.[48] As a general rule, dealers that are audited by the IRS for the first time for Form 8300 compliance have been subject to the lesser failure to file penalty of $100 per violation when the IRS has found substantial compliance with the Form 8300 filing requirements but occasional violations. On subsequent audits, the IRS will frequently assess the $25,000 per violation penalty for intentionally disregarding the cash reporting requirement. A federal district court in one case, *Tysinger Motor Company, Inc. v. U.S.*,[49] found in favor of the dealer when there was a subsequent audit with a pattern of limited violations that were not determined to be willful or intentional. More specifically, after a previous audit, the dealership had implemented a system designed to identify each transaction in excess of $10,000 and cause the transaction to be reported to the CFO who could then prepare and file Form 8300. The court relied, in part, on the fact that the dealership had "set up a system that would identify reportable transactions,"[50] and had made good-faith efforts to implement that system. In addition, the dealership filed the delinquent forms immediately after learning of the problem. For a period of time, the IRS assessed the $25,000 penalty on the first audit. The penalty should be based on the nature of the violation and the facts and circumstances of each situation.[51] Intentional disregard violations may also be subject to criminal prosecution, resulting in imprisonment, fines, or both.

C. Cash

The term "cash" means the following:

- U.S. and foreign currency received in any transaction.
- A cashier's check, money order, bank draft, or traveler's check (not in connection with proceeds of a bank loan or when received as a payment on certain promissory notes, installment sale contracts, or down payment plans) having a face amount of $10,000 or less that is received in a sale of a vehicle, part, or other consumer durable by a dealer.

Cash does not include a check drawn on the customer's own account, such as a personal check, regardless of the amount. ACH payments are not cash for the purpose of reporting on Form 8300 and ATM/debit card payments are not considered cash.

Each dealer should have clearly established procedures and designate an individual who answers customers' questions concerning the filing of Form 8300 and is responsible for filing the forms. All dealership personnel who have contacts with customers and/or handle cash should receive training annually concerning the Form 8300 requirements.

The dealership also should have a written policy concerning filing the Form 8300. The dealership should give a copy of the policy to all employees who have customer contacts or handle cash and obtain a signed acknowledgment that the appropriate employees have received and reviewed the policy. The dealership should conduct a self-audit regularly to ensure that the policy is followed.

In some cases, a customer may refuse to provide the dealership with his or her Taxpayer Identification Number (TIN). The Form 8300 instructions provide that a dealer who requests a TIN but is not able to get it within 15 days of the transaction should file the Form 8300 and attach a statement explaining why the TIN is not included. Dealers who abuse this limited exception may face significant civil and criminal penalties. Dealers should consult with their tax or legal advisors concerning whether it may be advisable to forego selling a vehicle to a customer who refuses to provide his or her TIN.

You can contact the IRS Detroit Computing Center with Form 8300 questions at 866.270.0733 or by email at 8300QUESTIONS@IRS.GOV. As noted above, the IRS Motor Vehicle Technical Advisor also has issued informal FAQs on the topic that are available at nada.org/regulatoryaffairs. See also information on irs.gov.

Form 8300 may be electronically filed using the Bank Secrecy Act (BSA) Electronic Filing (E-Filing) System, which is available here.

D. Money Laundering

Do not confuse cash reporting with money laundering. Laundering any amount of cash derived from illegal activities, including terrorist activities, is a felony that may result in the seizure by the IRS of dealership inventory and real estate. There have been dealership personnel who have been convicted and received prison sentences for money laundering and for willfully failing to report cash payments over $10,000.

The IRS conducts "sting" operations aimed at uncovering money laundering activities and Form 8300 violations including assisting in structuring transactions to avoid the required reporting.

Additional information on this topic is available in an interactive online course entitled "Cash Reporting: The Buck Stops Here" at nada.org. See also the IRS Motor Vehicle Technical Advisor Automotive Alert referenced above entitled "Cash Reporting and Your Dealership: Questions and Answers on Form 8300," available at nada.org/regulatoryaffairs.

E. USA Patriot Act

Dealers should also be aware of the government's concern about terrorist financing. The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) requires dealers to comply with the requirements under the USA PATRIOT Act regarding responding to requests for information from federal law enforcement agencies that are investigating money laundering or terrorist activity. When requested by FinCEN, a dealer must search dealership records for accounts and transactions with the identified party and send a report containing specified information to FinCEN. (Go to nada.org/regulatoryaffairs for additional information on this requirement and other USA Patriot Act provisions.)

F. OFAC

Dealers also must abide by long-standing restrictions enforced by the Department of the Treasury's Office of Foreign Assets Control (OFAC). These restrictions prohibit dealers and others from entering into transactions with certain sanctioned countries, governments, specially designated organizations, and specially designated nationals including those appearing on an electronic list maintained by OFAC. For additional information, visit the OFAC website, which is located currently at www.treas.gov/offices/enforcement/ofac, and www.nada.org/regulatoryaffairs.

V. CHOICE OF ENTITY

A. Overview

A dealership may be operated in a number of different forms of entity. The dealer should consider the legal consequences of the entity choice under state law and other business issues in addition to the federal and state income tax consequences.

A dealer has flexibility in determining the federal tax classification of the entity once a legal formation has been chosen under state law. A dealer may make an election to have an entity, other than a corporation, classified for federal purposes in a form other than the default treatment for that type of legal entity.[52] For example, partnership treatment would be the default federal tax classification for a limited liability company (LLC) with two or more members; the dealer, however, could elect to treat the LLC as a corporation under the so-called "check the box" regulations. In addition, federal tax treatment might also be dependent on other elections such as a corporation (or a non-corporate entity electing to be treated as a corporation) electing to be taxed under subchapter S ("S" corporation). In most states, treatment for state tax purposes follows the federal classification. There are significant exceptions, so state tax guidelines should be carefully considered.

Under the "check the box" regulations, for a non-corporate entity to elect to be classified as an entity type other than the default classification, the entity is required to file Form 8832, "Entity Classification Election," within 75 days of the effective date of the election. Additionally, a copy of the Form 8832 must be attached to the entity's federal tax return for the year of the election. If a non-corporate entity is electing to be classified as a corporation and also is properly electing to be taxed under subchapter S by timely filing Form 2553, "Election by a Small Business Corporation," the entity is deemed to have made an election to be classified as a corporation and is not required to separately file Form 8832.

Dealerships typically fall under one of the following entity types: C corporation, S corporation, partnership, or limited liability company. These entity types are compared in the tables following "Disregarded Entities" below.

B. Disregarded Entities

In addition, many dealership corporate structures include "disregarded entities." These are legal entities, usually qualified subchapter S subsidiaries (Q Subs) and single member limited liability companies. Although these entities generally are respected as separate legal entities under state law, for federal income tax purposes they are not treated as separate from their owner.[53] All of the assets, liabilities, and items of income, deduction, and credit are treated as the owner's and reported on the owner's tax return. Use of such disregarded entities can provide significant tax benefits while providing other legal and business advantages such as separate legal liability. Note that for certain other purposes, including federal payroll tax and excise tax reporting, these entities are not disregarded.

Applicable Factor	C Corporation	S Corporation	Partnership	Limited Liability Company
I. Formation				
A. Method	Articles of Incorporation	Articles of Incorporation	Partnership Agreement	Articles of Organization
B. Owner eligibility				
Number of owners	No limitation	100 shareholders ESOPs and certain related family members may be considered as one shareholder	Two or more for general partnership; one or more general and one or more limited for limited partnership	No limitation
Type of owners	No limitation	Individuals and certain trusts and estates; also certain tax-exempt organizations	No limitation	No limitation
Affiliate limits	No limitation	May own 80% or more of C corporation stock and 100% of qualified subchapter S subsidiary	No limitation	No limitation
C. Capital structure				
Equity	No limitations (multiple classes permitted)	Only one class of stock other than different voting rights	No limitations (multiple classes)	No limitations
D. Status determination				
Election by entity	No election requirement	Required election	No election requirement	No election requirement
Owner consent	None required	Consent required	None required	None required
E. Liability	Limited to shareholder's capital contributions	Limited to shareholder's capital contributions	General partners jointly and severally liable; limited partners generally limited to capital contributions	Limited to member's capital contributions

Applicable Factor	C Corporation	S Corporation	Partnership	Limited Liability Company
II. Operations				
A. Tax year	Any year permitted (limited for personal service corporation)	Generally calendar year	Generally calendar year	Generally calendar year
B. Tax on income	Corporate level	Owner level	Owner level	Member level
C. Elections	Corporate level	Corporate level	Partnership level	Corporate level
D. Specific allocation of income/deductions	Not permitted (except through multiple equity structure)	Not permitted	Permitted if substantial economic effect	Permitted if substantial economic effect
E. Character of income/deductions	No flow-through to shareholders	Flow-through to shareholders	Flow-through to partners	Flow-through to members
F. Net operating losses	No flow-through but generally two year carryback and carryforward indefinitely	Losses flow through to shareholders (limited basis)	Losses flow through to partners (limited basis)	Losses flow through to members (limited basis)
G. Net capital losses	No flow-through, but generally three-year carryback and five-year carryforward	Losses flow through to shareholders	Losses flow through to partners	Losses flow through to members
H. Effect of statutory limitations	Imposed at corporate level	Imposed at shareholder level	Imposed at partner level	Imposed at member level
III. Compensation				
A. Fringe benefits	Shareholder-officers qualify for benefits	Certain benefits includible in 2% shareholder's income	Limited participation for partners	Limited participation for members
B. Retirement benefits	Shareholder-officers in qualified plan	Certain limits on shareholder-employees	Certain limits applicable to partners	Certain limits applicable to member
C. Reasonable compensation limits	Applicable to shareholder-employees	Applicable to shareholder-employees	May be applicable in a family partnership context where capital is a material factor	May be applicable in a family LLC contact where capital is a material factor

VI. COMPENSATION TO OWNERS

A. C Corps

Shareholders of C corps are subject to special IRS scrutiny for excessive compensation. The IRS may contend that a portion of the compensation should be disallowed and recharacterized as a disguised dividend. To determine allowable compensation, the IRS looks to factors considered by the courts and how the taxpayer's fact pattern compares to the facts in those cases. The IRS will allow a deduction for compensation if it is reasonable.

General Factors

Generally, long-standing compensation plans that are tied to profitability will be recognized as reasonable when applied in both good and bad years. An absence of the payment of dividends is not fatal as long as the compensation meets the "outside investor" test. A significant rate of return on shareholder equity adds to the support for the compensation. The factors discussed in two leading court cases demonstrate the areas of consideration.[54]

Role in Company. Relevant considerations include the position held by the employee, hours worked, duties performed, and the general importance of the employee to the success of the company. When there is a large salary increase, comparing past duties and salary with current responsibilities and compensation also may provide significant insights into whether the compensation is reasonable.

External Comparison. Compare the employee's salary with those paid by similar companies for similar services including the opinions of industry experts obtained by both the company and the IRS.

Character and Condition of Company. Consider the company's size as indicated by its sales, net income, or capital value and the complexities of the business as well as the general economic conditions.

Conflict of Interest. Does a relationship exist between the company and the employee that might permit the company to disguise nondeductible corporate distributions of income as compensation? Consider whether the employee is the company's sole or controlling shareholder, and if family relationships indicate that the compensation plan may not be at arm's length. Other factors that support an attempt to disguise dividends include a bonus system that (a) distributes all or nearly all of the company's pre-tax earnings, (b) amounts to a disproportionately large percentage of gross income when combined with salary, or (c) provides large bonuses to owner-executives but none to non-owner management.

Internal Consistency. Is the compensation based on a structured, documented, and consistently applied program? Although there can be significant changes in business conditions from year to year, documented compensation plans that are consistently applied provide the best support.

Auto Dealer Cases

Several court cases involving auto dealer compensation issues have focused on the relationship between compensation and gross receipts. In several IRS examinations, IRS agents have asked for comparable compensation information to support the compensation paid to the shareholders of the dealership under IRS audit. One leading case questioned the compensation paid to a dealer.[55] The facts and decision in this case have been used very successfully in IRS audits to support compensation deductions in excess of $1 million. What needs to be shown is that the financial information of the dealer under IRS audit is as good as or better than that of the company. Of particular interest to the IRS agent is the comparison of compensation to gross receipts and return on equity.

B. S Corps

Since compensation is subject to employment taxes, some dealers decide to not pay any compensation to the owners thereby avoiding employment taxes for both the dealer and the owner. The IRS has targeted this issue on several S corps audits and selected the dealer for audit based solely on this factor. Whereas the IRS is concerned about unreasonably high compensation to owners of C corps, they are equally concerned about unreasonably low compensation to owners of S corps. Dealers should ensure that the compensation to S corps owners is commensurate with the services provided by the owners and the compensation paid to other dealer employees.

VII. COMPUTERIZED RECORDS

A. IRS Requirements

The IRS has certain requirements concerning the retention of computerized accounting records. Computerized records include all accounting and financial systems that process all or part of the dealer's transactions, records, or data by other than manual methods. Systems include microcomputer systems, data base management systems (DBMS) and all systems using electronic data interchange. Flash memory, CDs, and other machine-sensible media used for recording, consolidating, and summarizing accounting transactions and records in a dealer's computer system are records for purposes of IRS recordkeeping requirements. The IRS requires that dealers maintain these records for as long as their contents may be material in administering any tax law. This requirement applies to any record covered by a tax provision having unique or specific recordkeeping requirements.[56]

The IRS requests access to these records when it examines a dealer's tax return so the IRS agent can audit the records more efficiently by using the computer as an audit tool. The IRS specifies standards that must be met when a taxpayer maintains records using a computerized recordkeeping system. The standards vary for taxpayers with less than $10 million in assets, taxpayers with $10 million or more in assets, and taxpayers maintaining a DBMS.

