

# **Market Segment Specialization Program**

## *Independent Used Car Dealers*

**Training 3147-106 (Rev 08-2002)  
TPDS No. 84219B**



# **The IRS Mission**

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**Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.**

# Independent Used Car Dealers

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# **Chapter 1**

## **INDUSTRY BACKGROUND**

### **INTRODUCTION**

The used car industry as with any industry has certain business practices that are used throughout the industry. A key to a successful examination of a used car dealer is an understanding of these business practices.

### **INDUSTRY JARGON**

Certain jargon is widely used in the industry. Exhibit 1-1 contains definitions of terms used in the industry. However, even these terms may vary from region to region. Nevertheless, the list may be useful in understanding how the industry operates. Become familiar with these terms as many of them are used throughout the Guide.

### **INDUSTRY OVERVIEW**

The used car industry is composed of two major segments. The first segment is made up of the new car dealers who accept trade-ins on the sale of new automobiles and can also purchase used vehicles directly from customers, other car dealers, or at wholesale auto auctions. The new car dealers then sell the used vehicles either to retail customers, to used car dealers, directly to wholesalers through auctions, or to other miscellaneous customers.

The second segment of the industry is made up of independent auto dealers such dealers are not affiliated with an automaker and, whose principal business is the sale of used vehicles. Since no trade franchise (that is, General Motors, Ford, etc.) is necessary, the size of the used car dealership and the capital required to enter the industry varies. However, every used car dealer must be licensed with the state in which the dealership is physically located. Most states have different laws that govern the ability of individuals or businesses to sell used vehicles without a license. For example, one state permits an individual to sell up to five vehicles per year without obtaining a license. Other states are more or less restrictive.

Independent auto dealers acquire vehicles from trade-ins on the sale of used vehicles. Such dealers also purchase vehicles from individuals (private purchase arrangements), other new and used vehicle dealers, and at wholesale or retail auctions.



Typically, independent dealers maintain one or more sales locations where they keep their inventory. Most of these dealerships are engaged in retail sales. For an independent dealer, both the sale and delivery of the vehicle generally occur on site. Most sales are to individual customers, although dealers frequently, for various reasons, sell automobiles to other dealers or through auctions. A few states also allow retail dealers to sell vehicles on consignment.

Wholesalers make up a smaller second segment of the used vehicle trade. Wholesalers do not sell to the general public and generally do not have a sales lot. A wholesaler buys vehicles from retail dealers and either sells them directly to other retail dealers or takes the vehicles to auction. They may also purchase vehicles at auction for sale to retail dealers. Some wholesalers also purchase vehicles from public sources such as estates, fleets, businesses, and in response to newspaper ads, etc.

A sales lot used by an independent dealer can generate a significant amount of activity, which does not produce sale and is not related to a sales transaction. For example, customers frequently browse just to get an idea of what is available, or may visit the lot several times before buying a vehicle.

Many independent dealers do not repair customer vehicles after the customer's purchase; there is normally no service department. However, many dealers maintain a mechanic or have reconditioning facilities to prepare newly acquired vehicles for resale.

## **IMPACT OF STATE REGULATION AND STATE LAW**

Every state regulates the operations of the independent dealer and, requirements vary from state to state. The specific requirements imposed on a dealer depend on the particular state in which the dealer does business. Common dealership activities regulated by states include:

- Transfers, assignments, and reassignments of titles
- Title transfer processes
- Collection and repossession rights and liabilities
- Consignment rules and procedures
- Payments of commissions for referring buyers
- Documentation for sales and purchases.

Information about the specific state rules and regulations can be obtained from the sources listed at the end of this chapter. Additional information on state laws may be obtained from your state Motor Vehicle Division.

## **Curbstoners**

One problem that the industry faces is competition from unlicensed dealers (curbstoner) who buy, sell, and trade more used vehicles than a state allows without a license. In almost every case, the curbstoner has no fixed place of business and fails to adhere to most of the accepted industry practices or customs. It is not known how much revenue the curbstoners generate, although industry officials acknowledge that the amount is significant. Since curbstoners do business illegally it is likely that their income from sales goes unreported.

State attempts to enforce licensing laws against curbstoners are hampered by a lack of personnel and money. Furthermore, with no fixed place of business, a curbstoner is often difficult to track. Signs of potential curbstoning include:

- Multiple auto listings in a paper with the same phone number
- Displays of multiple vehicles "for sale" in shopping centers or similar parking lots all with the same phone number
- National Auto Data Service (NADS) information

When you find that an individual or business is engaged in curbstoning, a referral to the appropriate state regulatory agency may be appropriate. **Check with your Area Disclosure Office before making any referrals to other agencies.**

## **Records**

The Federal Truth in Mileage Act requires odometer statements to be retained by both the buying and selling dealers. Most states require that a licensed dealer maintain certain records, which must be available for inspection by the appropriate state licensing or regulatory agency. Information about the records a dealer is required to maintain in a particular state can be obtained from the state agency responsible for the regulation of independent dealers. (Normally this will be the state Motor Vehicle Division or the state Department of Revenue.) Aside from these state and federal requirements, other specific records that must be maintained will vary from state to state.

The sophistication of the accounting and records system (including record retention) will normally vary with the dealer's size and location. However, there are certain common industry practices that provide documentation for a sales transaction. These

practices will vary from state to state, since each state has different record retention requirements, but the basics will be the same. These industry practices are discussed in the various sections on income recognition and inventory. Currently, there is no overall computer accounting program specifically designed for independent dealers, however, there are many programs that are used by dealers.

The key record of a car sale is the car jacket, customer file, or deal jacket. A separate file is normally maintained for each sale. Many dealers create a deal jacket whenever a vehicle is purchased and assign a stock number to the vehicle. In that case, the deal jacket may also be used to track the cost of the vehicle and the cost of reconditioning the vehicle for sale. The file generally contains:

### **Cash Sale (No Trade-in)**

1. Sales, Retail Buyer's order (including the VIN),
2. Buyers name, address and other information,
3. Sales Price,
4. Sales tax (depending on the state, sales tax may be on the gross sales price or net sales price),
5. Documentary and Filing (Doc) fees,
6. State and Federal Disclosure statements, including Odometer readings,
7. Vehicle stock number,
8. Extended warranty or service contract information and information on any insurance purchased,
9. Form 8300, if applicable.

### **Sales with Trade-ins**

1. Same items as for a cash sale, and
2. Payoff on any outstanding loans, if applicable,
3. ACV of trade-in.

The customer file may be a separate manila folder, an envelope with the information in it, or simply papers stapled together. All are acceptable methods of record retention.

A dealer will normally also maintain cash receipts records that will show the cash received by the dealer on a daily basis. An analysis of the deposits will indicate the sources of the dealer's revenues, which could include:

- Auto sales
- Collections on self-financed sales
- Commissions from service/warranty contracts sold
- Commissions from disability and life insurance contracts sold

- Commissions from bank financing
- Customer paid service work

## **Consignments**

Some states allow dealers to sell vehicles on consignment. In these cases an individual may contract with the dealer to sell the vehicle. The individual receives a stated price upon the actual sale of the vehicle. The dealer receives either a flat fee or any excess of the sales price over the stated floor price agreed to with the owner. There are two different practices for recording the cost aspects of the consigned vehicles.

In the first and preferred method, when the consignment agreement is entered into, a stock number is assigned to the vehicle. Costs incurred in prepping and repairing the consigned vehicle are posted to its assigned stock number. The stock numbers assigned to consigned vehicles may have a different numbering system or some other designation that quickly identifies the vehicle as a consigned vehicle. At the time of sale, the consigned vehicle is then assigned another stock number to reflect the stated price to be paid the owner, and the reconditioning costs are transferred to the new stock number.

Under the second method, a stock number is not assigned until the sale of the consigned vehicle actually occurs. In either method, incidental and reconditioning costs incurred by the dealer are deducted from the stated price paid to the owner. Many dealers also treat consignment sales from other dealers differently than consignment sales from the general public. Consignment sales from the general public are more detailed in the dealer's books because of titling concerns.

## **Auctions**

Aside from customer trade-ins, the most significant source of inventory for dealers is an auction. Dealers use auctions both to buy and sell vehicles. Dealers use wholesale auctions, where only dealers are permitted to buy or sell. Most dealer transactions are handled by the wholesale auctions. Some states also permit retail auctions, which are open to the general public, and may be used by the dealers as well.

Each auction company is run independently, maintains different records, and has its own procedures. Some common rules and procedures are used in the auction industry include:

- Every dealer must register with the auction,
- The dealer will provide the auction with the year, make, VIN, and equipment of each vehicle offered for sale, either by phone or on site,
- The auction will issue the selling dealer an auction check, thereby assuming the risk of collection on the buyer's check,
- The auction will handle the actual assignment of title to the buyer,

- The seller may set the floor or lowest price that the vehicle may be sold for by the auction.

**Generally, each auction holds its general wholesale sale once a week.** It is common for dealers to attend more than one auction a week since each auction offers different types of vehicles in varying price ranges for sale. Special manufacturer and fleet auctions are held at various times throughout the year. Dealers often attend several auctions a month, many of which are in another state. By attending auctions outside of his or her area, a dealer is able to take advantage of better market conditions for a specific type of vehicle. For example, a dealer in Florida may want to purchase convertibles, which may have a high price in the Florida market. However, a Wisconsin auction may offer convertibles for sale at much lower prices due to the lack of demand there. The Florida dealer will travel to Wisconsin, buy the convertibles, and profit from their sale to customers in Florida. Thus a dealer from one part of the country can benefit from obtaining vehicles at an auction in another part of the country.

While the overwhelming number of dealers may have a valid business reason for attending out of state auctions, such practices are also a compliance concern. See Travel and Entertainment under Chapter 6, Expenses, for details. A few dealers have been found attending out of state auctions to facilitate buying and selling vehicles "off the books."

The starting point of an auction is the registration of the dealers participating in the auction whether they are buying or selling. The auction generally requires that the dealer be registered in advance. This usually involves obtaining a copy of the dealer's license.

Once registered a dealer may participate in an auction. The selling dealer will provide the auction with the appropriate information about the vehicles offered for sale, as discussed previously. The vehicles will be assigned a number, which will be displayed on the windshield, and offered for sale. Since the seller has the right to set a floor price below which the vehicle may not be sold, not all vehicles offered for sale at an auction are sold. However, on average roughly 50 percent of the vehicles in a regular wholesale auction will be sold.

Once a buyer has successfully bid on a vehicle at auction, he or she is afforded an opportunity to inspect the vehicle to be sure that all representations about the vehicle made by the seller are correct. If there are no problems, the buyer then proceeds to settlement, and gives the auction his or her check for the purchase price. The auction fills in the title in the buyer's name and delivers the title to the buyer.

On the other side of the transaction, the seller will sign the title and deliver it to the auction for completion. The seller will then receive an auction check, with the restrictions noted below. Each party will also receive an invoice (Block Ticket) that shows the vehicle sold, as well as the identities of the seller and

buyer. The auction invoice will also usually include an executed odometer statement.

The auction will not usually issue payment to a dealer without proof that a business bank account exists. Additionally, the auction normally provides restrictive endorsements on the check issued to the dealer to be certain that the proceeds are deposited to that account. For example, an auction will not issue a check to an individual, but will issue the check in the individual's business name. The check will normally bear some restrictive endorsement on the back, such as, "For Deposit to Account of Payee Only." Many auctions request a copy of a dealer's check to verify with the bank that the dealer actually has an account there.

Since the auctions guarantee that vehicle titles are lien free, the auctions handle all title issues to ensure that the transfer is made correctly. Some common title problems include incorrect VIN, unsatisfied liens, incorrect title assignments, and an incomplete chain of title. The auctions have a great deal of experience with interstate transactions and generally have a very good working relationship with the various states Motor Vehicle Divisions.

## **Titling Issues and Processes**

Titling procedures are determined by state law; thus there are 50 different sets of rules that apply. The state Division of Motor Vehicles, or similar agency, regulates the issuance and transfer of a vehicle's title and maintains a record of the owner. This information is available, although its usefulness in tracking an unreported sale or sales will depend on the database used by that particular state. In most states dealer to dealer transfers of title are accomplished through dealer reassignments. These reassignments are not usually recorded unless the state issued the original title or is recording the title once the vehicle is ultimately sold to a retail customer. All of these issues are compounded by the tremendous amount of interstate sales that occur. Although the use of state title transfers does have drawbacks and cannot be used to reconstruct or determine all of a dealer's sales, it remains a useful tool in checking the accuracy of reported sales. Despite no uniformity in titling rules or procedures, some very basic elements exist in all states:

- Every vehicle must have a title,
- There must be a written record of the sales transaction given to a customer,
- A title must contain certain specific information, although the contents will vary from state to state,
- A valid title must be produced in connection with a sale, but some exceptions exist for old vehicles in some states,
- Only dealers can reassign title, individuals cannot reassign titles.

Generally, title to vehicles purchased at an auction is reassigned directly from the seller to the buyer, although some states require the auction to note on the

reassignment of title that the transaction is an auction sale. Some dealers may also purchase vehicles purchased in Canada. Canadian titling laws are much different from those in the United States, and advice on procedures should be sought from an international examiner, who can put you in contact with the Revenue Service Representative for Canada. Do the same with any dealer transactions in Mexico.

In most states, dealers need not take actual title to a vehicle, but can reassign the title. This may be done on the title, or on a separate sheet attached to the title. The significance of reassignment is that the dealer will not have to register the title with the Motor Vehicle Division until the vehicle is sold "at retail" to a non-dealer customer. This can make tracking the sale of a vehicle very difficult.

#### **Example 1**

A dealer in Virginia takes a vehicle with a Maryland title in trade on a sale. The dealer then sells the trade-in at a North Carolina auction, where the title is reassigned to the North Carolina dealer who acquires the vehicle. That dealer then sells the vehicle to a Florida dealer with a reassignment of title. The Florida dealer then sells the vehicle to a New York dealer, again reassigning the title. Finally, the New York dealer sells the vehicle to a California dealer, by yet another title reassignment. The California dealer then sells the vehicle to a California resident. The State of California will issue the new title to the retail purchaser. California may notify Maryland, the state with record of the original title, of the new title. Maryland would then cancel the original title. The notice may show all of the reassignments. However, no title record of the vehicle's sales will appear in any of the intervening states. The Virginia, North Carolina, Florida and New York Motor Vehicle Divisions will not record the vehicle being sold in their state. However, each dealer should have a deal jacket for the transaction involving the vehicle.

## **Automobile Sales**

Used vehicles sales, obviously, are the principal source of income of a dealer. The sales of autos will generally be made to three broad groups. First, the bulk of the income will be from the sale of a single vehicle to an individual buyer. The dealer may also have income from direct sales to other dealers or wholesalers and from the sale of vehicles at wholesale or retail auctions.

Generally, sales proceeds from an auction will be paid to the dealer by check marked "deposit only" or "deposit only to the account of payee." Payments from sales to other dealers can be in cash, by check or from the proceeds of loans made by a third party. If more than \$10,000 is received in cash, the dealer will be required to file Form 8300, Report of Cash Payments over \$10,000 Received in a Trade or Business. See the Chapter 7, Required Filing Checks, for more information concerning Form 8300.

The ultimate determination of the sales price will depend on a number of factors. The initial "sales price" (asking or list price) established by the dealer

is rarely the final sales price. The difference is a discount allowed to the buyer. However, that discount will not be determined the same way for each buyer because different needs and desires motivate each buyer. Thus, some buyers want a large discount and accept the dealer's valuation of the trade-in; others want a large trade-in allowance (which in effect reduces the discount the dealer is willing to give) and still others only worry about the monthly payment. Since the dealer is interested in the bottom line profit on the sale of the vehicle, the sales price on substantially similar vehicles may differ greatly. For example, an individual who is willing to accept the ACV for his or her trade-in may have a lower sales price (or greater discount) than an individual who insists on a trade allowance greater than the trade-in's ACV, as illustrated by the following.

**Example 2**

A dealer wants a gross profit of \$500 each on two identical vehicles each with a cost basis of \$3,000. The asking price of each vehicle is \$3,900 before any discounts. Customer #1 has negotiated final sales price of \$3,500, with a \$2,000 cash payment and a trade-in allowance of \$1,500 which is the ACV of the vehicle traded in. The sales contract may show the net price of \$3,500 (\$2,000 + \$1,500) or the gross price of \$3,900, less a discount of \$400. Customer #2 has a trade-in with an ACV of \$1,500, but refuses to accept anything less than \$1,750 for his trade-in. For the second customer, on the identical vehicle, the final net sales price will be \$3,750 (\$2,000 + \$1,750) to take into account the \$250 over-allowance.

In each of these cases, the gross profit is \$500; however, the sales price and trade allowances are different. Furthermore, in each case, the cost of the trade-in for inventory purposes will be \$1,500. The proper accounting entry to record a sale with a trade-in is as follows using the gross sales price (using the example above):

	<b>CUSTOMER 1</b>		<b>CUSTOMER 2</b>	
	<u>DR</u>	<u>CR</u>	<u>DR</u>	<u>CR</u>
Cash	2,000		2,000	
Discount	400		150	
Overallowance			250	
Purchases or Inventory	1,500		1,500	
Sales		3,900		3,900

Notice that the only difference between these two transactions is that for Customer #1, the dealer combined the Overallowance and discount into one account, rather than maintain separate accounts for each type of discount. Note that a dealer may also account for the sale as a net sale, in which case the discount and overallowance would be netted against the sales price, and the net figure recorded as the sales price.