The rules that apply to most dealers require that dealers retain all machine-sensible files generated by a computerized recordkeeping system that affect the dealer's liability for any federal tax. Additionally, dealers are required to provide the IRS access to those records.

The IRS Motor Vehicle Technical Advisor issued an Automotive Alert dated January 21, 2005 (available at nada.org/regulatoryaffairs), which discusses electronic records retention requirements for dealerships including a listing of files that may be requested by the IRS computer audit specialist. In addition to files generated by the dealership on its own computers, the list includes files generated by third-party service providers for areas such as LIFO computations, payroll, fixed assets, and corporate tax preparation.

B. Penalties

The consequences for not complying with the recordkeeping rules include a possible negligence penalty, an inadequate records notice, and a subsequent IRS follow-up compliance examination. The inadequate records notice would be of concern to a publicly-held dealership that would have to disclose the notice in its financial statements and to a dealer who may have to disclose the notice when applying for financing.

C. Action Needed

Dealers should discuss the records retention requirements with their computer vendors and any other service provider related to any bookkeeping or tax service. The dealer should be especially concerned about the adequacy of the retained records when changing computer vendors or upgrading any computer system. The dealer needs to provide to the IRS not only the computerized records but also the software to run them.

VIII. DEMONSTRATORS

In November 2001, the IRS created several safe harbor methods for valuing demo use in Revenue Procedure 2001-56. These and other available demo valuation methods are explained in detail in NADA's *A Dealer Guide to the Federal Tax Treatment of Demos* (L17) available at nada.org. The guide contains several sample policy statements and forms.

IX. DEPRECIATION OF DEALERSHIP PROPERTY

A. Overview

Dealers are required to make significant investments in facilities and other fixed assets for their dealerships. The assignment of tax lives and proper depreciation is critical to maximizing the return on this investment through tax depreciation expense.

Property is assigned to a recovery class that determines the period over which property is depreciated. Generic asset classifications are provided by the IRS to cover depreciable assets used in all business activities. In addition, specific asset classifications are provided for assets used in a particular industry. For example, one such asset class covers assets used in "wholesale and retail trade." Therefore, certain assets such as shelves, safes, countertops, tacked-down carpeting, etc., may have a tax life of five years (instead of seven) if the asset is designed specifically for use within the retail dealership.[57]

B. Typical Dealership Asset Depreciation

Asset Description	Life
Parking Lot	
Cost of lighting, including wiring, conduit, and fixtures for lighting of the entire parking lot when light poles are mounted/bolted to the top of a cement footing.	5-year
Cost of lighting, including wiring, conduit, trenching, concrete work, and fixtures for lighting of the entire parking lot when light poles are embedded in concrete.	15-year
Cost of all paving, sidewalks, and concrete work, including concrete platforms.	15-year
Cost of landscaping and lawn sprinkler system.	15-year
Parts Department	
All compressors and related pumps including installation costs.	5-year
Signs.	5-year
All counter space related to the parts department, including retail counter space and cashier, etc.	5-year
Cost of shelving utilized in shelving system.	5-year
Service Department	
All above-ground tanks including installation costs (includes automatic transmission fluid, bulk oil, waste oil, fuel tanks, related piping, and pumps).	5-year
Loaner vehicles.[58]	5-year
Cost of above-ground lifts, including special concrete work, wiring, and installation labor.	5-year
Cost of shelf racks in service department tool room.	5-year
All tubing, pumps, and tanks related to the supplemental hydraulic system for the lifts.	5-year

Asset Description *(continued)*	**Life**
Service Department *(continued)*	
All pneumatic piping, air compressors, and support equipment related to the pneumatic tool system.	5-year
Lube, oil, and filter equipment and supplemental pumping and plumbing equipment.	5-year
Supplemental overhead vehicle exhaust removal system.	5-year
Cost of car wash system, including special concrete work, wiring, and installation labor.	5-year
All counter space within the service department, including dispatcher counter and parts counter for technicians, etc.	5-year
Cost of detail bays, including special concrete work, wiring, and installation labor.	5-year
Cost of all service equipment (connected with wholesale and retail trade) not separately identified above.	5-year
Body Shop	
Downdraft paint booths including all supplementary exhaust systems, electrical work, and additional concrete work to install booths.	5-year
All retail counter space within the body shop.	5-year
All shelving to store parts and supplies in the body shop.	5-year
All piping, air compressors, and support equipment related to pneumatic tools system.	5-year
Concrete reinforced area for frame machine including steel frame in the concrete.	5-year
New- and Used-Car Showroom	
Cost of showroom displays.	5-year
Cost associated with work/welcoming stations, including special concrete work, electric wiring, and installation labor.	5-year
Cost of furniture and fixtures in the showroom and retail setting.	5-year
Accounting Office	
All costs associated with computer room air conditioning unit, including duct work, wiring, etc.	5-year
Removable partitions.	7-year
Tables, desks, and other furniture and fixtures.	7-year

Asset Description *(continued)*	**Life**
General Items	
Building and structural components.	39-year
All signs and installation costs, including franchise signs and those attached to the building.	5-year
Paging/intercom system for dealership employees.	5-year
Security system and fire extinguishers.	39-year
All computer wiring and installation costs.	5-year
All phone system costs related to central unit and control board (the wiring throughout the building should not be included).	5-year
All clocks, including time clocks.	5-year
Cost of furniture not separately identified above.	7-year
All kitchen and office appliances and vending machines.	5-year
Cashier's safe.	7-year
Shelving not directly related to retail sales activity including cost of shelves in record storage room.	7-year

C. First Year Bonus Depreciation and Section 179 Expensing Election

Bonus Depreciation

Taxpayers are allowed a first-year bonus depreciation deduction on qualified property. This additional depreciation expense is claimed in the first year the property is placed in service. The amount of the bonus depreciation deduction is a percentage of the qualified cost of the property as follows:

- 50 percent for property placed in service during 2015, 2016 and 2017
- 40 percent in 2018
- 30 percent in 2019

Regular depreciation is allowed on the balance of the asset cost after the first-year bonus.

Generally, qualified property includes new fixed assets with a recovery period of 20 years or less. For a dealership, this is generally new property that would otherwise be depreciated over five, seven or 15 years. Various special rules and requirements may apply including an election to not claim bonus depreciation.

Section 179 Expensing

Most dealers and other taxpayers may be able to deduct (rather than depreciate) the cost of certain fixed assets used in their business. Taxpayers file an election with their tax return to elect the Section 179 expensing of the cost of qualified property. The deduction is generally limited to $500,000. This amount is reduced dollar for dollar to the extent that the overall Section 179 fixed asset additions exceed $2 million. There are other limitations that may apply. Both the $500,000 and $2 million dollar amounts are indexed for inflation beginning in 2016.

Section 179 may apply to qualified leasehold improvements and qualified retail improvement property. The items are subject to a specified limitation as follows:

- $250,000 allowed in 2015
- $500,000 allowed beginning in 2016

Air-conditioning and heating units are eligible for the Section 179 expensing beginning in 2016.

Various additional rules and requirements exist including the requirement to have positive taxable income, limitations on certain related taxpayers and that both an S corporation/partnership as well as the shareholder/partner are subject to the deduction limitation, the investment limitation and the taxable income limitation.

Vehicle Limitations

Vehicles purchased by a dealership or its business customers may qualify for bonus depreciation and the Section 179 deduction. The IRS places certain additional restrictions on the amount of the deductions available to taxpayers, but most taxpayers can purchase qualifying vehicles for use in a trade or business and potentially realize enhanced tax benefits.

Most vehicles over 6,000 pounds gross curb (unloaded) weight are not subject to the vehicle-specific restrictions. Limitations may apply to SUVs over 6,000 pounds. Certain other vehicles weighing less than 6,000 pounds may be eligible for an additional $8,000 bonus depreciation or Section 179 expensing amounts for business purchasers. Otherwise, the first year depreciation deduction may be limited:

- for trucks (including SUVs) and vans to $11,060 in the first year
- for cars to $11,160 in the first year

These rules are complicated and subject to a number of exceptions, qualifications, limitations and other details.

Special Property Categories

Lessors and lessees may qualify for a shorter depreciable life for Qualified Leasehold Improvement Property. A 15-year depreciable life, rather than the usual 39-year depreciation, may be used. Assets qualifying also qualify for bonus depreciation. However, this shorter life is not allowed for related party leased property which excludes many dealership rental entities from utilizing this provision.

Qualified Retail Improvements may qualify for a 15-year depreciable life rather than the usual 39-year depreciation. The improved building area must be open to the general public and used in the retail trade or business of selling tangible personal property such as a dealership selling vehicles. There are additional provisions concerning whether these qualifying assets are eligible for bonus depreciation. There is no exclusion for related party leases and rental property. Dealerships commonly use these rules for showroom renovations.

D. Tangible Property Regulations

The tangible property regulations (the tangible regulations) affect all taxpayers who acquire, produce, improve, repair or dispose of tangible property and provide a framework for distinguishing currently deductible costs from costs that must be capitalized. The tangible regulations also provide taxpayers the ability to claim a partial disposition of components of personal and real property assets. The 2013 tangible regulations[59] require affected taxpayers to make changes to their current accounting methods related to these areas by filing an "Application for Change in Accounting Method" (Form 3115). The tangible regulations also include numerous provisions that may be implemented prospectively as elections on an annual basis. Although the tangible regulations are effective for tax years beginning on or after Jan. 1, 2014, transition rules provide taxpayers the flexibility to adopt the tangible regulations with their 2012, 2013 or 2014 tax returns.

Areas affected by the tangible regulations:

Treatment of Materials and Supplies. The tangible regulations:

- Provide that non-incidental supplies must be capitalized until used or consumed. They also state that incidental supplies, those items that are not tracked or inventoried, must be deducted when paid or incurred.

- ► Provide a general rule that rotable, temporary and spare parts are deducted in the year disposed.
- ► Provide an optional accounting method for rotable and temporary spare parts, a sub-class of materials and supplies.
- ► Allow taxpayers to elect to capitalize and depreciate rotable, temporary and standby emergency spare parts.
- ► Expand the definition of materials and supplies to include items with a cost of $200 or less.

Acquisitions of Tangible Property. The tangible regulations:

- ► Permit taxpayers to make an annual *de minimis* safe harbor election. The election allows taxpayers with an applicable financial statement to deduct those items that they also deduct for financial reporting purposes pursuant to a book accounting policy up to $5,000 per item or invoice and taxpayers without an applicable financial statement to deduct up to $2,500 per item or invoice.[60]
- ► Clarify that changes to a taxpayer's financial accounting policies regarding *de minimis* capitalization do not constitute an accounting method change.
- ► Place the burden of proof on taxpayers to demonstrate that their method of expensing items clearly reflects income if the items deducted do not fall within the safe harbor.
- ► Provide rules regarding the capitalization of costs that facilitate the acquisition of tangible property.

Improvements to Tangible Property. The tangible regulations clarify that expenditures that constitute an improvement to a unit of property must be capitalized.

The tangible regulations provide a framework of guidance (including many examples) to help taxpayers determine whether an expenditure gives rise to an improvement to a unit of property through a betterment, restoration, or adaptation of the unit of property.

The tangible regulations:

- ► Define a unit of property for purposes of applying the betterment and restoration standards. As part of the restoration rules, the tangible regulations illustrate what is considered a major component, a significant portion of a major component, or substantial structural part of a unit of property.
- ► Provide a safe harbor for routine maintenance applicable to both personal and real property.
- ► Allow a taxpayer to make an annual election to capitalize repair and maintenance expenditures as improvements if the taxpayer treats such costs as capital expenditures for financial accounting purposes. The annual conformity election does not apply to repair and maintenance expenditures deducted for financial reporting purposes.
- ► Provide a safe harbor regarding building improvements for small taxpayers (those with gross receipts of $10 million or less).

Property Dispositions. The tangible regulations provide disposition rules that allow taxpayers to elect to claim a loss upon the disposition of a structural component of a building or upon the disposition of a component of any other asset without identifying the component as an asset before the disposition event.

Impact Analysis, Adoption, and Implementation of the Tangible Regulations. The tangible regulations contain many taxpayer elections, optional accounting methods and safe harbors. Therefore, taxpayers should carefully evaluate their options to ensure that they adopt the most favorable allowable methods. Furthermore, the accounting method changes associated with the improvement rules contained in the tangible regulations may require implementation with a timing (catch-up) adjustment to reflect the difference between a taxpayer's old and new methods. Computing this adjustment will require taxpayers to analyze historical accounting records for capitalized improvement costs and repairs and maintenance expenditures. Although computing the timing (catch-up) adjustment may require a significant investment of time and resources, taxpayers may find that they have historically overcapitalized costs to improve property—which will result in a favorable adjustment upon adoption.

Complying with the 2013 tangible regulations may require changing book accounting policies and/or book accounting methods to align with newly required tax methods. Therefore, taxpayers should consider the impact the new rules will have on their internal accounting procedures and systems. Furthermore, the impact of the 2013 regulations may have financial reporting consequences that must be addressed.

E. Selected Items of Interest

Building Demolition

When a building is demolished, both the demolition expense and any remaining undepreciated cost of the building must be capitalized to the land.[61]

Cost Segregation Studies

Purchasers of dealership property can gain tremendous tax benefits by conducting a cost segregation or building study. The study identifies and segregates facility components into asset classes with a shorter tax life. In significant construction projects and building purchases, the value of the tax deferral can be substantial when shorter depreciable lives are selected. Through the completion of a cost segregation study, a significant portion of the facility costs can be depreciated for tax return purposes over five, seven or 15 years, rather than the traditional 39 years otherwise used for buildings and improvements.