Many dealers do sell service or warranty contracts at or close to the time of the sale of the vehicle. These service/warranty contracts are most often third party obligor contracts, with the dealer receiving a commission for the sale.



Recently, some dealers have begun to establish separate related companies to sell these contracts.

There are several business reasons to establish a separate company to sell the contracts. Liability can be isolated in a separate entity, ownership of the separate entity can be spread among employees or family members, and any problems associated with the sale of these contracts can be handled without jeopardizing the vehicle sales business. There are no inherent prohibitions against using a separate company for this business, and there are normally no additional costs that are incurred above the normal costs of creating a new entity.

## **INITIAL INTERVIEW**

The initial interview is crucial in all examinations. When examining an independent used vehicle dealer, as with all other examinations, the standard interview questions are required. There are a number of specific industry related questions that should also be included as part of the interview process. These questions will help the examiner gain an understanding of how the dealer operates his or her business and help determine the scope and depth of the examination. **Remember to be flexible and adapt the line of questioning to the taxpayer's responses.**

During the initial interview, the examiner should address the dealer's internal controls. Areas to consider include what the owner is doing to protect himself or herself from the occasional dishonest employee. This is of primary concern when examining buy here/pay here lots where customers are coming in with weekly payments on financed vehicles. The need for the determination whether internal controls are adequate increases when the owner or close relatives are not physically present on the business premises or if the taxpayer has more than one business. When questioning the owner on how cash is handled, the examiner should appraise the responses in light of whether they are likely to protect the owner. Effective questioning may lead to the identification of records that would not have been provided during the course of the examination. For example, the examiner may want to ask the owner if he or she keeps a personal record or list of his or her profits on each vehicle or deal. The examiner may also want to ask what other records, listings or summaries on business transactions, other than those already provided the business or owner maintained.

## General Questions

1. What types of sales transactions did you have for the year under examination?
  - a. Any sales at auctions? If yes, which?
  - b. Any sales to wholesalers? If yes, which?
  - c. Any sales to other dealers? If yes, which?
  - d. Any consignment sales? If yes, volume?
  - e. Any scrap sales? If yes, describe.
  - f. Any in-house dealer financing sales?
  - g. Any third party financing sales?
  - h. Did you have any other types of sales transactions?
  - i. Did you have any sales that resulted in a loss on the sale? If yes, describe the nature of these sales.
  - j. What sales did you have to relatives or friends during the year? Identify.
  
2. Besides the above sales transactions, what are your other sources of income or revenue?
  - a. Interest income on dealer financed sales?
  
  - b. Commissions or referral fees on third party financing?
    - 1) What third party financiers did you use?
    - 2) What was the fee/commission arrangement?
  
  - c. Commissions or referral fees on vehicle insurance placement?
    - 1) Which insurance companies were used?
    - 2) What was the fee/commission arrangement?
  
  - d. Commissions or referral fees on warranty/repair placement programs?
    - 1) Which were used?
    - 2) What was the fee/commission arrangement?
  
  - e. What other commission/referral fee arrangements do you have income from?
  
  - f. Do you have any other sources of income/revenue that we have not discussed? If so, please describe.

## How Sales Are Recorded

1. When selling a vehicle, how do you report the sale?
  - a. Gross sales price per Sales Contract?
  - b. Net cash received upon sale after discount and/or trade-in?

2. Through the use of a sales contract made in the year under examination, show me how you recorded the sale.
3. Do you have an outside accountant/bookkeeper record your sales? If so, explain in detail what records you provide.
4. Are sales taxes reported in the gross sales price?
5. Are licensing fees or titling fees included in the sales price? (Note; if answer is no, look for them as expense items, if so, make the appropriate adjustment.)
6. If the sales taxes and/or licensing and titling fees are reported in gross sales, how do you account for them? Are they listed as a separate item on the books?
7. How often do you reconcile deposits to income? Identify the specific bank accounts that sales income is deposited to.
8. Give specific examples of when sales income has not been deposited.
9. Have you ever deposited any sales receipts into any other bank accounts (payroll account, personal draw account, etc.)? If so, list them.
10. Explain how cash sales transactions are recorded.
11. Do you have any business expenses you pay in cash? Provide specific examples.
12. What is the original source of these cash funds?
13. How do you treat customer deposits?
  - a. How are they recorded on the books when received?
  - b. How are they recorded when the sale is finalized?
14. Do you have a minimum deal gross profit percentage or dollar amount (for example, \$100 minimum profit per vehicle) for consummated sales?
  - a. Do you disregard your minimum gross profit to consummate a sale?
  - b. Do you use an average gross profit markup in establishing the original sales price for the year under examination?
  - c. NOTE: If used, the average gross profit markup for a vehicle that is common, in average condition, and in a common color will reflect a gross profit significantly different than that of a vehicle in limited supply.

15. Do you sell warranty or service contracts?
  - a. How do you record the income from them on the books?
  - b. How do you record the expense items on the books?
  - c. Note: Be attentive to proper timing of Income/expenses.
  
16. Do you finance sales?
  - a. How do you record the income from the financing on the books?
  - b. Note: Be attentive to proper timing of income.
  
17. Do you sell finance contracts?
  - a. How does this transaction work?
  - b. Who do you sell finance contracts to?
  - c. Have the taxpayer walk you through a specific example.
  - d. Do you own or are you a shareholder of the finance company?
  - e. If the owner of the vehicle dealer is also an owner of the finance company, see Related Finance Companies under Accounting Methods, for additional information.
  - f. Do you have a dealer reserve account at any financial institution?  
(See discussion of finance reserve income (*Commissioner v. Hansen*, 360 U.S. 446 (1959)) in the Gross Receipts section of this ATG.)
  
18. What other goods or services do you provide in your business? How are these transactions reported on the books? Vehicle repairs? Porter/detailing services? Vehicle mats, etc.?

### **Pricing Policies and Discounts**

1. When setting an asking price for a vehicle, what information sources do you consult, for example, Blue Book?
2. When valuing a trade-in vehicle, what method do you use, that is, resale value to a customer, wholesale value to another dealer, or some other method such as personal judgement? Please explain the method by giving an example?
3. How do you arrive at the amount of discount you recognize on a sale? Please provide an example.
4. When overvaluing a trade-in how do you record it on the books? How do you record this paper loss?
5. When recording a sale of a trade-in on the books, how are the ACV and the discount recorded on the books?

### **Inventory Items**

1. When setting an inventory value for a vehicle, what information sources do you consult, that is, Blue Book?
  - a. Do you ever change this value?
  - b. How is this change in value recorded on the books?

- c. What factors are considered when changing the inventory value?
  - d. Do you always use one official valuation guide or do you consult more than one? Please explain. (Methods of fixing values differ among valuation guides. See Discussion of Treas. Reg. section 1.446-1(a)(2) in Chapter 4.)
  - e. For any vehicle that is valued below cost, how does the asking price at any point in time differ from the value recorded on the books at year-end? Please explain. (The propriety of a write-down may be determined by actual sales price. See discussion on Treas. Reg. section 1.471-4(b) in Chapter 4.)
2. If a vehicle is portered or repairs are made to it for resale, how do you record these costs?
    - a. Current expense?
    - b. Added to the value of the vehicle?
  3. When junking a vehicle for scrap, how do you account for it?
    - a. What value is used for vehicles in ending inventory?
    - b. Does this value differ from the one originally recorded at the time of acquisition?
    - c. In determining the yearly LIFO index, what is the vehicle in ending inventory compared to in the ending inventory of the preceding year (that is, the taxpayer's own cost for the same type of vehicle or a "reconstructed" cost from an official valuation guide for the same type of vehicle at the beginning of the year)?
    - d. Explain how these vehicles are comparable.

### **Miscellaneous**

1. Have you ever taken items other than vehicles in trade?
  - a. Please explain.
  - b. How was this accounted for on the books?
2. Explain the titling regulations that you are responsible for as a licensed vehicle dealer.
3. Provide your log/record of titles for all vehicles sold for the year.
4. Do you acquire vehicles at auctions?
  - a. If yes, which auctions?
  - b. Which, if any, are out of state?
5. Do you acquire vehicles from wholesalers?
  - a. If yes and a few are used, which wholesalers are used?
  - b. If yes, and many are used, who are the primary wholesalers?
  - c. What out of town wholesalers do you use?

6. What other non trade-in sources of vehicles do you utilize?
  - a. What business names do they operate under?
  - b. Are any of these businesses out of state?
  - c. If yes, which ones are out of state?
7. How can I identify how a vehicle was acquired for resale?
8. How do you gauge the used vehicle market at any given time?
9. How does this affect your pricing and valuation practices?
10. Do you and your family members own a vehicle?
  - a. Do you or your family members drive vehicles off the lot?
  - b. If so, which vehicles are used by you and your family?
  - c. How are gas, oil, and other expenses paid and by whom?
  - d. Are the use of the vehicle and/or payment of personal vehicle expenses included in income?
  - e. If you use a vehicle for business, what records do you keep?
  - f. What are the natures of the business trips?

## **INFORMATION SOURCES ON USED CAR DEALERS**

National Independent Auto Dealers Association (NIADA)  
2521 Brown Blvd. Ste. 100  
Arlington, TX 76006-5299

State Division of Motor Vehicles  
(See local phone directory or state government listing for address)

American Association of Motor Vehicles Administrators  
4200 Wilson Blvd. Ste 1100  
Arlington, VA 22203

National Auto Data Service (NADS)  
4211 S.E. International Way  
Milwaukee, OR 97222

State Independent Auto Dealers Association  
(Address can be obtained from NIADA)

State Business Licensing Bureau  
(See local phone directory or state government listing for address)

Municipal or County Business Licensing Bureau  
(See local phone directory or municipal or county government listing for address)

[www.independentdealer.com](http://www.independentdealer.com)

(a website devoted to Independent Dealers and the used motor vehicle industry)

**Financial information** on used vehicle retailers and wholesalers, including average financial ratios is available from:

Robert Morris Associates  
One Liberty Place  
Philadelphia, PA 19103

The Robert Morris business ratios are available at most public or university libraries.

The data in the ROBERT MORRIS ASSOCIATES ANNUAL STATEMENT STUDIES was compiled with the help of commercial bankers. Data generated is useful in giving general information about industries, including used vehicle dealers. The publishers do warn the users that since the averages were not generated from a statistical sample, they should not be used as industry norms. The numbers are, however, very useful for comparative purpose.

Data available includes current year and historical year data (the 4 immediately preceding years) for balance sheet and income statement items. A variety of additional financial ratios are provided.

The data are further broken down by asset size for the current year. Asset and liability classifications closely approximate the balance sheet on a tax return. The income data are sparse, including only three expense classes: cost of sales, operating expenses, and all other expenses.

## Industry Jargon

**A.A.M.V.A.** - American Association of Motor Vehicle Administrators. The association consists of the various state motor vehicle department administrators.

**ACV - ACTUAL CASH VALUE** - The wholesale value assigned to a trade-in or purchase. The ACV will usually differ from trade-in allowance (the credit allowed customer on purchase of vehicle). ACV becomes cost adjusted by reconditioning costs and other costs. The ACV is determined by the dealer at the time of purchase or trade, based on valuation guides and adjusted for the specifics of each vehicle. ACV can be higher or lower than the trade-in allowance.

**AUTO AUCTION** - Auto auctions are generally of two types. Dealer Auctions are open to licensed car dealers only. Public auctions are open to every one. Selling prices are set through competitive bidding on each vehicle rather than by the seller.

**BIRD DOG FEES** - A fee paid for a customer referral. The referral may be made by a licensed or unlicensed individual and may be regulated or unregulated by the particular state.

**BLACK BOOK** - One of several publications listing wholesale and retail price ranges of used vehicles. See guidebook below.

**BOOK VALUE** - The wholesale value of a given used vehicle in a specific market area at a particular time of the year, as determined by a recognized wholesale appraisal guide book.

**BROKER** - A middleman who locates vehicles for other dealers, usually on a commission basis. A broker does not take title or possession of the vehicles, whereas a wholesaler takes possession and title of the vehicles.

**BUY HERE/PAY HERE DEALER** - A dealer that offers in-house dealer financing for the vehicles sold. (Dealer provides financing either on his or her own or through a separate finance company owned and run by the dealer. Usually the finance company will share employees and office space with the dealership.) Also see Related Finance Company.

**CAR JACKET (DEAL JACKET)** - The complete history of a vehicle from the time it is purchased to its sale. The jacket should contain, in addition to the purchase and sale price, any invoices and costs associated with repairs, delivery and parts. It also contains any Federal Trade Commission and state required notices such as odometer statements, Vehicle Identification Number (VIN), stock number and records of the sales transaction. The jacket is normally a folder containing all the information; however, some dealers may maintain a ledger sheet or index card on each vehicle instead of the folder.



**CHARGE BACK** - A loan financed through the dealer is paid off sooner than the loan term. The finance company will make the dealer pay back part of the commission. This also happens with insurance commissions.

**CURBING** - Sale of a vehicle by an unlicensed dealer from a shopping center parking lot or similar area. See CURBSTONER.

**CURBSTONER** - An unlicensed dealer. These "merchants" sell in violation of the law, usually from shopping center parking lots or similar areas. Since each state has different licensing requirements, the definition of a "curbstoner" will vary from state to state.

**CUSTOMER FILE** - Refer to CAR JACKET.

**DEAL** - The completed sale of a vehicle or truck to an individual or another dealer.

**DEALSHEET** - The sales order or invoice showing the sale of a vehicle to an individual or another dealer.

**DELIVERY EXPENSE** - Transportation of used vehicles from the point of purchase to the dealership, or the cost incurred to transport autos involved in a dealer trade. This activity may also be referred to as hiking or shuttling.

The service may be done by the owner, a towing service, self-employed individuals, or employees. This expense may lead to an employment tax issue depending on facts and circumstances.

**DETAILING** - To prepare a vehicle for resale. This usually includes cleaning, minor repairs and cosmetic work. Detailing is often used synonymously with reconditioning. This may be done by the dealer, an outside business, or individuals brought in to do the work. Also called Porterage. This expense may lead to an employment tax issue.

**DISCOUNT** - The difference between the asking and list price established by the dealer and the final sales price of a vehicle.

**DOCUMENTARY (DOC) FEE** - A fee charged for processing or handling the documentation of a sales transaction. May also be called procurement fee or processing fee.

**DOMEBOOK<sup>(TM)</sup>** - A journal used by small businesses to help organize income and expenses on a monthly basis. It has separate monthly pages for receipts, purchases, and other expenses.

**DOUBLE DIP** - Person with a loan for the purchase of a vehicle and with additional outside financing for down payment that may or may not be shown as a lien on the title.

**FLOORING/FLOOR PLANNING** - Costs incurred in obtaining inventory, usually through loans from a bank or other financial institution. Includes interest on the loans. Some dealers may be utilizing auction floor plans for the purchase of vehicles. This is a growing industry and one that will probably become common in the next few years.

**GUIDEBOOK** - A book used to value trade-ins and vehicles in inventory. It is also used for sale purposes. The most common guidebooks used in the industry include the Kelley *Blue Book*, *NADA Used Car Guide*, "*Black Book*," "*Red Book*," "*Gold Book*," *CPI Book*, and *Galves*. There are other publications that may be used on a regional basis. Guidebooks are often referred to as the Black Book, Blue Book, Yellow or Gold Book. Each of these publications is recognized by the industry as one of the official used vehicle guides for determining values of used cars. The popularity of a particular book varies by region.

**HIKING** - See Delivery Expense above.

**IN-HOUSE FINANCING** - Financing provided by the dealer. Also known as Buy Here/Pay Here.

**KELLEY BLUE BOOK** - One of several publications listing wholesale and retail price ranges of used cars. See guidebook above.

**L O C** - Line of Credit, usually from a bank. A loan on which the dealer can take out money whenever needed; similar to a checking account with interest charged. The line has a maximum amount that can be outstanding at any time. Similar to floor planning, but not used solely for purchases of inventory.

**N.A.A.A.** - National Auto Auction Association

**N.A.D.A.** - National Automobile Dealers Association

**N.A.D.S.** - National Auto Data Service

**NET SALES PRICE** - Sales price less any trade-in allowance or discounts.

**N.I.A.D.A.** - National Independent Automobile Dealers Association.

**ONE PAY** - Single payment contract for delivery of vehicle. Allows dealer to deliver vehicle to customer immediately rather than waiting for loan approval. Customer usually is obtaining own financing and will pay the sales price in full once financing is provided by the lender. This is often reflected by a demand note from the customer.

**OPEN TITLE** - A title signed by the seller that has the buyer's name left open or blank. Also called a skip title. Generally, transferring a vehicle with an open title is illegal.

**OVERALLOWANCE** - The excess of trade-in allowed over the auto's ACV. This is used as a means to close the deal. Usually, the difference is made up by decreasing the discount on the vehicle purchased.