Soft Costs Related to Construction Projects

In all construction projects there are *hard costs*, which are for the building, furniture and fixtures, land improvements, etc., and *soft costs*, which are for permits, fees, interest expense, etc., or any costs for items other than direct material, labor or property acquisition for resale. The hard costs, also known as direct costs, are more easily allocated and assigned depreciation lives. The soft costs, also known as indirect costs, must be capitalized and reasonably allocated to the assets they are deemed to support.[62]

X. EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

A. Who are Employees?

As a general rule, all individuals who perform services for a dealership are considered employees if the dealership controls, or has the right to control, the individual. For federal income tax purposes, the IRS has historically considered 20 factors and, more recently, additionally considered three categories of evidence to evaluate and determine if any particular individual is an employee.[63] If, however, a dealership consistently has treated individuals who perform a certain type of work as independent contractors, and there is a reasonable basis for the treatment, the IRS is prevented by "Section 530" from changing the treatment.[64] A reasonable basis can include a situation in which a significant portion of the industry treats such workers as independent contractors.[65] Additionally, under the Voluntary Classification Settlement Program, employers can voluntarily reclassify their workers as employees with some relief from prior year payroll tax liabilities if certain conditions are met. The program is also available for dealers under IRS audit, other than an employment tax audit. The 20 factors and three categories of evidence are summarized below.

There is a special rule that applies to certain manufacturer payments to salespersons. Incentive payments paid by an automotive manufacturer whether directly to individual salespersons or through a dealer are taxable income for the salesperson, but are not subject to federal employment tax withholding by the dealer or the manufacturer. The payments are also not subject to self-employment tax and are to be reported by the salesperson as "Other Income" on page 1 of Form 1040.[66]

B. Twenty Factors

These are the 20 factors:

1. **Instructions.** A worker who is required to comply with the dealer's instructions about when, where and how he or she is to work is ordinarily an employee. This control factor is present if the dealer has the right to require compliance with instructions.

2. **Training.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.
3. **Integration.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. **Services Rendered Personally.** If the services must be rendered personally, presumably the dealer is interested in the methods used to accomplish the work as well as in the results.
5. **Hiring, Supervising and Paying Assistants.** If the dealer hires, supervises and pays assistants, that factor generally shows control over the workers on the job.
6. **Continuing Relationship.** A continuing relationship between the worker and the dealer indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. **Set Hours of Work.** The establishment of set hours of work by the dealer indicates control.
8. **Full-Time Required.** If the worker must devote substantially full-time to the business of the dealer, the dealer has control over the amount of time the worker spends working and implicitly restricts the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
9. **Doing Work on Employer's Premises.** If the work is performed on the premises of the dealer, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which a dealer generally would require that employees perform such services on the dealer's premises. Control over the place of work is indicated when the dealer has the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. **Order or Sequence Set.** If a worker must perform services in the order or sequence set by the dealer, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the dealer. Often, because of the nature of an occupation, the dealer does not set the order of the services or sets the order infrequently. It is sufficient to show control, however, if the dealer retains the right to do so.
11. **Oral or Written Reports.** A requirement that the worker submit regular or written reports to the dealer indicates a degree of control.
12. **Payment by Hour, Week, Month.** Payment by the hour, week or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the fee for a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.
13. **Payment of Business and/or Traveling Expenses.** If the dealer ordinarily pays the worker's business and/or traveling expenses, the worker is ordinarily an employee. A dealer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.
14. **Furnishing of Tools and Materials.** The fact that the dealer furnishes significant tools, materials and other equipment tends to show the existence of an employer-employee relationship.

15. **Significant Investment.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the dealer for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.
16. **Realization of Profit or Loss.** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
17. **Working for More than One Firm at a Time.** If a worker performs more than *de minimis* services for multiple unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. **Making Services Available to General Public.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. **Right to Discharge.** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.
20. **Right to Terminate.** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

These are the three additional categories of evidence that the IRS considers.

1. **Behavioral Control.** Facts concerning behavior control: These facts show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done—as long as the employer has the right to direct and control the work.

   For example:

   Instructions. If the worker receives extensive instructions on how work is to be done, this suggests an employer-employee relationship. Instructions can cover a wide range of topics, for example: how, when or where to do the work; what tools or equipment to use; what assistants to hire to help with the work; where to purchase supplies and services.

   If the worker receives less extensive instructions about what should be done, but not how it should be done, this suggests an independent contractor relationship. For instance, instructions about time and place may be less important than directions on how the work is performed.

   Training. If the business provides the worker with training about required procedures and methods, this indicates that the business wants the work done in a certain way, and suggests an employer/employee relationship.

2. **Financial Control.** Facts concerning financial control: These facts show whether there is a right to direct or control the business part of the work.

   For example:

   Significant Investment. If the worker has a significant investment in his or her work, this suggests an independent contractor relationship. While there is no precise dollar test, the investment must have substance. However, a significant investment is not necessary to be an independent contractor.

   Expenses. If the worker is not reimbursed for some or all business expenses, then this suggests an independent contractor relationship, especially if the unreimbursed business expenses are high.

   Opportunity for Profit or Loss. If the worker can realize a profit or incur a loss, this suggests that they are in business for themselves and that an independent contractor relationship exists.

3. **Relationship of the Parties.** Facts concerning relationship of the parties: These are facts that illustrate how the business and the worker perceive their relationship.

   For example:

   Employee Benefits. If the worker receives benefits, such as insurance, pension, or paid leave, this is an indication that the worker may be an employee. If the worker does not receive benefits, however, the worker could be either an employee or an independent contractor.

   Written Contracts. A written contract may show what both the worker and the business intend. This may be very significant if it is difficult, if not impossible, to determine status based on other facts.

XI. ENVIRONMENTAL ISSUES

A. Alternative Motor Vehicle Credit

For 2016, the IRS allows a credit for certain vehicles that are qualified fuel cell vehicles. These vehicles are propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel. There are certain additional requirements. The credit is available for new vehicles placed in service in 2016. The vehicle's manufacturer or domestic distributor certifies to the IRS the maximum amount of the credit. The credit is not allowed if the IRS withdraws the certification for a vehicle before the date that the vehicle is purchased by the taxpayer. The base amount of the credit for vehicles weighing less than 8,500 pounds is $4,000 plus up to an additional $4,000 depending on the vehicle's city fuel economy. For heavy vehicles, the credit can be up to $40,000.

B. Alternative Fuel Vehicle Refueling Property Credit

For 2016, the IRS allows a credit for the installation of alternative fuel vehicle property used in a trade or business or installed at a taxpayer's residence. The credit applies to property used to store an alternative fuel and to dispense it into a motor vehicle fuel tank and property used to recharge an electric vehicle.

The credit is limited to $30,000 for property installed at each business location or $1,000 for property installed at a taxpayer's main residence. See Form 8911 for additional requirements.

C. Plug-In Electric Drive Vehicle Credit

The IRS allows taxpayers a credit for the purchase of Qualified Plug-in Electric Drive Motor Vehicles including new four-wheeled passenger vehicles and light trucks with a gross vehicle weight of less than 14,000 pounds. Taxpayers can generally rely on the manufacturer's certification to the IRS for the amount of the credit for a specific vehicle. The amount of the credit ranges from $2,500 to $7,500. Find the qualifying vehicles and the credit amount for each year on the IRS website.[67]

The vehicles must be acquired for use or lease and not for resale. For leased vehicles, only the lessor may claim the credit. For vehicles sold to a tax-exempt organization, governmental unit or a foreign person or entity, the purchaser can transfer the credit to the seller if certain conditions are met.

The vehicle must be manufactured for use on public streets, roads and highways and used predominantly in the United States. A vehicle is considered acquired when title to the vehicle passes to the taxpayer under state law and the vehicle must be placed into service during the tax year.

XII. ESTATE AND GIFT TAX

A. Estate Planning Process

Proper estate planning is vital for two reasons: First, planning allows your estate to avoid unnecessary taxes, expenses and potential problems; second, and perhaps more importantly, planning assures that the assets you have accumulated over many years of hard work are distributed in accordance with your wishes.

There are generally five stages of the estate planning process.

First, you must determine your intentions. You must make difficult decisions regarding the beneficiaries of your estate and how your assets will be allocated. You must decide whether to give money to your heirs directly, or give the money to a trustee to hold in trust for your heirs. If you decide to use a trust, you must decide when the trust will close. You may decide to have the trust distribute the assets to your children when they reach a certain age that you specify, or with proper planning you could delay the distribution to some distant future date such as, for example, to your great-grandchildren 20 years after the death of your last grandchild. Many people make charitable contributions by way of their wills, particularly if they feel their heirs do not need (or will be better off without) the inheritance. This stage of the estate planning process is without a doubt the most important, and often the most difficult.

Second, you will want to explore tax- and cost-saving methods. Your attorney or accountant can give assistance in identifying ways of achieving your goals at the lowest tax and administrative costs. There are many estate planning strategies available that could significantly reduce your estate tax burden if implemented early enough.

Third, legal documents must be drafted and executed. In addition to the Last Will and Testament, these documents might include trust agreements (both revocable and/or irrevocable), durable Power of Attorney forms, Medical Authorizations or Living Wills.

Fourth, the ownership and titling of assets may need to be rearranged. For example, if an asset is held jointly with someone else, any provision in the will as to its disposition may be ineffective. Life insurance should usually be owned inside an irrevocable trust.

Finally, there must be a periodic review of the estate plan. Changes in the estate plan may be necessary whenever there are significant modifications to the applicable tax law; any time there is a birth, death, marriage or divorce in the family; or when the nature or amount of your assets changes significantly. In addition, it is generally recommended that the entire estate plan be reviewed at least every five years.

B. Estate and Gift Tax Applicable Exclusion

On January 2, 2013, the American Taxpayer Relief Act of 2012 was signed into law. The 2012 Taxpayer Relief Act made permanent (retroactively) many of the estate, gift and generation-skipping transfer tax provisions that had been extended by the 2010 Taxpayer Relief Act but were due to expire on December 31, 2012. The 2010 Act had temporarily increased the basic exclusion amount to $5 million (adjusted annually for inflation) for both gift and estate tax purposes. It also introduced the portability election that allows any unused exclusion amount (the "deceased spousal unused exclusion amount" or DSUE) to be transferred to a surviving spouse. The 2012 Taxpayer Relief Act made permanent both the increased applicable exclusion amount and the portability election.

The tax laws provide an Applicable Exclusion from estate and gift taxes for a specified amount of assets. For 2016, the cumulative lifetime amount of the Estate and Gift Tax Exclusion is $5,450,000.

Previous and current estate tax and gift tax exclusions and tax rates are shown in the table below.

C. Gift-Splitting Election

For married donors, a gift made by one spouse to any person (other than the donor's spouse) can be considered as made one-half by each spouse. To make this election, gift tax returns are filed on which both spouses "check a box" and consent to split all gifts made by either of them during the calendar year. The effect of the gift-splitting provision is that both spouses can use their exclusions even if the gift is made by only one spouse. For example, assume Joe gifts $100,000 to his son and $100,000 to his daughter. If an election to gift-split is made, then Joe and his wife are each treated as gifting $50,000 to the son and $50,000 to the daughter.

D. Benefits of Lifetime Gifting Program

Annual Exclusion Gifts

A highly effective estate tax planning device is to remove assets from someone's future estate through $14,000 (2016 amount) per person annual gifts. These gifts do not utilize any of the donor's lifetime Applicable Exclusion amount (i.e., they are not "added back" in computing tax on the taxable estate). The exclusion amount is indexed for inflation.

Each U.S. citizen may exclude the first $14,000 of gifts made to any donee during a calendar year in determining the total amount of gifts for that calendar year. By maximizing the use of the annual exclusion a significant amount of wealth can avoid estate and gift taxes. For example, Dad and Mom can gift $28,000 to each of their three children and two grandchildren (for a total of $140,000) each year gift tax-free. Annual exclusion gifts can be accomplished either by outright gifts or by transfers into trusts, using cash or property in-kind (e.g., shares of stock in either a publicly traded company or a closely-held family business, or interests in a Family Limited Partnership (FLP)).

Education And Medical Gifts

Any transfers made directly to an educational institution to pay tuition or to a health care provider for medical care (including health insurance premiums) are not considered gifts. Thus, these amounts could be paid in addition to any $14,000 annual exclusion gifts made to that person. Note that payments for something other than basic tuition (e.g., books, supplies, room and board, etc.) do not qualify for the tuition exclusion.

Calendar Year	Applicable Exclusion		Estate and Gift Tax Rate on Excess
	Estate Tax	Gift Tax	
2009	$3.5 million	$1.0 million	45%
2010	N/A (repealed)	$1.0 million	35% (gift tax only)
2011	$5.0 million	$5.0 million	35%
2012	$5,120,000	$5,120,000	40%
2013	$5,250,000	$5,250,000	40%
2014	$5,340,000	$5,340,000	40%
2015	$5,430,000	$5,430,000	40%
2016	$5,450,000	$5,450,000	40%

Applicable Exclusion Amount Gifts

Gifts in excess of the annual exclusion amount ($14,000) and the education or medical exclusions will utilize a portion of the donor's lifetime exclusion of $5,450,000 (2016 amount). Thus, although gift tax is not owed until the cumulative lifetime gifts exceed the exclusion amount, the fact that the exclusion was utilized during the lifetime means that there will be less exclusion available to avoid estate tax upon death. Therefore, the benefit of making this level of gift is that it utilizes the exemption based on the current value of the property. If the assets will be worth more by the time of death, the donor will avoid estate tax on the higher value by using the exemption via gifts at the current (lower) value. In other words, future appreciation will avoid estate tax. Often lifetime gifts involve non-voting shares of stock, which may have a lower value for gift tax purposes than they will as part of the estate's value. However, the recipient's cost basis for income tax purposes for property received via a gift is equal to the donor's basis, whereas property received via inheritance obtains a cost basis equal to the fair market value on the date of death. Therefore, proposed gifts of appreciated property should be analyzed to compare the benefit of avoiding estate tax on future appreciation against the income tax detriment of the potential loss of any "step-up-in-basis" upon death.