**PACKAGE DEAL** - The purchase of two or more vehicles for a lump sum price. This generally occurs between dealers and is one way to sell a vehicle that otherwise would be difficult to move.

**PORTERING** - See DETAILING above.

**RATE SPREAD** - A rate spread occurs when a dealership had made arrangements to write vehicle loans for a financial institution. The dealership will pre-arrange the amount of interest rate that the financial institution will charge on vehicle loans to buyers. The dealership will then write loans at a higher rate and receive the excess interest generated by the loan as an income payment from the financial institution.

**REASSIGNED TITLE** - A title transferred from dealer to dealer which may not require processing by the state in which the dealer operates.

**RECONDITIONING** - Any work done to prepare a vehicle for sale. Includes parts, labor, cleaning, and other work done on a vehicle. May be part of detailing or portering expense.

**RELATED FINANCE COMPANY (RFC)** - A finance company owned and operated by the dealer. Shows up as a separate entity for tax purposes.

**REPO** - Repossession of a vehicle when the purchaser defaults on the loan.

**SHUTTLING** - See DELIVERY EXPENSE above.

**SKIP** - Renege on payment of a loan. The term also applies to a buyer who can't be located, that is, took off in the middle of the night for parts unknown.

**SLED** - A vehicle with an actual cash value (ACV) of \$300 or less. Also known as a clunker, iron, roach, or pot.

**SPIFF** - A cash incentive paid to salesmen for selling a special vehicle, such as one that has been on the lot for a long time.

**SPOT DELIVERY** - A sales situation where the buyer takes the vehicle home subject to financing approval. If financing is not approved, the customer must return the vehicle.

**SUBLET** - To have work performed by outside vendors, usually when the dealer either is not equipped for the work, or is unable to perform the work within a reasonable time.

**TRADE-DOWN** - A retail customer trades a vehicle for one of lesser value. Will be found only with retail deals.

**TRADE-IN** - An item taken in by a dealer as part of a deal on the sale of a vehicle from the dealer's inventory. Usually another vehicle, but may be a boat, motorcycle, camping trailer or other items agreed on by the dealer and customer. Value of the item is deducted from the amount due on the sale of the vehicle purchased.

**UNWIND** - Reversing a sale due a purchaser's inadequate credit or some other problem with the transaction.

**UPSIDE DOWN** - A sales situation where the trade-in has an ACV less than the remaining loan amount on the vehicle.

**USED CAR LOG** - A record of all purchases of and sales of used vehicles, usually showing the year, make, identification number, date purchased, date sold, who it was purchased from and who it was sold to. Requirements will vary from state to state. This book may be referred to as a Police Book or State Log in some parts of the country.

**VEHICLE IDENTIFICATION NUMBER (VIN)** - The unique identification number assigned to a vehicle by the manufacturer. The VIN is used to specifically identify which vehicle is being sold or traded.

**WARRANTY** - Protection plan or guarantee on the vehicle and/or certain systems such as the drive train offered by a dealer. Length of warranty varies from dealer to dealer.

**WASHOUT** - A series of sales transactions where the trade-in of a prior sale is sold partially in exchange for another trade-in. For example, Car A is sold for cash plus trade-in of Car B. Car B is then sold for cash and the trade-in of Car C

**WHOLESALER** - Specializes in selling vehicles to other dealers for an agreed price. Unlike a broker, the wholesaler takes possession and title of the vehicle. They do not sell to the general public. These transactions may be subject to state and local sales taxes depending of your state requirements. Retail dealers also will sell wholesale to other dealers.

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## Chapter 2

# ACCOUNTING METHODS

### GENERAL INFORMATION

Small independent used car dealerships do not have the sophisticated books and records found at new car dealerships. Internal controls may be poor and could be totally nonexistent. Records are usually kept by the owner or family member, with the accountant preparing the general ledger from check stubs and deposit slips provided by the owner. In such businesses, it is necessary to closely examine the method of accounting used in preparing the tax returns. Frequently the return will indicate the accrual method of accounting is being used, but further examination reveals either the cash method or the no longer allowed installment method of accounting.

Used car dealerships normally maintain an inventory, which is a material income producing item. Material income producing items are required to be accounted for under an accrual method of accounting. Nationwide, many used car dealerships have been found to be using an improper accounting method, either the cash method or the installment method.

In parts of the country, dealers will report inventory under the accrual method, but account for sales under the installment method. This improper method is evident when a vehicle is purchased from the dealer under an installment plan. Instead of reporting the full sales price as income at the time of the sale, income is reported ratably over the life of the installment plan. This improper method defers the reporting of income to subsequent years for installment plans that overlap tax years.

Used car dealerships frequently use hybrid accounting methods. The most common hybrid method involves using the accrual method for gross receipts and cost of goods sold and the cash method for other expense items. Such methods are acceptable as long as they clearly reflect the dealer's income and conform to the regulations.

Dealerships may have more than one business operating at the same location. Provided requirements are met, those other businesses may be eligible to use the cash method of accounting. The method is acceptable as long as it clearly reflects the dealer's income from the business and conforms to the regulations. The car dealership and the other businesses should be on separate returns or Schedules C.

It is important to note that Internal Revenue Code section 448 does not affect the authority of the Internal Revenue Service to require the use of an accounting method that clearly reflects income or the requirement that the taxpayer secure the consent of the Internal Revenue Service prior to changing its accounting method (Temporary Treasury Regulation section 1.448-1T(c)). For example, a taxpayer may be required to change its accounting method under IRC section 446(b) to the accrual method because it more clearly reflects income.

A method of accounting involves the consistent treatment of a material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction (Treas. Reg. section 1.446-1(e)(2)(ii) and Rev. Proc. 91-31, 1991-1 C.B. 566). Section 2.02 of Rev. Proc. 92-20, 1992-1 C.B. 685 provides a definition of “method of accounting.” It states in part: “\*\*\* the relevant question is generally whether the practice permanently changes the amount of taxable income.” Consistent treatment is established by using an improper method for 2 or more tax years (Rev. Proc. 92-20, 1992-1 C.B. 685 and Rev. Rul. 90-38, 1990-1 C.B. 57) and a proper method for one year (Treas. Reg. section 1.446-1(e)(1)).

## CHANGE OF ACCOUNTING

Treas. Reg. section 1.446-1(e)(2)(ii) defines a change in method of accounting as a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. An accounting method change will invariably cause timing differences in reporting of income or deductions.

Generally, there are two adjustments necessary for a change in method of accounting. The first will require an adjustment to income in the year of change to avoid duplication or omission of income or deductions under IRC section 481(a). This adjustment is the timing difference between using the old method of accounting and the new method of accounting. The adjustment may consist of:

1. Items not previously reported as income, such as accounts receivable, and
2. Items previously deducted, such as any beginning inventory, or allowing a deduction for items not previously deducted, such as accounts payable.

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

**Rev. Proc. 97- 27 provides the administrative procedures applicable to changes in methods of** accounting. It applies a gradation of incentives to encourage voluntary compliance with proper tax accounting principles, and to

discourage taxpayers from delaying the filing of applications for permission to change an improper accounting.

Different rules apply to all LIFO method changes.

## **Issue**

Is the proper accounting method being used?

## **Audit Techniques**

- Ask the taxpayer or representative how sales were recorded and if any credit sales were made.
- Review the sales journal for recurring payments from individuals.
- If detailed sales journals are not available, review deposit slips for recurring payments from individuals. This may indicate the dealer is on a cash or installment basis for reporting income.
- Review sales invoices for terms of sales.

If the taxpayer is using either the cash or installment method of reporting income, you will need to determine the amount that has not been reported as income for the remainder of the life of the contract. This can be done in one of three ways:

- Use the accounts receivable balances at the end of the year to determine the unreported income resulting from the improper accounting method;
- Analyze the sales contracts to determine which contracts have not been fully reported as income in the year under examination and subsequent years; or
- Determine whether the dealer offers in-house financing, and if so, whether all income from the sale is included at the time of the sale. See the section on financing for details on handling this issue.

## **References**

- IRC section 446(c) lists the permissible methods of accounting for computing taxable income.
- IRC section 448 places limits on the use of the cash method of accounting.
- IRC section 453(b)(2)(A) and (B) disallow the use of installment method on any dealer disposition and disposition of personal property that would



have to be included in inventory if the property were on hand at the close of the taxable year.

- IRC section 481 sets forth rules for adjusting income for the year of change when there is a change in the method of accounting and for calculating the tax by limiting the tax to an amount of the tax that would result from allocating the increase to income from the change to the year of change and the preceding 2 years.
- Treas. Reg. section 1.446-1(c)(2)(i) states that in any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of the subparagraph.

*Wilkinson-Beane, Inc., v. Commissioner*, 420 F.2d 352 (1st Cir. 1970). The Court of Appeals upheld the decision of the Tax Court that the Commissioner was justified in changing the accounting method to the accrual basis to reflect income. The fact that the difference between the cash and accrual method was less than two tenths of one percent was immaterial.

*Smith v. Commissioner*, T. C. Memo. 1983-472. The court ruled that where the purchase and sale of automobiles was the principal income-producing factor in a used car dealer's business, requiring the use of an inventory, the dealer was required to use the accrual method of accounting.

Rev. Proc. 92-20, 1992-1 C.B. 685 provides the general procedures for obtaining the consent of the Commissioner to change an accounting method under Treas. Reg. section 1.446-1(e). Section 6 provides procedures for taxpayers under examination.

Rev. Proc. 92-74, 1992-2 C.B. 442, provides the procedures by which certain taxpayers required to use inventories to clearly reflect income may obtain expeditious consent to change their accounting method to either:

An overall accrual method, or

An accrual method in conjunction with a request to change to a special method.

This Revenue Procedure modifies and supersedes Revenue 85-36, 1985-2 C.B. 434.

## Chapter 3

# GROSS RECEIPTS

## INTRODUCTION TO GROSS RECEIPTS

Most of a used car dealership's income is from the sale of cars. Not all car sales are retail sales. Dealers may sell to other dealers, often in package deals. Dealers may also sell vehicles at various auctions, both wholesale (dealers only) and retail (public) auctions. Since inventory is a significant part of a dealer's business, the dealers are required to use the accrual method of accounting for sales and cost of sales. However, where permission has been obtained, some hybrid methods of accounting may be appropriate for other expense items. For a detailed discussion of appropriate accounting methods, see the Chapter 2.

Many dealerships will accept cash payments in addition to personal checks, money orders, and bank drafts. Dealerships receiving cash or cash equivalents in excess of \$10,000 are required to file Form 8300 with the IRS. See the Chapter 7, required filing checks, for a detailed discussion of Form 8300 requirements.

Throughout the country, dealerships have been found to be recording sales at net rather than gross sales price and showing the amount of the trade-in as a return or allowance on the sales contract. They then take the sale of the vehicle they received in trade and include it as cost of goods sold when it is sold. This treatment results in a double deduction of the cost of an auto taken as a trade-in.

It is necessary that the examiner understand a dealer's handling of a vehicle for gross receipts, purchases, inventory, repossessions, and trade-ins. Only when the examiner understands the dealer's accounting for a vehicle from the time it is acquired to the ultimate sale, can the examiner:

- Choose and tailor the audit techniques best suited for the dealer, based on the records and accounting procedures used, and
- Ensure that income and costs are not being omitted or duplicated as a result of the dealer's accounting procedures.

## INTERNAL CONTROLS

Many used car dealerships tend to have poor internal controls; therefore, gross receipts must be examined closely. Poor internal controls may exist whether the dealership is a sole proprietorship or a corporation. The owner/shareholder or family members will make the bank deposits and keep the records of cash receipts and sales. Often records of the cash receipts, based on these bank deposits, are

given to the accountant as the monthly sales figures. The accountant reconciles the bank deposits and may report them as gross receipts on the return.

## **MISCELLANEOUS INCOME**

In addition to income from the sale of used cars, many dealerships have secondary and related sources of income. These include:

- Service contract income
- Financing income
- Insurance income.

Not all dealerships have all of these secondary sources of income, but it is common for a dealer to have one or more of them. Generally, secondary sources of income are listed on the customer file.

Used car dealership may also provide other income-producing services. These services that include body repair work and routine maintenance such as oil changes and tune-ups. Leasing used cars on plans similar to those of new car dealership has become another source of income for used car dealers in certain parts of the country.

Dealers may also buy vehicles that are later scrapped or junked. When this occurs, it is common for parts from the junked car to be used to recondition other cars that are eventually sold to customers. A dealer may also buy cars that are already scrap cars (also called junked cars) for parts that are used to recondition cars for sale to customers. The parts taken from a junked car may be used to recondition several cars (for example, the carburetor used for one car, the alternator for another). However, it would be unusual for the parts to be sold to third parties, since there is no network for such parts. A proportionate cost of the parts used should be added to the inventoried cost of the car sold. Once the usable parts have been removed, the junked car is normally sold to a scrap or junkyard for a small fee. The income received for the scrap or junk value of the car should be recorded on the dealer's books, although the amount of such income is usually very small, normally under \$50 per car. Not many dealerships regularly purchase scrapped or junked cars due to space limitations and the bad appearance that the cars make on the dealer's lot.

Dealers frequently attend auctions to purchase cars for inventory. Many auctions give prizes with the purchase of certain cars, or hold drawings for prizes during the auction. Frequently these prizes are of minimal value; however, large items such as television sets and stereo equipment may occasionally be given away. Such prizes are includible as income to the dealership. New car dealerships may also give prizes to used car dealerships for purchasing certain types or quantities of cars during a given period of time. These prizes are also gross income.

## Fee Income

Auction fees are payments collected by a dealer for purchasing a particular vehicle for a customer at auction. Some dealers will bring the customer to the auction, although the dealer may have his or her buying card revoked by the auction if caught doing this. Other dealers will take a description of the vehicle as an open "buy order," then buy the particular type of vehicle when it goes through the auction. Many states have licensing requirements that make it illegal for some of the dealers to purchase a particular vehicle for a customer at auction. Dealerships caught in such activities will not only lose auction privileges, but may also have their dealer license revoked.

Typical auction fees are paid by the customer, not the auction, and range from \$150 to \$350, depending on the cost of the car, relationship with the customer, etc. The dealer may be reluctant to admit this type of income as the activity is discouraged by the auction.

The best way to check for auction fee income is to obtain a print out of the vehicles purchased from auctions the dealer does business with and spot check the listings for inclusion in income. Check unusual purchases. For instance, if a dealer primarily sells domestic "sleds," a \$20,000 Mercedes SL sports car purchased at auction would be out of character. There may be various legitimate reasons for such a purchase, such as a ready made sale, or needing a leading car to put in a package deal with less desirable cars currently in inventory.

Bird Dog Fees are a form of commission payment also known as finder or referral fees. These fees are generated by:

1. Serving as a broker between two dealers/wholesalers, etc.
2. Finding a retail buyer for another dealer.

These fees are often paid in the form of a check written directly to the dealership or in cash. Many dealerships will claim these fees as an expense, but very few dealerships claims the income. One examination uncovered \$32,000 in broker fees for sales between dealers, none of which was reported as income.

## Rebate Income

Dealerships may offer life insurance and disability insurance to buyers at the time of sale. The insurance policies are generally purchased from unrelated insurance companies, with the dealer receiving a commission from the sale of the insurance. There is very little self-insuring through related insurance companies in the industry, due to the complexity of meeting the definition of an insurance company, and complying with the multitude of regulations set up by state insurance commissioners.

Referral fees from an insurance agent or agency are typically paid to the individual who made the referral rather than the dealership. The commission may be in cash, bartered insurance coverage, trips, etc. Such income can be found by reviewing

either the deal files of the year under exam, or current deal files. Look for a particular agent writing most of the coverage.

Credit life and disability insurance (CLI) is usually offered in conjunction with financing and provides that if the insured event happens (that is, the buyer dies or becomes disabled), the buyer's note will be paid off by the insurance company. The commissions may range from 30 to 50 percent. If offered, CLI should be a large source of income.

Although most states allow car dealerships to sell CLI and earn commission income on each policy sold by the dealer, some states -- Michigan, for example, -- specifically prohibit car dealerships and their employees from receiving any portion of the insurance premium attributable to the retail sale of a motor vehicle. Therefore, in states such as Michigan, it is a common practice for an automobile dealer to establish a "dealer-related" insurance agency with a family member of the owner as an officer or owner of the dealer-related agency. Michigan law is violated if it can be shown that the dealer controls or manages the insurance company.

Auto dealerships in Michigan and states with similar laws may not deduct under IRC section 162(a) the commissions paid to the Finance and Insurance manager for the sale of CLI. These expenses do not relate to the dealership business, but rather to the "dealer-related" insurance agency. Michigan law further prohibits the dealer-related insurance agency from reimbursing the dealership for the dealer's actual costs incurred in connection with the sale of CLI.

If you are unsure of the laws regulating the sale of insurance by auto dealerships in your state, contact the state Attorney General's Office, Department of Motor Vehicles, Department of Commerce, Financial Institutions Bureau, Insurance Bureau, or related state agencies for information.

Financing rebates may take several forms. There may be a reserve account set aside by the finance company for recourse paper or aggregate loan performance. As the loan portfolio ages, some of the reserve may be refunded to the dealer. Some smaller finance sources may make kickbacks to the dealer for sending the finance company business.