Finally, it could also be beneficial to make gifts in excess of the lifetime applicable exclusion amount of $5,450,000 during a person's life. Although gift tax will be owed, the payment of the gift tax will effectively reduce the donor's net worth by the amount of gift tax paid, thus reducing the amount of assets subject to the estate tax (provided the donor lives at least three years after the gift). Thus, even though the gift tax will be paid at a rate of 40 percent, the "effective" tax rate (taking into account estate tax avoidance of the gift tax itself if the donor lives three years) on gifts is about 28.6 percent, whereas the estate tax is a full 40 percent.

XIII. EXCISE TAX

The Internal Revenue Code imposes a 12 percent federal excise tax (FET) on the first retail sale of: 1) truck chassis and bodies with a Gross Vehicle Weight (GVW) in excess of 33,000 lbs., 2) truck trailer and semitrailer chassis and bodies with a GVW in excess of 26,000 lbs. and 3) tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer. With regard to the third element, an NADA-led coalition secured an amendment to the Internal Revenue Code in August 2005 that excludes from the tax highway tractors that: 1) are Class 5 (19,500 lbs. GVW) and below, *and* 2) have a gross combined weight with a trailer or semitrailer (known as Gross Combination Weight (GCW)) that does not exceed 33,000 lbs. For details, see the NADA *Driven* Guide *A Dealer Guide to Federal Excise Tax Compliance*, available at nada.org.

The American Truck Dealers (ATD) division of NADA monitors and reports on numerous FET developments. For additional information, visit atd.org or contact ATD at 800.352.6232.

XIV. EXTENDED SERVICE CONTRACTS

A. Overview

Dealers typically offer a variety of F&I products to the purchaser of a new or used vehicle. Among these products are extended service contracts (ESCs). These contracts provide coverage for mechanical breakdown that is similar to the coverage provided by a new-car warranty. Auto dealers should be aware of the tax implications of selling ESCs.

ESCs typically fall into one of two categories: "dealer obligor" or "third-party obligor." Dealer obligor contracts are between the customer and the dealer. Third-party obligor contracts are between the customer and someone other than the dealer (e.g., the manufacturer, an administrator, etc.).

B. Third-Party Obligor Contracts

The tax reporting for these contracts is quite simple. The dealer usually is acting as an agent for the third party and receives a commission for each contract sold. Frequently, the commission is merely the difference between the sales price of the contract and the amount that the third party requires. However the commission is determined, the dealer merely reports the commission as income.

Example: Dealer sells a manufacturer's ESC for $800 and pays the manufacturer $600 for the contract. The $200 difference is the dealer's commission. The contract clearly states that it is between the customer and the manufacturer. The $200 commission is reported as income by the dealer.

C. Dealer Obligor Contracts

The tax reporting for dealer obligor contracts is more complicated. A few states still require dealers to be "on the hook" for certain types of service contracts. (Some dealers sell both third-party obligor contracts and dealer obligor contracts.) The IRS requires dealers to report the entire sales price of dealer obligor contracts as income.

Example: Dealer sells a dealer obligor contract for $800. The contract clearly states that it is between the customer and the dealer. The entire $800 is reported as income by the dealer.

The deduction for expenses on dealer obligor contracts depends on how the contract is structured. If the dealer is self-insured (i.e., pays claims on the contracts as they are incurred), the expenses are deductible when the claims are approved for payment (accrual method dealer).

Example: Dealer sells the contract in Year 1 and approves claims for payment as follows: Year 2–$350; Year 3–$150. The dealer deducts $350 in Year 2 and $150 in Year 3.

Some dealers cover their risk on the contracts through insurance. The IRS holds that premiums on such insurance that cover more than one year must be deducted ratably by amortizing the expense over the months of coverage.

Example: Dealer sells the contract in Year 1 and pays a $600 insurance premium for coverage of all risk under the contract for the next four years. The $600 premium is deductible at the rate of $12.50 per month for the next 48 months.

Other dealers arrange with a service contract administrator to hold the funds that will be used to pay claims arising under certain contracts the dealer sells. If the dealer is the owner of the funds, the dealer deducts expenses when the claims are approved for payment. Note: The use of the administrator to handle the claims does not affect the tax treatment compared to the dealer who handles the claims directly.

Example: Dealer sells the contract in Year 1 and transfers $600 to the administrator for future claims. Claims are approved by the administrator as follows: Year 2–$350; Year 3–$150. The dealer deducts $350 in Year 2 and $150 in Year 3.

The treatment is different, however, if the dealer transfers funds to an administrator who becomes the owner of the funds. In this case, the dealer should treat the amount as a deduction ratably over the months of coverage.

Example: Dealer sells the contract in Year 1 and transfers $600 to an administrator for future claims under the contract for the next four years. The funds are owned by the administrator and normally will not be returned to the dealer. The $600 amount is deductible at the rate of $12.50 per month for the next 48 months.

The IRS has provided an alternative method of accounting for dealer obligor service contracts when the liability under the contract is covered by insurance. For these contracts, the dealer must report, in the year the contract is sold to the customer, the difference between the sales price of the contract and the insurance premium. The balance of the income is reported over a number of years based on the years of coverage under the contract. In addition to reporting this amount as income, the dealer reports an additional amount of income. This is intended to compensate the federal government for the time value of money.[68] Dealers who are otherwise properly reporting income and expenses for dealer obligor contracts may change to this method using the "automatic" process.[69]

Alternatively, the dealer could adopt or elect to use a special deferral method of accounting. Under this method, in the year the contract is sold, the dealer would include in income the portion of the selling price earned in the first year. In the second year, the dealer would include in income the remaining amount of the selling price.[70]

D. Dealer-Owned Warranty Companies

The IRS has concluded several times that ESCs could be contracts of insurance and companies who sell them could qualify as insurance companies.[71] If a dealer establishes a separate company for the dealer obligor contracts, the company may qualify as an insurance company. Insurance companies are granted very favorable tax treatment. They are allowed to defer reporting premium income until it is earned and they can deduct claims that are incurred even if not reported to the company. These rules allow the payment of tax to be postponed significantly. Small insurance companies may also qualify for an election where they are only taxed on investment income and all underwriting income is tax-free. This election is only available when net written premiums do not exceed $1.2 million. Special rules apply regarding ownership attribution to limit a taxpayer from circumventing the $1.2 million limit. Dealers should seek the guidance of competent tax advisors concerning these matters.

Dealers should also be cautious when considering F&I products outside of ESCs that might be treated as insurance. For example, prepaid maintenance and tire wear are not considered insurance for federal income tax purposes while tire damage from road hazards may be considered insurance. (See also chapter XVII, Insurance and Reinsurance Companies.)

XV. FACTORY FRANCHISE AGREEMENTS

A. Overview

Is a franchise agreement with a manufacturer a personal asset of the dealer-owner or is it owned by the entity that operates the dealership? Industry practice is to grant manufacturer franchise agreements based in large part on the qualifications of the individual dealer who can largely determine the type of business entity that should operate the franchise activities. These sales and service agreements are typically in the form of a personal services contract between the manufacturer and the individual dealer.

B. Goodwill

Regardless of the ownership, personal or corporate, nearly all dealership assets include some form of intangible in the form of goodwill or going concern value commonly referred to as "Blue Sky." Such assets are capital in nature and amortized over a period of 15 years for tax purposes.[72] However, in the dealership industry, the franchise itself may not be an amortizable asset of the corporation due to the personal nature of the sales and service agreement.[73]

C. Damage to Goodwill

As manufacturers grant new franchise locations and move to consolidate others, they are concerned about their relations with dealers who have a dealership in the geographic market area where a store is being added or eliminated. Frequently, manufacturers will make a payment to the affected dealer to mitigate the effects of adding or eliminating a store. Depending on the specific facts and circumstances, these payments may be considered as damages to goodwill.[74] The tax treatment of the payments could include reducing the dealer's basis in the dealer's existing goodwill, taxing them as capital gain, or taxing them as ordinary income.[75]

D. Franchise Termination

If the manufacturer terminates or cancels the franchise agreement with the dealer, the cancellation could qualify as an exchange and be treated as long-term capital gain if the franchise has been held for more than one year.[76]

E. Personal Goodwill

In some cases, when a dealer is purchasing the stock of a dealership, the dealer should consider separating the purchase into two parts: one part, the purchase of the personal intangible asset (i.e., goodwill, going-concern value, etc.); and the other part, the stock that represents the remaining value of the dealership. In this way, the dealer has acquired an asset (i.e., the personal intangible asset) that can be amortized.

Likewise, a dealer who owns a C corp or S corp that is selling the assets of a dealership during the built-in gains holding period can avoid the double tax by selling the personal goodwill as an individual apart from the sale of the other assets and pay a single capital gains tax on this part of the sale.[77]

Factors that may be favorable to the existence of personal goodwill include:

- Manufacturer sales and service agreement is a personal service contract that includes the name of the dealer and requires the services of the dealer.
- The persona of the dealer is a key intangible value to the dealership because of the relationships between the dealer and customers/community, personal name/image recognition (advertising, name on or associated with the dealership, community involvement, etc.).
- Innovations implemented by the dealer, e.g., evening/weekend service hours, unique customer service in the sales/service area, sponsorship of charitable causes and events.
- Dealer community involvement and leadership.
- No prior employment or non-compete agreement with the dealership.
- Personal goodwill is considered early on in the negotiations rather than as an afterthought for tax purposes.
- Separate agreements for the sale of entity assets and the dealer's personal goodwill.
- Dealer is retained by the purchaser through a consulting/employment agreement that contains a non-compete provision.
- Entity sales agreement includes the sale of entity-owned goodwill such as going concern.
- Evidence that the personal goodwill transferred to the purchaser because of dealer's continuing service to the dealership, use of dealer's name on the dealership, continuing at the same location, dealer's name use in advertising, etc.

Questions that should be considered and that may pose some difficulty in the valuation process or in tax planning include:

- How to allocate a value to the intangible asset (personal goodwill) and at what amount?
- If all of the stock of a dealership is gifted away during the lifetime of the dealer, is the intangible asset (personal goodwill embodied in the dealer's franchise agreement) includible in the gross estate of the dealer (assuming that the dealer is still the named person on the franchise agreement), and if so, what is its fair market value?
- If a C corporation acquires the dealership in either a stock or an asset purchase (and, in effect, pays a separate amount for the franchise rights), is there a constructive dividend to the dealer (since a franchise agreement is a personal services contract)?
- If there is a sale or termination of a franchise that was originally purchased in bulk with other franchises, can the unamortized franchise cost be offset against the proceeds from the sale or termination?
- If there is a sale or termination of a franchise resulting in a gain, is the gain treated as long-term capital gain or ordinary income?

XVI. FINANCE COMPANIES

A. Finance Contracts

Dealers frequently assist customers by providing financing for the vehicles they sell and then assigning the finance contract to a third-party bank or finance company. The dealer usually retains the right to a portion of the finance charge paid by the customer to the finance company. The dealer may receive this participation from the finance company up-front when the finance company acquires the contract, or the participation may be retained by the finance company and paid to the dealer at a later time (e.g., incrementally after each payment is received from the customer or after the customer has paid the contract in full). In some cases, the participation is placed in a "reserve account" for the dealer by the finance company when it acquires the contract.

If the dealer receives the participation up-front, the amount is generally reduced to take into account a possible early termination of the finance contract and the possibility of a loss on the contract if the customer defaults. The amount received by the dealer is taxable income when the dealer earns the right to receive the amount.

If the dealer's participation is paid at a later time, the amount is taxable income to the dealer when the contract is accepted by the finance company. In some cases, that time corresponds to the time the participation amount is placed in a "reserve account" or otherwise is identified as being the amount the dealer will receive if the contract is ultimately paid in full. If there are charge-backs against the participation amount for early termination or default, the dealer is entitled to a deduction when the charge-back occurs.[78]

B. Related Finance Companies

The use of related finance companies (RFCs) is a common practice in the used-car industry. These companies serve many valid business purposes. However, some RFCs being utilized by new- and used-car dealers may not be structured properly and thus may not survive IRS scrutiny.

The potential tax benefit enjoyed by a properly structured RFC transaction is that the dealership deducts, as a loss, any discount on the sale of the finance contract to the RFC while the RFC reports the discount income as it is received (cash basis). The loss is deductible only between related corporations if they are members of a controlled group and the loss does not exceed the gain on the third-party sale of the vehicle.[79] The loss is not deductible if either of the related companies is not a corporation.

Example: The dealer sells a vehicle for $10,000, $1,000 down and a finance contract for $9,000. The dealer sells the finance contract to the RFC for $7,000 and deducts the $2,000 discount as a loss. The RFC reports, as ordinary income, the $2,000 discount ratably as the RFC receives the $9,000.

There are several reasons for creating and using an RFC. These include 1) providing credit to enable the purchaser to buy a car; 2) improving the collection of accounts receivable; 3) avoiding licensing and other regulatory requirements on the dealer entity; 4) preventing adverse publicity on repossessions and other collection activities from affecting the dealership; 5) insulating the dealership from the financial risk of default on the notes; and 6) diversification of ownership.

There are three tax issues that exist in dealing with RFCs. The first involves the economic reasons for the arrangement, the second involves the validity (form) of the RFC itself, and the third and most critical issue involves the economic substance of the discounting transactions (i.e., are they at arm's length, bona fide sales and at fair market value?).

C. Buy-Here Pay-Here

For dealers that provide financing for the sale of vehicles, the income that should be reported when the vehicle is sold is the difference between the sales price and the cost. The sales price is the cash received, the value of the trade-in(s) and the face amount of the finance contract. If the customer defaults on the contract, the gain or loss is the difference between the amount owed on the contract and the value, if any, of the repossessed vehicle. The IRS has a guide for its agents for sales of used vehicles that discusses many issues relating to buy-here pay-here dealers.[80] Dealers are not allowed to use the installment method of reporting the sale.

D. Subprime Financing

Some auto finance companies have programs that enable dealers to offer dealer financing for high-risk customers as part of the sale of a vehicle. These customers generally cannot obtain financing from traditional sources such as banks, captive finance companies of automobile manufacturers, or other finance companies.

Under some programs, an automobile dealer becomes a member of the program by entering into an agreement with the (unrelated) finance company. As a member, a dealer may assign its retail installment contracts to the finance company in the same fashion it would with a traditional lender.

Under the agreement, the finance company pays the dealer an up-front cash amount referred to as an advance, which is typically calculated as a percentage of the face amount of the assigned contract. The finance company's obligation is to collect the payments on the contracts assigned to it by a dealer. The collections are first applied against the advance to the dealer. The dealer ultimately receives additional payments when the finance company collects sufficient payments from the customer. Monthly customer payments are generally applied (these payments may be applied to a pool of contracts) as follows:

- To monthly collection costs, if any;
- To pay the finance company's service fee;
- To repay dealer advances; and then
- To the dealer.

Different tax treatment may apply to individual programs based on their particular facts and circumstances. For example, the dealer may maintain ownership of the consumer retail installment contract or the dealer may transfer ownership of the consumer contract to the finance company. Each of the tax applications has advantages and limitations.

The basic tax concepts of the most common situation are as follows:

- When a dealership sells a car, it recognizes a gain upon the sale. The gain is equal to the entire sales price (cash down payment plus the face amount of the finance contract plus the actual cash value of property traded-in) less the cost of the car. The gain is taxable in the year of sale. At this time, the dealer's tax basis in the installment contract is equal to the face amount.
- When the dealership assigns the installment contract to the finance company, the dealership treats the assignment as a sale of the contract and recognizes a loss, because the sales price of the contract for tax purposes will be less than the dealer's basis in the contract. This tax loss is recognized in the year in which the contract is assigned to the finance company. This deductible loss may partially or fully offset the gain the dealership recognizes on the sale of the car.
- The sales price of the installment contract is the cash received by the dealer plus the fair market value (FMV) of any future payments that the dealer may receive. In many cases, there is considerable doubt that the dealer will receive any future payments. In these cases, the FMV may be zero. Thus, the sales price of the contract is just the cash received by the dealer.

Application of these rules for each dealer depends upon the facts and circumstances of the arrangement with the finance company. Several years ago, the IRS addressed three specific cases and indicated that it would issue further guidance to use in determining the FMV of the right to receive installment payments.[81] No guidance has been issued to date.

XVII. INSURANCE AND REINSURANCE COMPANIES

Producer-owned reinsurance companies (PORCs) allow automobile dealers to participate in the underwriting profits from selling credit life/accident and health insurance and other F&I products including service contracts, gap, and etch. These reinsurance companies are generally owned and controlled by the dealer or dealers producing the business and are limited to reinsuring the business they produce—hence the term "producer-owned" reinsurance company.

Reinsurance is the transfer of risk from one insurance company, the direct writer, to another reinsurer or reinsurance company. As individuals buy insurance to protect themselves from the risk of a devastating loss, so do insurance companies. One insurance company transfers, or cedes, all or part of the risk, along with part of the premium, to another insurance company. This transaction, known as reinsurance, is a common way for one company to cover risks it cannot or does not want to accept itself (although the direct writer remains obligated to the customer for payment of claims). In a true PORC, a third-party insurance company provides the policy to the dealership's customer and then reinsures the related risk to the reinsurance company owned by the dealership.

The actual scope of PORCs in the dealership industry includes arrangements beyond the limited structure described above. They include dealer-owned insurance companies, group captives, and other arrangements designed to allow the dealer to participate in the underwriting income. In addition, the arrangements may include formation of an insurance company in a foreign domicile. This may have a significant impact on the taxation and required reporting by the entity and its owners.

The reason dealers form a PORC is the opportunity to realize a greater share of the profits on the business they produce. The two major sources of profit for an insurance company are underwriting profit and investment income. Underwriting profit is the profit from premiums after claims and expenses have been paid. Any underwriting profit is in addition to commissions already earned. Investment income is generated from the interest earned on the reserves invested until they are needed to pay claims.

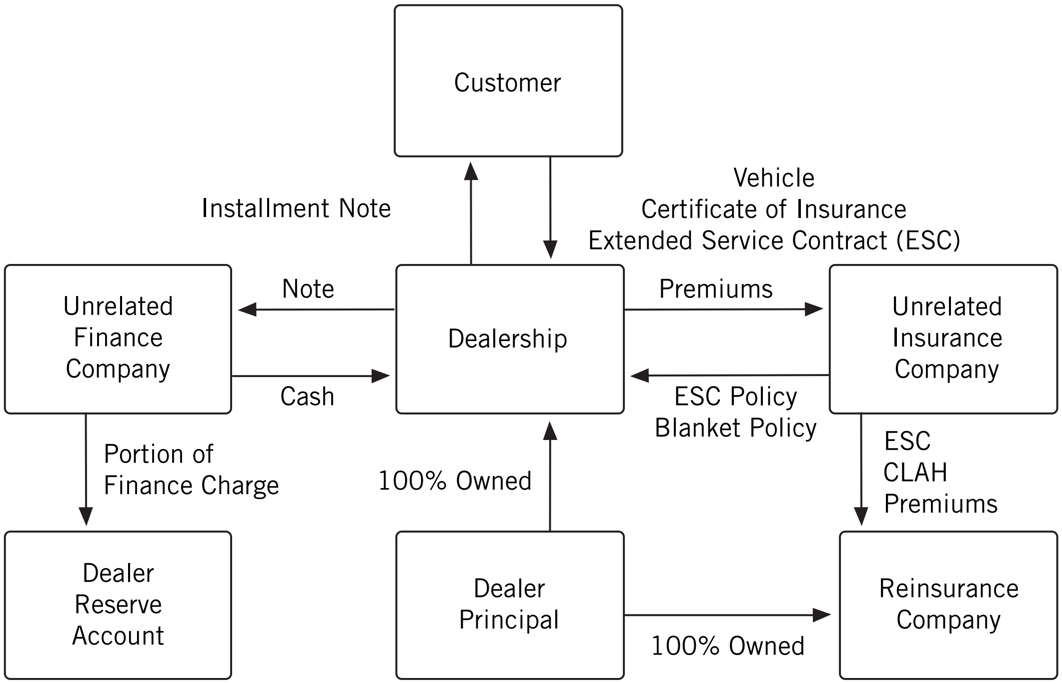
In addition to participating in underwriting profits on F&I products, dealers may also form a PORC or "captive" for the purpose of insuring risks to the dealership itself. Such a captive could be used to insure risks such as garage liability and workers' compensation. The captive can be an alternative source of risk financing for the dealer and may result in reduced commercial insurance savings in addition to income tax benefits. Such arrangements are often entered into in conjunction with commercial insurance coverage by providing coverage for high deductibles or gaps in the commercial insurance.

PORCs allow a dealer numerous alternatives for investing insurance company reserves, deferring income, ownership of the company, and reinsuring other products in the dealer's company in which the dealer has an insurable interest. In some cases, PORCs are exempt from tax or are taxed only on their investment income.[82]

The IRS closely scrutinizes these arrangements. In 2002, the IRS issued a notice indicating that many such arrangements were potential tax shelters or "listed transactions," requiring disclosure by the taxpayer.[83] The IRS subsequently withdrew the notice but still believes that some PORCs are abusive.[84] Here are some issues to keep in mind:

- Is the PORC established for tax avoidance?
- Is the PORC an actual entity?
- Is the PORC a cash cow?
- Are there over-submits that flow through to the PORC?
- Is the PORC only the dealer's pocketbook?
- Is the reinsurance arrangement really only a way to increase the commission income of the dealership that is regulated by state laws?
- Is there a genuine transfer of risk?
- Is the PORC under-capitalized or over-capitalized?
- Are proper agreements executed and are the parties in compliance with all terms?
- Does the substance of all of the PORC's transactions match the form?
- Are there significant and/or non-performing loans from the PORC to the dealer?
- Does the PORC own assets that are used personally by the owner of the dealership such as yachts, vacation property, airplanes, etc.?
- Does the PORC pay for personal expenses of the owner of the dealership?

Typical Auto Dealer Arrangement



CLAH = Credit, Life and Health

XVIII. INVENTORY

A. General Rules

Most dealers identify the cost of new vehicles using the actual cost of the vehicle (specific identification). The cost of new vehicles is the amount shown on the factory invoice[85] including destination charges less factory holdback,[86] factory floor plan finance assistance, and certain advertising assessments.

The cost of used vehicles is either the amount of cash paid for the vehicle plus transportation or the actual cash value of a trade-in. Alternatively, the cost of used vehicles for tax purposes can be determined based on the appropriate value in an official used-car guide. Most dealers identify the cost of used vehicles using specific identification.

The cost of parts is the amount shown on the invoice. Industry practice has been to adjust the actual historical cost of parts purchased from the factory to the factory's current replacement cost. Tax law does not permit the practice of recording an adjustment that increases the parts inventory amount to replacement cost as income. The IRS now allows replacement cost as an acceptable method of valuing parts inventories for either the FIFO or LIFO inventory methods.[87]

The cost of significant accessories added to new or used vehicles or significant reconditioning of used vehicles should be added to their original cost. If the dealer's employees perform the work, the labor cost should not include any profit. Likewise, the cost of parts should be at dealer cost.

B. Trade Discounts

Several manufacturers provide trade discounts, often referred to as wholesale floor plan assistance or interest credits. For each new vehicle that the taxpayer purchases, the invoice price includes an amount that is the manufacturer's estimate of the dealer's cost of financing to hold the car. The taxpayer is guaranteed the wholesale finance credit from the manufacturer for each new vehicle the taxpayer purchases regardless of whether the taxpayer finances the purchase and incurs interest costs or pays cash. Such interest credits qualify as trade discounts.

The proper method for recording these trade discounts is to reduce the cost of the inventory.[88] This method is favorable for the dealer as it defers the recognition of income and reduces current income tax expense. A dealer not using this method can change using the "automatic" procedures.[89]

Some practitioners have questioned whether taxpayers utilizing the LIFO method for their new-vehicle inventories would be in violation of the requirement to value inventories at cost if they are not reducing the cost of their inventory for trade discounts. Informal comment from the IRS chief counsel's office indicates that this would not be deemed to be a violation of the cost requirement.

C. Lower Of Cost Or Market

A dealer can elect to value vehicles in inventory at the lower of cost or market. Generally, market is what it would cost to replace the vehicle at the end of the year.[90] Alternatively, a dealer can value the vehicle at an actual offering price (up to 30 days after the end of the year) less direct costs incurred to sell the vehicle.[91]

A dealership that makes an adjustment to the lower of cost or market must make the adjustment based on a vehicle-by-vehicle determination.[92] The amount of the write-down should be substantiated by the value shown in an official used-car guide. The recording of the market adjustment to the dealer's general ledger does not need to be done on an individual vehicle basis so long as the dealer maintains the support for such adjustment.

D. LIFO

During times of inflation, the Last In First Out (LIFO) method of valuing inventory will generally result in a lower value of inventory than other methods.[93] By using the LIFO method, dealers are able to lower their income tax for a period of time. The dealer should view this benefit as an interest-free use of money. It is not a permanent benefit. Eventually, but maybe not for many years, the benefit will be lost and the taxes saved must be paid.

Most dealers do not keep their books and records during the year on a LIFO basis but convert to LIFO at the end of the year. Dealers usually maintain the inventory cost of new and used vehicles during the year using the specific identification method. This method provides the most relevant information needed to effectively manage the sale of vehicles. On the other hand, the inventory of parts is usually maintained on the basis of replacement cost.[94]

When electing LIFO, caution is urged concerning four specific areas that the IRS views as the most important: 1) properly electing LIFO; 2) basing LIFO computations on actual cost; 3) the conformity requirement; and 4) keeping records for the specific LIFO method elected. If the IRS finds violations in any one of these areas, it may terminate the LIFO election and immediately restore to income and assess taxes on the cumulative LIFO benefit.[95]

Dealers elect this method by filing an IRS Form 970, "Application to Use LIFO Inventory Method," with the tax return for the year LIFO is elected.[96] Even though the LIFO election, and the tax return for the year of the LIFO election, are filed after the year the LIFO election has ended, the dealer must ensure during the year for which LIFO is elected that all requirements have been met, particularly the conformity requirement. The election must specifically identify the goods. An election for "all new vehicles" is broader than "new cars" or "new Fords." Note that a subsequent election is necessary when additional goods, not identified in an earlier election, enter the inventory to be valued under LIFO.

If, as a result of electing LIFO, an adjustment is necessary to restore inventory value to cost, the adjustment is taken into income over three years beginning with the year for which LIFO is elected.