In *Commissioner v. Hansen*, 360 U.S. 446 (1959); the Supreme Court held that when an accrual basis car dealer sells installment paper to a finance company, it must report as income not only the amount of cash received from the finance company but also the amount held in reserve by the finance company that records the reserve as a liability to the dealer because the dealer has a fixed right to receive the reserve even though not until a later year.

To find if income from finance rebates exists, look at the dealer agreement with the finance company, loan proceeds and recorded income. The dealership should be asked to provide account statements to determine the transactions in the reserve account. A listing of contracts financed, the amount financed and the withheld amount should also be reviewed. Review the title work or lien, checking for

common finances sources. If the dealer records deposit sources, you may be able to spot check the deposit slips.

Some dealers sell a lot of "sleds," which often have had some body or paint work. Also some dealers specialize in insurance rebuilds. It has been a common practice for body shops to inflate the costs of repairs and rebate the difference to the owner in cash.

## **Warranty Contracts**

Used car dealers sell two basic types of extended service contracts. The first type, which is known as third party or "Administrator" obligor contract, is between the customer and an unrelated underwriter. The dealer is merely an agent for the underwriter and keeps as profit the difference between the sales price of the contract and the "cost" paid to the underwriter.

The second type is a contract between the customer and the dealer (known as a "Dealer obligor" contract). In the case of a dealer obligor contract the dealer may buy insurance covering his or her risk or be "self-insured." If the dealer buys insurance, the income and expenses should be reported according to Rev. Proc. 92-97, 1992-2 C.B. 510 and Rev. Proc. 92-98, 1992-2 C.B. 512. If the dealer is "self-insured," the sales price of the contract should be reported as income in the year the contract is sold and expenses deducted in accordance with provisions of IRC section 461(h).

Dealer obligor warranties are more profitable. The warranty accounts need to be carefully examined for proper reporting of income and expenses.

## **Consignments**

Where permitted by law, a secondary source of sales for dealership may be consigned cars. These are vehicles that are not owned by the dealer, but are sold for a customer. Typically, the owner will permit the dealer to sell the car for a stated price. If the dealer sells the car for more than that price, the excess is the dealer's profit or commission on the sale. Generally, the consignor is responsible for any incidental charges, such as cleaning or reconditioning the car for sale. Those charges are usually subtracted from the amount due the owner on the sale. The buyer makes payment to the dealer, who in turn, will remit the stated price to the consignor after payment of liens and deductions for incidental costs. The consignment of an auto is usually evidenced by a written contract between the owner and the dealer. States may have specific requirements that the dealer must meet. Dealerships generally do not include consigned cars in inventory until the sale of the car actually occurs. At that time, it is purchased from the consignor, at the agreed price, and put into inventory. This is normally when the vehicle is assigned a stock number.

## **Dealer Financing**

Dealers commonly receive commissions on sales of financial products. Some dealers make arrangements with finance companies to provide financing for their customers. The finance company frequently pays the dealer a commission or "finder's fee" based on the amount of the loan, or a set fee per loan.

Dealers may also have gross income from a rate spread on a loan. A dealer may have made arrangements with a finance company to write loans at a set interest rate, 8 percent, for example. When a car buyer purchases an auto from the dealership, the dealership may write the loan for a higher interest rate, 10 percent, for example. The excess interest generated by the higher rate would be paid to the dealership by the finance company and would be includible income. The rate spread in this example is 2 percent, the difference between the rate the finance company charges the dealer and the rate the dealer charges the car buyer.

A dealer financing his or her own sales (Buy Here/Pay Here Lot) generally collects on the buyer's note in one of two ways. First, he or she will get monthly or weekly payments over the term of the note. The portion of the monthly or weekly payment reflecting interest is income to the dealer. The principal portion of the payment will reduce the receivable since the sales income has already been recognized at the time of sale.

Alternatively a dealer may sell a note or a number of notes (bulk sale) to a third party at a discounted amount. The discounts are often significant, usually exceeding 20 percent of the principal, and in some cases approaching 50 percent. The dealer may continue to have secondary liability for the note (a recourse note). The discount is deducted at the time that the note is sold since the dealer is not entitled to any more collections on the note, and the usual accounting entry on a \$5,000 note sold for 20 percent discount is:

	<u>DR</u>	<u>CR</u>
Cash	4,000	
Discount on Note	1,000	
Notes Receivable		5,000

A detailed discussion of the sales and discounting of note receivable can be found in the Related Finance Company section.

A dealer who finances a car sale customarily keeps a financing file. Since both the state and federal government under various statutes regulate the financing transaction, a dealer must maintain a paper trail of the transaction. A financing file usually contains the following documents:

- Promissory Note.
- Security Agreement.
- Disclosure Notices required by law (if not contained in the Note or Security Agreement).
- Credit Application and Credit Report.
- Vehicle Title. (Some states send the title to the owner, and provide a notation of lien on the title.) In those states, the dealer will not have physical possession of the title).

## **SALES TAXES, REGISTRATION AND LICENSING FEES**

Sales taxes and registration/license fees are collected by the dealer and paid to the state. In most states, used car dealers are required to charge sales tax on all retail sales. Many municipalities have their own retail sales taxes, which the dealers are also required to collect. In several states, autos with a lien will be charged an additional fee to register the lien. The lien fee is normally passed on to the customer. New license plates may or may not be required when the vehicle is sold, depending on state law. If license plates are necessary, many states require the dealer to collect the fee from the buyer and submit the additional amount to the state. The dealer may also have income from sales to other dealers or wholesalers and from the sale of vehicles at wholesale or retail auctions. Sales to other dealers are not subject to sales tax in many states. Check state and local laws to determine whether sales taxes are applied to wholesale auto transactions. Some dealers include these fees in gross receipts and deduct the amounts paid to the state as an expense. Other dealers will not include these amounts in income or expenses.

## **NON-TAXABLE RECEIPTS**

There are several forms of non-taxable receipts. Most used car dealers have lines of credit or other loans with local banks. Loans are frequently transferred into the checking account electronically. These loans may not all appear in the general ledgers. Owners will also frequently put their own money into the business when there is a cash shortage. These loans may appear in the general ledger or adjusting entries.

Many used car dealers receive checks from customers that are returned for insufficient funds. These checks are generally re-deposited in the dealer's account and may erroneously be included in income a second time if the accountant is preparing the sales from the deposit slips. These checks may pose a problem in verifying income based on deposit analysis.



## INCOME REPORTING

There are certain issues in dealer income recognition that agents should consider during an audit. These include:

Not recording a trade-in on a sale, then selling the trade-in for cash. One way to avoid reporting all sales is by cash sales in which a trade-in is sold directly to a third party. The dealer takes a car in as a trade from customer A. Customer A signs the title, but the dealer does not put the car in inventory or show it on the dealsheet as a trade-in. The dealer then sells the car to customer B for cash and signs the title over to the customer. The dealer keeps the cash and the title shows a direct sale from customer A to customer B. There is no indication that the dealer was ever involved in the trade.

Indications that this may be occurring include unidentified cash deposits, reconditioning costs incurred about the same time as the sale of the trade-in, but not allocated to vehicles, substantial sales discounts, or sales contracts that show a trade-in allowance with no corresponding stock number assignment. However, substantial discounts are frequently given by dealers to get rid of overage vehicles, where a cash (no financing) sale occurs or in similar situations.

Reporting net sales based on financing obtained, omitting cash received. Comparing the sales contracts with the financing files should disclose this problem. Also, the state sales tax can be used to determine the sales price, which should include any cash paid.

Not reporting the sale of all cars purchased. Comparing the purchase of vehicles acquired by trade and at auctions to a subsequent sale of that vehicle can provide information on accuracy of sales figures. Also, a review of claimed travel expenses can lead to information about auctions attended where possible purchases occurred or sales were made. However, dealers may attend auctions where they make no purchases or sales.

Purchasing a group of cars, allocating the entire purchase price to only some of the units; then selling one or more units off the books. A review of the purchase documents may provide evidence of the number of cars purchased. Furthermore, an analysis of the cost assigned to the inventoried cars acquired in the package should be made for reasonableness. However, it is common for the buyer to assign a different value to each car in the group than the seller has assigned. The buyer is not privy to the seller's allocations, and generally bases his or her allocation on the relative value of each vehicle in the group.