Most taxpayers use the dollar value LIFO method. The dollar value method generally is easier to apply than some other methods and provides a greater benefit. Under the dollar value method, the cost of goods on hand at the end of the year is converted to a base year cost (meaning the first year that the LIFO method is used) through the use of an index that is a measurement of inflation. The LIFO value of the ending inventory is generally the base year cost of the inventory plus layers, or increments, which are quantity increases valued on the basis of the costs incurred in the year the quantity increase occurred. The difference between the LIFO inventory value and the inventory value under the taxpayer's previous inventory method is commonly referred to as the LIFO reserve. It is possible to roughly estimate the increase to a LIFO reserve for a year if the inflation index for the year is known or can be reasonably estimated. Simply multiply the inflation index for the year by the beginning inventory amount (non-LIFO).

E. Alternative LIFO Methods

The IRS allows retail automobile dealers to elect to use simplified methods to compute LIFO for new and used automobiles and light-duty trucks. The method for new vehicles, Alternative LIFO Method, was originally introduced in 1992.[97] The method for used vehicles, Used Vehicle Alternative LIFO Method, was introduced in 2001.[98] These methods provide for a simplified calculation of the annual index of inflation and prescribe the procedures the dealer must follow to properly implement the methods. These methods provide specific step-by-step instructions regarding completion of the LIFO calculation. For each separate trade or business, pools must be established, regardless of manufacturer. As discussed below under "Pooling," automobiles and light-duty trucks may be included in the same pool. A dealer may adopt the methods when first electing LIFO or may use an automatic consent procedure to change to the method.[99]

F. Conformity

A dealership may only use the LIFO inventory method if it has used no method other than the LIFO method in inventorying goods for the purpose of a report or statement covering a taxable year.[100] Dealers who use LIFO should ensure that all financial statements—to shareholders, partners, other proprietors, or beneficiaries or for credit purposes—report income on the LIFO basis. Normally, a LIFO adjustment should be included at least once a year on the statements to the factory. All statements covering any taxable year, or any other twelve-month period, must have the LIFO adjustment.[101] Also ensure that the income for any short taxable year is on the LIFO basis. A reasonable estimate of the LIFO adjustment is acceptable. The LIFO adjustment should encompass all inventory on LIFO (such as new and used vehicles and parts).

An automobile dealer's financial statements provided to the manufacturer and its credit subsidiary with which the dealer finances its purchase of new automobiles are "for credit purposes" because they were issued to a creditor with whom the dealer maintains a continuing credit relationship. An automobile dealer must, on the statements provided to the factory, reflect the LIFO adjustment on the income statement for a month and the year and on the balance sheet. Such statements may reflect the income statement adjustment as either an adjustment to cost of goods sold or on the line for other income and expense.[102]

G. C Corp to S Corp and other Transfers

When a C corporation that used LIFO converts to S corporation status, the LIFO reserve is included in income of the last taxable year of the C corporation.[103] The rule also applies if the inventory is transferred to an S corporation in a nontaxable transaction. In addition, C corporations owning partnerships that elect S status are required to pay tax on the allocable amount of LIFO recapture related to the inventory held by the partnership.[104]

The additional tax due to recapturing the LIFO reserve may be paid in four equal annual installments.[105] The first payment is due on the due date of the last return filed by the C corporation without regard to extensions. Likewise, the remaining three payments must be paid by the three subsequent due dates of either the converted or transferee S corporation year's returns also without regard to extensions. No interest is assessed on the installment payments.

The recapture is not triggered when an S corporation transfers LIFO inventory to an LLC or when a sole proprietorship transfers LIFO inventory to an S corporation.

Special care should be taken when making any LIFO inventory transfer in an entity formation or entity restructuring. In addition to protecting the existing LIFO benefits, the potential need to file a new LIFO election should be considered. Dealers should always consult their tax advisors when considering any such transaction.

H. Pooling

It is to the dealer's benefit to have as few LIFO pools as possible. As retailers, dealers are required to have a separate pool for each major line, type, or class of goods.[106] In the past, many dealers had the following pools: new cars, new trucks, used cars, used trucks, and parts. Due to the changing nature of vehicles, there is no clear dividing line between cars and trucks.

The IRS allows dealers to include cars and light-duty trucks in the same LIFO pool. However, dealers are still required to maintain separate LIFO pools for new and used vehicles. Dealers can either originally elect or change to the "Vehicle-Pool Method" and place all new cars and new light-duty trucks in one pool and all used cars and used light-duty trucks in a separate pool.[107] A change to the "Vehicle-Pool Method" is made by using the automatic consent procedures.[108]

A dealer that continues to maintain separate LIFO pools for cars and light-duty trucks may originally elect or change to the "Method of Pooling for Crossover Vehicles." Under this method, the dealer assigns crossover vehicles to either a car (new or used) LIFO pool or a light-duty truck (new or used) LIFO pool. Once elected, the method must continue to be used consistently.[109] A change to the "Method of Pooling for Crossover Vehicles" is made by using the automatic consent procedures.[110]

A taxpayer with two or more separate and distinct trades or businesses may, but is not required to, use a different method of accounting, including LIFO pooling, for each trade or business. No trades or businesses will be considered to be separate and distinct unless a complete and separate set of books and records is kept for each trade or business.[111] Therefore, a single dealership business with two separate locations may have separate LIFO elections and pooling for each location. However, the IRS provides dealers considerable flexibility and should also allow the same dealer to treat the two locations as one trade or business.

I. Inventory Price Index Computation Method

Dealers are allowed to determine their inventory inflation by using published Bureau of Labor Statistics (BLS) indexes. This external index method is referred to as the Inventory Price Index Computation (IPIC) method.[112] Dealers electing the IPIC method must use it for all LIFO inventories.

Under the IPIC method, LIFO indexes are computed with reference to consumer price index (CPI) or producer price index (PPI) for specific categories of inventory items.[113] Retailers may select indexes from either the CPI Detailed Report or PPIs. If equally appropriate indexes could be selected, a retailer using the retail method must select from the CPI.

Index categories are assigned to a taxpayer's inventory items. The inventory index categories are then grouped into a pool or pools. Published indexes and weights are used to compute the appropriate index for an index category, and then an index is computed for the pool.

J. LIFO Termination

A dealer that desires to discontinue the use of the LIFO method may do so either for one of its LIFO inventory pools or for all its LIFO inventory pools. The IRS generally allows these changes on an "automatic" basis. The recapture of the LIFO reserve that is added to income is spread over four years. Following a LIFO termination, the dealer may not re-elect LIFO for five years.[114]

XIX. IRS EXAMINATIONS

If your dealership is examined by an IRS agent, your tax advisor should be involved at the earliest point of contact by the agent. Each agent brings to the examination his or her own background, experience, knowledge, skills and perspective. The agent needs to be dealt with in a professional manner and an experienced advisor is best suited to provide information to the agent.

The following are several (by no means all) planning considerations for IRS examinations.

A. Floor Plan Assistance

Dealers who account for manufacturers' floor plan assistance program payments by reporting the amounts as income in the year received should consider changing their tax method of accounting to reporting the amounts as an adjustment to the purchase price of the vehicle. These amounts qualify as trade discounts (see chapter XVIII, Inventory).

Under their present accounting method, many dealers record purchases of vehicles at the gross invoice price. They report floor plan assistance payments as a reduction to floor plan interest expense in the year received. According to the IRS, dealers should treat such payments as a reduction in the cost of vehicles purchased in the year the vehicle is purchased. An adjustment from the cash to accrual method may also be necessary (reducing the benefit).

For dealers who change to this method by filing a Form 3115 (see chapter I, Accounting Methods), certain representations are material to whether the IRS grants the change in accounting method. These include the following:

- Floor plan assistance payments are received/earned solely as the result of the purchase of the merchandise to which they relate and the dealership is neither obligated nor expected to perform or provide any services in exchange for the floor plan assistance program payments.
- The floor plan assistance program payments are not a reimbursement of any expenditure incurred or to be incurred by the dealership and the dealership is guaranteed each floor plan assistance program payment from the manufacturer for each eligible new vehicle.

B. Image Upgrades and Franchise Assistance

Manufacturers may provide funds to dealerships in order to encourage dealers to upgrade their retail stores. The facts and circumstances of specific image upgrade programs may vary and therefore produce different tax results. For example, the tax results may vary depending on the relationship of the cash payments to purchases of automotive products, the nature and ownership of the image upgrades, or the contractual relationship between the dealership and the manufacturer.

The IRS Office of Chief Counsel issued an informal opinion concerning three situations where auto dealers may receive amounts from automobile manufacturers under facility image upgrade programs.[115]

Manufacturers may also provide assistance to dealers who are purchasing a franchise or in exchange for an agreement to not protest the location of a new store in their market area. As with image upgrades, the facts and circumstances may vary and will dictate the tax consequences.

It is possible that certain payments may reduce the dealer's cost of related assets (e.g., buildings or goodwill) rather than be includible in current income. This and other tax considerations are addressed in an NADA publication entitled *Tax Implications of Dealership Facility Image Upgrades* available at nada.org/regulatoryaffairs. Because of the many options and planning opportunities, dealers should discuss the appropriate tax treatment of such payments with their tax advisors.

C. Salesperson Incentive Bonuses

Incentive payments made by an automobile manufacturer, whether directly to salespersons or through a dealer, are taxable income. Manufacturers report these payments to salespersons on Form 1099-MISC, Miscellaneous Income. They do not treat them as wages. Therefore, these incentive payments from the manufacturer are not subject to federal income tax withholding, Social Security, Medicare, or federal unemployment tax. The

IRS has announced that it agrees with this treatment.[116] Also, it is the position of the IRS that these payments are not considered to be self-employment income and therefore are not subject to self-employment tax. Any expenses incurred by a salesperson are deductible only as an itemized deduction subject to the 2 percent of adjusted gross income limitation.[117]

D. Holdback

A "holdback" charge included in the manufacturer's invoice price of motor vehicles to dealers is not includible in the dealer's purchases, cost of sales, in valuing inventories, or as a deduction for federal income tax purposes.[118] The amount of the holdback should be accounted for as a receivable to the dealership, which should not impact income.

E. Warranty Advances

Warranty advances from the manufacturer to the dealer are not includible in the gross income of the dealer when the amount of unpaid but accrued warranty claims exceeds the total amount of the warranty advances during the year. The warranty advances represent a reduction of the accounts receivable from the manufacturer for warranty work performed.[119]

F. Rebates

Rebates paid by an automobile manufacturer to qualifying retail customers represent a reduction in the purchase price of the automobile, requiring a downward adjustment to the basis of the automobiles in the hands of the purchasers.[120]

A manufacturer's rebate received by an automobile dealer represents a trade discount and, therefore, must be treated as a reduction in the cost of the automobile in the year of purchase. A trade discount is a discount always allowed irrespective of time of payment. The rebate is based solely on the total cost of dealer purchases, and does not relate to sales volume, length of time that the dealer holds the automobile in inventory, or other incentives that the manufacturer may offer.[121]

A manufacturer's rebate that is based on the sale of the vehicle, sales volume, or other criteria that must be satisfied to earn the rebate, is income to the dealer at the time the criteria are fulfilled.

XX. MISCELLANEOUS

A. 12-month Capitalization Rule

There are 23 categories of intangibles that a taxpayer must capitalize and the cost of all other intangibles is deductible.[122]

A special 12-month rule allows a taxpayer to expense amounts paid to create any right or benefit for the taxpayer that does not extend beyond the earlier of:

- 12 months after the first date on which the taxpayer realizes the right or benefit, or
- The end of the taxable year following the taxable year in which the payment is made.

This rule is particularly helpful for expensing the cost of what would otherwise be treated as a prepaid expense, such as insurance premiums. If the dealer pays an insurance premium for a policy that is for a term of 12 months or less and the term expires by the end of the following taxable year, the premium is deductible currently. Amounts paid for similar benefits are also deductible. However, this 12-month rule does not apply to prepaid rent or prepaid interest. They are deductible only for the period to which they relate.

Dealers who are not expensing insurance premiums and other items should file IRS Form 3115, "Application for Change in Method of Accounting." The IRS permits these changes to be made under the automatic procedures for these filings.[123] Dealers should check with their tax advisors for the current rules.

B. Like-Kind Exchanges

Like-kind or Section 1031 exchange provisions are a very powerful tax planning tool. Most commonly used for real property, a like-kind exchange defers the gain on property sold when a replacement property is acquired.[124] The gain on the old property reduces the tax basis in the new property, thus delaying the current payment of tax.[125] This allows the taxpayer to reinvest all of the sale proceeds into a new property.

In its simplest form, the exchange occurs between two individuals at the same time, such as a trade-in on a car purchase. Specific requirements must be met to qualify to defer the gain under Section 1031. These statutory guidelines require that the exchanged and replacement property be business or investment properties and the exchanged properties be of like-kind.[126] In addition, provisions exist for the exchange to occur between multiple parties and when the sale and purchase occur at different times. Additional requirements must be met under these circumstances for the transaction to qualify.

Under certain circumstances, a dealer may arrange a like-kind exchange on the sale of the dealership intangibles (Blue Sky) other than goodwill or going concern value. Franchise rights or supplier-based intangibles may qualify for Section 1031 treatments. In the sale of a dealership's assets, such an approach should be carefully considered and planned.

C. Deferred Third-Party Exchanges

In most situations, sellers of property, especially real estate, rarely are matched up with other sellers who want to trade properties. Even so, a property owner can still benefit from the like-kind provisions by using a third party intermediary to facilitate an exchange. A taxpayer can sell its property and have the proceeds deposited with a qualified intermediary. The taxpayer then generally has 45 days to identify a replacement property and 180 days to complete the purchase of the replacement property using the proceeds from the original sale.[127]

The IRS rules also provide for a reverse version of a deferred exchange. In these cases, the taxpayer finds the new replacement property prior to the sale of an existing property upon which a like-kind exchange is desired.[128]

Due to the specific technical and tax reporting requirements, dealers should consult their tax advisors when considering and conducting a like-kind exchange.

D. Passive Activities

Dealers should be aware of the passive activity rules when structuring the ownership of dealerships and holding the dealership real estate personally, outside of the operating company. In general, losses from passive activities, such as renting real estate, are only deductible to the extent of income gained from passive activities. However, a so-called "self-rental rule" can result in activities where the income is subject to tax even though losses from similar activities are not deductible.[129]

Example: A dealer owns two dealerships. The dealer also owns two entities that hold the real estate. The real estate in one of the entities is rented to one dealership and the real estate in the other entity is rented to the second dealership. One of the rental entities reports a rental profit and the other reports a rental loss. The "self-rental rule" applies. Thus, the rental profit is considered to be from a non-passive activity and the rental loss is considered to be from a passive activity. The rental loss would not be deductible unless the dealer has unrelated passive activity income.

Dealers should consult with their tax advisors to ensure rental arrangements with related companies avoid these unintended consequences.

E. Travel and Entertainment

Certain expenditures for meals and entertainment are subject to a 50 percent deduction limitation. The limit applies to expenses for food or beverages, entertainment, amusement, recreation, and use of a facility for these activities. Dealers should be aware that the rule does not apply to all such expenses and records for expenses that are 100 percent deductible should be properly maintained. The 100 percent deductible expenses are 1) employee recreational expenses; 2) expenses connected with employee training; 3) expenses for meals for employees to enable them to work through a lunch hour; 4) expenses treated as employee compensation; 5) services and facilities made available to the public (e.g., coffee and rolls in the dealership).[130]

Deductions for the use of business aircraft are subject to rules that treat the aircraft as an entertainment facility.[131] The deduction is limited to the amount that is included in the income of the person benefiting from the expense. These rules apply when an officer, director, over 10 percent owner, partner, or managing member uses the aircraft. The IRS has specific guidance on how the aircraft expenses are to be apportioned to the passengers.[132]

XXI. RECORDS RETENTION: SUGGESTED SCHEDULE

Type of Record	Length of Time to Retain
Accident reports/claims (settled cases)	7 years
Accounts payable ledgers and schedules	7 years
Accounts receivable ledgers and schedules	7 years
Audit reports	Permanently
Bank reconciliations	2 years
Bank statements	3 years
Capital stock and bond records: ledgers, transfer registers, stubs showing issues, record of interest coupons, options, etc.	Permanently
Cash books	Permanently
Charts of accounts	Permanently
Checks (canceled)	7 years (exception below)
Checks (canceled) for important payments (taxes, property purchases, special contracts, etc.)	Permanently (file with papers pertaining to underlying transaction)
Contracts, mortgages, notes, and leases	Expired: 7 years Still in effect: Permanently
Correspondence (general)	2 years
Correspondence (legal and important matters only)	Permanently
Correspondence (routine) with customers and/or vendors	2 years
Deeds, mortgages, and bills of sale	Permanently
Depreciation schedules	Permanently
Duplicate deposit slips	2 years
Employment applications	3 years
Expense analyses/expense distribution schedules	7 years
Financial statements (year-end, other optional)	Permanently
Form 8300	5 years
Garnishments	7 years
General/private ledgers, year-end trial balance	Permanently
Insurance policies (expired)	3 years
Insurance records, current accident reports, claims, policies, etc.	Permanently
Internal audit reports	3 years (longer retention periods may be desirable)

Type of Record	Length of Time to Retain
Internal reports (miscellaneous)	3 years
Inventories of products, materials, and supplies	7 years
Invoices (to customers, from vendors)	7 years
Journals	Permanently
Magnetic tape and tab cards	1 year
Minute books of directors, stockholders, bylaws, and charter	Permanently
Notes receivable ledgers and schedules	7 years
Option records (expired)	7 years
Patents and related papers	Permanently
Payroll records and summaries	7 years
Personnel files (terminated)	7 years
Petty cash vouchers	3 years
Physical inventory tags	3 years
Plant cost ledgers	7 years
Property appraisals by outside appraisers	Permanently
Property records, including costs, depreciation reserves, year-end trial balances, depreciation schedules, blueprints and plans	Permanently
Purchase orders (except purchasing department copy)	1 year
Purchase orders (purchasing department copy)	7 years
Receiving sheets	1 year
Retirement and pension records	Permanently
Requisitions	1 year
Sales commission reports	3 years
Sales records	7 years
Scrap and salvage records (inventories, sales, etc.)	7 years
Stenographers' notebooks	1 year
Stock and bond certificates (canceled)	7 years
Stockroom withdrawal forms	1 year
Subsidiary ledgers	7 years

Type of Record	Length of Time to Retain
Tax returns and worksheets, revenue agents' reports, and other documents relating to determination of income tax liability	Permanently
Time books/cards	7 years
Trademark registrations and copyrights	Permanently
Training manuals	Permanently
Union agreements	Permanently
Voucher register and schedules	7 years
Vouchers for payments to vendors, employees, etc. (includes allowances and reimbursements of employees, officers, etc., for travel and entertainment expenses)	7 years
Withholding tax statements	7 years

XXII. TOOL PLANS

A. Accountable Plans

Dealers employ service technicians and usually require them to provide, at their own expense, many of the tools they use to service vehicles. The technicians typically are paid on an hourly basis and do not receive any reimbursement for the cost of tools they must provide. Several companies have designed tool reimbursement plans for dealerships that "reimburse" the technicians for the cost of their tools. These plans purport to meet the IRS accountable plan requirements that provide relief from the payroll taxes that normally apply to wages. Most of the plans allocate a portion of the technician's compensation and identify that portion as a reimbursement for tools purchased by the technician. Tool plan promoters administer their plans for the dealer and charge the dealer a fee for this service.

How tool reimbursement plans generally work:

- Service technicians' total income doesn't change. The allocation of their compensation for tools and equipment is separated from the value of the techs' time and services.
- An administrator determines the tool reimbursement rate, sometimes by using a proprietary formula.
- The dealer provides the administrator with the appropriate timekeeping information for each pay period.
- The administrator charges a fee for the necessary paperwork, administration and accounting services.

The marketed benefits include:

- Reducing employer expenses (payroll taxes and workers' compensation insurance contributions); and
- Increasing employee benefits and take-home pay.

The following rules apply in order to meet the requirements of an accountable plan:

- **Business connection.** Only certain specified expenses qualify and they must be paid or incurred by the employee in connection with the performance of services as an employee of the employer. If the employer pays an amount to an employee regardless of whether the employee incurs the expense, the plan does not qualify. The plan would not qualify, for example, in the case of an employer who pays employees $200, designating $50 as reimbursement for travel expenses for each day that the employee travels, regardless of the employee's actual travel. Since the employer pays $200 per day whether the employee is away or not, none of the $50 is considered to be paid under an accountable plan.

- **Substantiation.** Each business expense must be substantiated either under the rules governing travel and entertainment expenses or in sufficient detail to determine the specific nature of each expense and to conclude that the expense is attributable to the employer's business activities. Each element of the expense must be substantiated.
- **Return of excess.** Employees are required to return any excess amount paid under the arrangement within a reasonable period of time. A safe harbor period is available.[133]

B. Recharacterization Issue

One overriding issue that concerns the IRS is the recharacterization of wages as illustrated thus: A dealership changes the pay structure of a technician who is paid $20 per hour to a plan under which the tech is paid $5 per hour as a tool allowance (under a plan that appears to meet the business connection, substantiation and returning of excess provisions) and $15 as wages. The $5 is paid to the employee for all hours worked. When the reimbursement equals the total expenses incurred by the employee, the employee's wages return to $20 per hour. Does the $5 payment qualify under the accountable plan?

The IRS addressed this issue by stating: The final rules clarify that "if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer's business that are not deductible, the arrangement does not meet the business connection requirement . . . and all amounts paid under the arrangement are treated as paid under a nonaccountable plan." These amounts are subject to withholding and payment of employment taxes when paid. Thus, no part of an employee's salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.[134]

The IRS believes that the dealer has recharacterized the service technician's wages since the technician will receive $20 per hour regardless of the amount of expenses being reimbursed. The arrangement constitutes a recharacterization of wages and does not meet the business connection requirement of accountable plans.[135]

Even if the plan meets the accountable plan rules and the payments are not subject to employment taxes, other considerations may affect the employee.

- Employee's Social Security benefits will be reduced (although the additional take-home pay can be invested into various retirement plans such as a 401(k)).
- Amount paid into a state's workers' compensation insurance fund is reduced (although a disability rider policy will cover employees if they are injured or disabled).
- Administrative costs and individual state wage and labor laws may negate any real benefits to the dealer.

The IRS has ruled that a particular tool plan did not meet the accountable plan rules since the amount of reimbursement paid the techs was based on a formula and not on the amount actually spent by each tech as required by IRS rules.[136]

The IRS again addressed the recharacterization issue when it said: "Generally, wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred deductible business expenses related to the employee's business. The ruling discusses four situations and concludes that three of the situations do not qualify as accountable plans whereas the fourth situation does qualify.[137]

Potential IRS tax issues include:

- Is the arrangement merely a disguised payment of wages?
- Does the program satisfy the accountable plan requirements under IRC 62 and regulations?

- › Business connection requirement.
  - › Substantiation requirement.
  - › Return of excess requirement.
- ▶ Is there a recharacterization issue?

Factors that are important to the IRS if they audit a tool plan include:

- ▶ When did the employer establish such a program, i.e., was it after the Tax Reform Act of 1986 or the Family Support Act of 1987?
- ▶ Why did the employer establish such a program, i.e., were there other than tax motivations?
- ▶ Is the arrangement a written program, does it reflect an arm's length transaction, and is there a basis for allocating amounts between wages and rentals?
- ▶ Are the specific terms of the arrangement actually followed, i.e., are certain requirements meaningless?
- ▶ Does a proprietary formula used to determine the tool reimbursement amount fulfill the business connection requirements of Reg. 1.62-2(d) (i.e., are expenses paid or incurred by the employee in connection with the performance of the employee's services to the dealer)?
- ▶ Are the substantiation requirements of Reg. 1.62-2(e)(3) met when there are no expense reports to support each of the elements of the expenditure or "use?"
- ▶ Were the tools purchased while the employee was working for the present employer?

The IRS has issued an "Employee Tool & Equipment Alert" advising taxpayers who are considering implementing a tool plan to take a cautious approach.[138]

Legal action has been taken by the government against two tool plan vendors resulting in a permanent injunction for one company and the ability of the IRS to obtain customer lists from the other company.[139]

XXIII. UNIFORM CAPITALIZATION

Dealers generally are subject to the Uniform Capitalization (UNICAP) rules if their gross sales exceed $10 million. These rules require dealers to capitalize certain operating costs rather than deduct them currently. The rules for UNICAP are complex and may require dealerships to capitalize purchasing, storage and handling costs. The IRS also maintains that dealerships are producers and are subject to comprehensive capitalization rules.

A. Safe Harbor Accounting Methods

After years of discussion and controversy, including a Tax Court proceeding, the IRS resolved UNICAP for most dealerships. When a dealership adopts two safe harbor provisions, only certain purchasing and off-site storage costs must be capitalized.

Under the first safe harbor, a motor vehicle dealership may treat its entire store, including any integral vehicle lots, as a retail sales facility. Consequently, the dealership is not required to capitalize handling and storage costs at the facility.

Under the second safe harbor, a motor vehicle dealership may treat itself as not having any production activities. Consequently, a dealership is not required to capitalize most handling costs on both dealership-owned vehicles and customer-owned vehicles. Only the cost of vehicle parts used on dealership owned-vehicles must be capitalized as an acquisition cost including parts acquired through a contractor.[140]

All dealerships that desire to use these methods must adopt them originally or make an accounting method change.

B. Reseller UNICAP Rules

Even though the dealership uses the two safe harbor methods, there may be some expenses that are subject to capitalization under the UNICAP rules. These rules are designed to require a dealer to capitalize some amount of operating expenses but there are several elections and provisions that a dealer can adopt to minimize the amount of capitalized expenses. In many cases, the dealer may not be required to capitalize any costs. In general, the UNICAP rules require that indirect costs associated with inventory be added to the cost of inventory and deducted only when the inventory is sold. Since inventory is usually replaced with new stock, there is a certain amount of costs that will continually be added to inventory.

There are two categories of costs that a dealership may still be required to capitalize:

Purchasing Costs. If the dealer has any employees who spend time in purchasing activities, then a portion, or perhaps all, of the employees' compensation, including "service costs," may be required to be capitalized.

Off-site Storage Costs. If the dealer has any off-site storage facilities, then costs allocable to the facility must be capitalized.

There are several technical methods the dealer can adopt to help minimize the amount of costs capitalized. These include:

- Simplified Service Cost Method: Other indirect costs are allocated in one step using a labor-based formula.[141]
- Labor Election: Labor costs of persons involved in purchase activities are not considered for all persons who spend less than 1/3 of their time in purchasing activities.[142]

C. Change in Method of Accounting

The way a dealer determines the applicable UNICAP costs is a method of accounting. A review of the dealer's UNICAP method may reveal that the dealer would be able to reduce, if not eliminate, the UNICAP amount. Before a dealer can take advantage of more favorable UNICAP rules, the dealer is required to obtain the consent of the IRS. This is accomplished by filing IRS Form 3115, "Application for Change in Accounting Method," using either the advance request or automatic procedures as described in chapter I, Accounting Methods.[143] The dealer should consult with a qualified tax consultant for the application of these rules.

ENDNOTES

1. 26 C.F.R. § 1.446-1(a)(2).
2. 26 C.F.R. § 1.446-1(a)(1).
3. 26 C.F.R. § 1.446-1(d).
4. 26 C.F.R. §§ 1.446-1(a)(4)(i), 1.446-1(c)(2)(i) and 1.471-1.
5. 26 C.F.R. § 1.446-1(c)(1)(ii)(A).
6. 26 C.F.R. § 1.461-1(a)(2)(i).
7. 26 C.F.R. § 1.461-4.
8. 26 C.F.R. § 1.461-4(d)(6)(ii).
9. 26 C.F.R. §§ 1.263(a)-1 (T.D. 9636, 9-13-2013 corrected 7-18-2014.)
10. 26 U.S.C. § 461(h)(2)(C) and 26 C.F.R. § 1.461-4(g)(2).
11. 26 U.S.C. § 461(c) and 26 C.F.R. §§ 1.461-1(c), 1.461-4(g)(6) and (8), Example 8.
12. 26 C.F.R. § 1.461-4(e).
13. 26 C.F.R. § 1.461-4(d)(2).
14. 26 U.S.C. § 404(a)(5).
15. 26 C.F.R. §§ 1.461-4(d)(1), (2), (3), (4) and (5).
16. 26 C.F.R. § 1.461-2(a).
17. Rev. Ruls. 96-51 and 2007-12.
18. 26 C.F.R. §§ 1.263(a)-4(f).
19. 26 U.S.C. § 267(a).
20. 26 U.S.C. § 267(b).
21. 26 C.F.R. § 1.446-1(e)(2).
22. 26 C.F.R. § 1.446-1(e)(3).
23. 26 C.F.R. § 1.481-1(c)(1).
24. Rev. Proc. 2015-13 § 8.
25. 26 U.S.C. § 446(b) and Rev. Proc. 2002-18, § 5.03.
26. Rev. Procs. 2002-19 and 2002-18, § 6.
27. Rev. Proc. 2015-14.
28. Rev. Proc. 2015-13 § 6.03(i).
29. Rev. Procs. 2015-14 § 6.
30. Rev. Proc. 2015-14, § 21.04.
31. Rev. Proc. 2015-14, § 22.01.
32. Rev. Proc. 2015-14, § 22.03.
33. Rev. Proc. 2015-14, § 22.04.
34. Rev. Proc. 2015-14, § 11.07.
35. Rev. Proc. 2015-14, § 22.08.
36. Rev. Proc. 2015-1, Appendix A.
37. Rev. Proc. 2015-13 § 11.03(2)(a).

38. Rev. Proc. 2015-13 § 8.
39. 26 C.F.R. § 1.263A-1(e)(3)(iii)(A).
40. 26 C.F.R. § 1.461-4(d)(7), Example (5).
41. Letter Ruling 9243010.
42. Rev. Proc. 2015-13 and 2015-14, § 21.13.
43. 26 C.F.R. §§ 1.461-4(d)(6)(ii) and 1.461-5.
44. 26 C.F.R. § 1.6050I-1(e)(1).
45. 26 C.F.R. § 1.6050I-1(f)(3).
46. The FinCEN E-filing system may be accessed at http://bsaefiling.fincen.treas.gov/main.html
47. *See* IRS Motor Vehicle Technical Advisor Automotive Alert entitled "Cash Reporting and Your Dealership: Questions and Answers on Form 8300," January 2009, available at nada.org/regulatoryaffairs.
48. 26 C.F.R. § 301.6721-1.
49. Tysinger Motor Company, Inc. v. U.S., 428 F.Supp.480 (E.D. Va. 2006).
50. *Id.* at 485.
51. TAM 200501016
52. 26 C.F.R. § 301.7701-3.
53. 26 C.F.R. § 301.7701-1.
54. *See Elliotts, Inc., v. Comm'r*, 716 F.2d 1242 (9th Cir. 1983), and *Labelgraphics, Inc. v. Comm'r*, T.C.M. 1998-343, *aff'd* 221 F.3d 1901 (9th Cir 2000).
55. *See Automotive Investment Development Inc., v. Comm'r*, T.C.M. 298 (1993).
56. Rev. Proc. 98-25.
57. Rev. Proc. 87-56.
58. Listed property annual depreciation limitation does not apply if property leased or held for leasing by any person regularly engaged in the business of leasing such property (*See* 26 U.S.C. § 280F(c)(1)).
59. Treasury Decision 9636 issued September 13, 2013.
60. IRS Notice 2015-82 expands the deduction from $500 to $2,500 without an applicable financial statement.
61. 26 U.S.C. § 280B.
62. 26 C.F.R. § 1.263A-1(e)(3) provides detailed descriptions of these soft costs, while section 1.263A-1(f) outlines the allowable methods for allocating the costs.
63. Rev. Rul. 87-41 and IRS Tax Publication 1779.
64. Section 530(a) of the Revenue Act of 1978.
65. IRS Pub. 1976.
66. IRS Pub. 3204 (12-98).
67. Tentative credit amounts are available at https://www.irs.gov/Businesses/Qualified-Vehicles-Acquired-after-12-31-2009.
68. Rev. Proc. 97-38. Taxpayers, in specified circumstances, may include in income in the year of sale only part of the sales price of a multiyear service warranty contract. The remaining amount is included in income over the life of the contract. A change to the Service Warranty Income Method (SWIM) is made as explained in Rev. Procs. 2015-13 and 2015-14 §14.10.
69. Rev. Proc. 2015-13. Certain eligible taxpayers may change to SWIM (as described in Rev. Proc. 97-38) using the automatic procedures. 2015-14 § 14.10.

70. Rev. Proc. 2004-34, as modified and clarified by Rev. Proc. 2011-18, and Rev. Procs 2015-14, § 15.07.

71. PLR 200525004 (Taxpayer's ESCs are insurance contracts for federal income tax purposes, and the taxpayer may be treated as an insurance company so long as more than half of the taxpayer's business during the taxable year consists of issuing such contracts).

72. 26 U.S.C. § 197.

73. *See Noyes-Buick Co. v. Nichols*, 14 F.Supp. 548 (D. Mass. 1926)(Goodwill continues to be embodied in the franchise and is not property subject to transfer or other disposition by the corporation); *Floyd D. Akers v. Comm'r*, 6 T.C. 693 (1946), *acq.* 1946-1 C.B. 1 and 1976-2 C.B. 1 (In the case of a liquidating corporate distribution, franchise agreements are personal services contracts. No goodwill can exist in a corporation that operates under a "terminable at will" franchise).

74. *See R.J. Durkee v. Comm'r*, 162 F.2d 184 (6th Cir. 1947) (Settlement payments were for damage to goodwill, not for lost profits. The use of lost profits for determining the amount of damage to goodwill is evidentiary only).

75. *See Big Four Industries, Inc. v. Comm'r*, 40 T.C. 1055 (1963), *acq.* 1964-2 C.B. 4 (Settlement was found to be compensation for damage to goodwill when explicitly stated in the settlement decree and such compensation is taxed as capital gain to the extent it exceeds basis).

76. PLR 200218034. The ruling was sought by NADA to address the termination of Oldsmobile franchises. Rev. Rul. 2007-37.

77. *See Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998). Personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill. *See also Norwalk v. Comm'r* 76 T.C.M. 208 (1998) and *H&M Inc. v. Comm'r* 104 T.C.M. 452 (2012).

78. *See Resale Mobile Homes, Inc. v. Comm'r*, 965 F.2d 818 (10th Cir. 1992), *cert. den.* 506 U.S. 873 (1992).

79. 26 C.F.R. §§ 1.267(f)-1(f).

80. IRS Retail Industry Audit Technique Guide, chapter 3, Independent Used Automobile Dealerships, available at www.irs.gov.

81. TAMs 199840001, 199909002 and 199909003.

82. 26 U.S.C. §§ 501(c)(15) and 831(b).

83. IRS Notice 2002-70.

84. IRS Notice 2004-65 and Notice 2009-59.

85. 26 C.F.R. § 1.471-3. Cost means the invoice price less trade or other discounts plus transportation or other necessary charges incurred in acquiring the goods.

86. Rev. Rul. 72-326. A "holdback" charge included in the manufacturer's invoice price of motor vehicles to dealers is not includible in the manufacturer's gross income and the dealer may not include the amount in the inventoriable cost of the vehicles.

87. Rev. Proc. 2002-17 modified by Rev. Proc. 2006-14. An automobile dealer may use replacement cost to value parts inventories.

88. 26 C.F.R. § 1.471-3(b). Cost is the invoice price reduced by the amount of trade or other discounts. Rev. Rul. 84-41 states that it is not proper for an automobile dealer to record the cost of new vehicles in inventory (and cost of goods sold) without reduction of a manufacturer's rebate. The manufacturer's rebate received by the automobile dealer represents a trade discount and, therefore, must be treated as a reduction in the cost of the automobiles in the year of purchase.

89. Rev. Proc. 2015-13. Rev. Proc. 2015-14 §21.04 describes qualifying volume-related trade discounts and provides an automatic method change.

90. 26 C.F.R. § 1.471-4. Lower of cost or market—market is current replacement cost.

91. 26 C.F.R. § 1.471-2(c). Inventory unsalable at normal prices because of damage, shop wear, change of style,

secondhand goods, etc. should be valued at bona fide selling price (actual offering price up to 30 days after the end of the year) less direct cost of disposition.

92. Rev. Rul. 67-107. Used cars taken in on trade may be valued based on an official used-car guide. The IRS agrees that both traded-in and purchased vehicles may be valued on the basis of amounts shown in an official used-car guide.
93. 26 U.S.C. § 472(a). A taxpayer may use the LIFO method.
94. Rev. Proc. 2002-17 modified by Rev. Proc. 2006-16. A taxpayer that is an automobile dealership is permitted to use the replacement cost method to approximate the actual cost of its vehicle parts inventory.
95. Rev. Proc. 79-23. The IRS may terminate LIFO for the following reasons: Conformity violation; failure to properly elect LIFO; failure to value LIFO inventory at cost; or failure to maintain adequate books and records.
96. 26 C.F.R. § 1.472-2(a).
97. Rev. Proc. 97-36 modified by Rev. Proc. 2008-23.
98. Rev. Proc. 2001-23 modified by Rev. Proc. 2008-23.
99. Rev. Proc. 2015-13 and Rev. Proc. 2015-14 §§ 22.03 (new), 22.04 (used) and 22.08 (vehicle pool method). Changes to the Alternative LIFO method may be made under the "automatic" procedures which give automatic consent to the change without paying a filing fee.
100. 26 U.S.C. §§ 472(c) and (e).
101. 26 C.F.R. § 1.472-2(e). 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 one-year period that both begins and ends in a taxable year for which the taxpayer used the LIFO inventory method.
102. Rev. Rul. 97-42.
103. 26 U.S.C. § 1363(d)(1) and 26 C.F.R. § 1.1363-2(a).
104. 26 C.F.R. § 1.1363-2(b).
105. 26 U.S.C. § 1363(d) and 26 C.F.R. § 1.1363-2(b).
106. 26 C.F.R. § 1.472-8(c).
107. Rev. Proc. 2008-23.
108. Rev. Proc. 2015-13 and Rev. Proc. 2015-14.
109. Rev. Proc. 2008-23.
110. Rev. Proc. 2015-13 and Rev. Proc. 2015-14.
111. 26 C.F.R. § 1.446-1(d).
112. 26 C.F.R. § 1.472-8(e)(3).
113. 26 C.F.R. § 1.472-8(e)(3)(iii).
114. Rev. Proc. 2015-14.
115. IRS Chief Counsel Memorandum AM2014-004 (April 7, 2014), "Auto Dealer Facility Upgrade Programs," currently available at https://www.irs.gov/pub/irs-utl/AM2014-004.pdf.
116. IRS Publication 3204 (Rev. 2-2008).
117. IRS Pub. 3204.
118. Rev. Rul. 72-326.
119. Rev. Rul. 72-595.
120. Rev. Rul. 76-96.

121. Rev. Rul. 84-41.
122. 26 C.F.R. §§ 1.263(a)-4(c)(1)(i)–(xv) and (d)(2)-(9).
123. Rev. Proc. 2015-13 and Rev. Proc. 2015-14, §10.05.
124. 26 U.S.C. § 1031.
125. 26 U.S.C. § 1031(d).
126. 26 U.S.C. § 1031(a).
127. 26 U.S.C. § 1031(a)(3).
128. Rev. Proc. 2000-37, as modified by Rev. Proc. 2004-51.
129. 26 C.F.R. § 1.469-2(f)(6).
130. 26 U.S.C. § 274(n).
131. 26 C.F.R. §§ 1.274-10(a)(2)(ii)(c) and 1.274-9(b).
132. 26 C.F.R. § 1.274-10(a)(2)(ii)(C).
133. 26 C.F.R. § 1.62-2(c).
134. Treasury Decision 8324, 55 Fed. Reg. 51,688 (Dec. 17, 1990), as modified by 56 Fed. Reg. 8,911 (Mar. 4, 1991) and Rev. Rul. 2012-25.
135. Rev. Rul. 2012-25.
136. Rev. Rul. 2005-52.
137. Rev. Rul. 2012-25.
138. *See* IRS "Employee Tool & Equipment Alert" (January 30, 2008), available at https://www.irs.gov/businesses/employee-tool-equipment-alert.
139. *See* Press Release, Department of Justice (January 18, 2013), available at http://www.justice.gov/tax/pr/federal-court-permanently-bars-virginia-company-s-promotion-tool-reimbursement-and-tool.
140. Rev. Proc. 2010-44.
141. 26 C.F.R. §§ 1.263A-1(h) and (g)(4)(ii).
142. 26 C.F.R. § 1.263A-3(c)(3)(ii)(A).
143. Rev. Procs. 2015-13 and 2015-14.

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