Purchases from other dealers are generally similar to purchases from auctions. However, there may be no written record of the transaction, and the transfer of title probably will be by a reassignment of title to the purchasing dealer. Frequently, the

dealer may make a package purchase. This is a purchase of several cars for a lump sum. The purchasing dealer should record the cost of the cars based on the ACV of each car to the total purchase price. The ACV of cars sold in a package can vary greatly since it is common to put one or two cars that are difficult to sell in a package, with the expectation that the purchaser will want the other cars in the package enough to accept the entire package. As with cars purchased at auctions, the cost of the car will be increased by any reconditioning costs incurred in preparing the car for sale.

As mentioned above, dealers may purchase "clunkers" cars as part of a package deal. The dealer may know this at the time of purchase, in which case a low market value will be placed on the inventory value of the vehicle. At other times, a dealer will not realize it bought a "clunker" until reconditioning has begun. At this point in time, the dealer has two likely options:

- Sell the car from his or her lot, or
- Sell the car at an auction.

Either way, the likely result will be a loss on the sale of the vehicle and no further transactions with the other dealer.

Another method dealers may use to avoid reporting all income is to purchase four cars from another dealer or at auction. The purchase document will show four cars purchased. The dealer then books three cars into inventory and sells the fourth car without reporting the sale on his or her books. If such activities are suspected, check with the auction house as a third party source.

The independent used car dealer may take almost anything as a trade-in. Boats, trailers, snowmobiles, campers, etc. may be accepted as a trade-in. These traded items may or may not end up on the lot for sale. The owner of the dealership may be getting personal use of these items and sell them on the side as personal property instead of inventory.

Vehicles taken in as trades may not be issued a separate stock number. It is a common industry practice for the new trade-in to be assigned a stock number that is based on the original stock number. For instance, a car with stock number 122 is sold and a 1988 Plymouth is taken in as a trade; the Plymouth will be assigned stock number 122A.

In some parts of the country, used car dealers have been found to be members of bartering clubs. For example, in Wisconsin, a dealer may receive "points" from a bartering club based on the value of a car, which can be exchanged for services or goods such as mechanical or body work on cars purchased for resale. Such activities are frequently not included as income.

Many dealers engaged in "Buy Here/Pay Here" operations might repossess the same vehicle several times before it is ultimately sold. The dealer reports the gain on the first repossession, but not on the subsequent repossessions. See Repossessions below for more information on this topic. Treatment of "Buy Here/Pay Here" operations are included in Chapter 8, Related Finance Company.

## **STATE DEPARTMENTS OF TRANSPORTATION/MOTOR VEHICLES**

Some state Departments of Transportation/motor vehicle: require all car dealers to maintain a record book of all used cars purchased and sold. The details of this requirement are discussed in the section on inventory valuation. Use of this log will not only help in determining inventory and cost of goods sold, but also in verifying all items are included in gross receipts.

In some states, such as Virginia, the number of dealer plates issued by the state is based on gross receipts. Some other states issue plates based on the number of salesmen or units sold. Wisconsin and other states will allow a dealer to have any number of dealer plates, as long as the dealer pays the fees for them. If your state is one in which the number of plates a dealer has is dependent on gross receipts, that number can give the examiner an idea of the correctness of the amount on the return.

## **REPOSSESSED VEHICLES**

Repossessions are common in the used car industry. When a repossession occurs, the industry practice is to bring the car back into inventory at the vehicle's ACV, determined by the N.A.D.A. blue book or other Department of Transportation approved valuation guide. Likewise, the defaulting buyer receives a credit against the balance due for the ACV of the car. Alternatively, the dealer may obtain bids from other dealers or simply sell the car at an auction. In those cases, the buyer is credited with the net sales price of the car. State law often controls what the dealer can do with a repossession, how the repossessed car should be valued, and what sales procedures must be used to sell a repossessed car. Accordingly, where the dealer has substantial repossessions, state law on repossessions should be reviewed. Repossession costs increase the basis of the car. These costs can include attorney's fees, repossession fees, repair costs and retitling fees.

Small dealers may have better experience with repossessions than the larger dealers because they see it as a moneymaker, or they require a larger percentage of the purchase price as a down payment. A deficiency can arise when the ACV is less than the amount owed, just as a gain can arise when the ACV is greater than the amount owed. For example, a car repossessed has an ACV of \$1,800. The amount owed the dealer at the time of the default on the loan is \$3,000. A \$1,200 deficiency exists. Using the same ACV of \$1,800 and the amount owed to the

dealer at the time of the default on the loan of \$1,500, the repossession would result in a \$300 gain.

The dealer will try to collect the deficiency from the defaulting buyer, although state law will dictate what collection procedures may be used. The dealer will also resell the car, either in a private sale or at public auction. If the sales price is less than the ACV credited to the borrower, the dealer may attempt to collect the difference from the buyer. Likewise, if the sales price exceeds the ACV credited to the buyer, the deficiency is reduced by the excess of sales price over ACV. If the repossessed car is sold with an overage (sales price exceeds the amount owed the dealer), the overage is repaid to the owner of the vehicle. Such requirements vary from state to state and may be shown on the contract.

Many dealers will create a new stock number for the repossession, while others will reassign (restock) the old number.

When a sale of personal property is reported under a deferred payment plan, the gain on a subsequent repossession is equal to the Fair Market Value (FMV) less the seller's basis in the instrument obligation and less any repossession costs. The basis of a repossession is the FMV on the day of repossession. The basis of the obligation is figured on its full face value or its fair market value at the time of the original sale, whichever was used to figure the gain or loss at the time of sale. From this amount, subtract all payments of principal received on the obligation. If only part of the obligation is discharged by the repossession, figure the basis in that part.

The fair market value is the price at which a willing buyer would purchase a vehicle from a willing seller with neither party being under any constraints to complete the transaction. The FMV can be different than the Actual Cash Value, which is based on adjusted wholesale values.

(NOTE: Dealers can not use the installment method for reporting the sale of inventory items. -- See Chapter 2, Accounting Methods.)

## **Issues**

Are gross receipts properly reported on the return and is gain or loss properly reflected on repossessed vehicles?

## **Audit Techniques**

Pre-audit planning should include the following steps:

- Look into the owner's/shareholder's standard of living prior to starting the audit. This may indicate he or she is living beyond the means shown on the return.
- Analyze prior and subsequent return information as percentages of Gross Profit. Large changes in percentage of Gross Profit may indicate need for examination of a particular issue.

- Run a cash transaction record (Form 8300) check to determine if large amounts of cash are being received and/or deposited. This should be done before starting the examination.
- Perform a quick Cash-T on shareholder/owner based on return information.
- Check with your state's corporate charter division for a listing of all corporations in which the owners are officers or directors.
- Visit the business location and check for additional income sources; such as a body shop or garage for mechanical work, or other on site businesses such as related finance companies.
- As with all items under examination, reconcile the gross receipts shown on the return with the amount per books.
- Scan General Ledger for unusual entries such as:
  - Debits to Sales
  - Credits to Expense Accounts
  - Cash Over/Under Accounts.

Carefully review internal controls. Who receives cash, makes deposits, and records income? This is an important part of the initial interview.

If a dealership has poor internal controls or if there are indications of significant unreported gross receipts, the use of indirect methods is appropriate.

If records are poor, ask for all of the dealsheets for the year and total them up. The total should be the sales for the year shown on the return. If this technique must be used for medium and large dealers, test for a month's sales prior to taking the time necessary to do a total for the entire year.

Trace a few vehicles through the dealer's accounting system to see how they impact inventory, cost of sales, expenses and sales. This should be done for each category or type of sales transactions.

Cash disbursements should be reviewed to determine which vehicles have been purchased with cash, and then the vehicles traced to their ultimate sale. Any unexplained cash disbursements should be analyzed.

Furthermore, sales prices of the purchased cars should be compared to the ultimate sales price, particularly where there is an indication that the cars were part of a package deal, to determine whether the cost of the packaged cars is properly allocated among the vehicles purchased.

If it is not practical to conduct the gross receipts, purchases, inventory, trade-in and repossession techniques simultaneously for a few vehicles, these accounts should be done in sequence instead of jumping to other areas of the examination.

Determine if the dealer engages in bartering, and if so, how actions are handled on the books for income reporting purposes. This should be determined during the initial interview.

Determine if sales taxes and registration/licensing fees are included in income. This should be determined during the initial interview.

Determine if the dealer has received any prizes from auctions or other dealers. This issue is best addressed during the initial interview.

A comparison of the financing file with the customer file is one way to verify the sales price and terms of the deal.

Determine whether the dealer is offering in-house financing and how these sales are recorded. There should be an accounts receivable set up to reflect the amount due on the car and the full amount should be shown as a sale.

If in-house financing is provided:

- Sample financing agreements for proper income reporting of the sale.
- Determine whether interest and other customer charges are properly included as income.
- For a detailed discussion of the treatment of related finance companies, refer to the Related Finance Company section of this ATG.
- Determine if the dealer has an arrangement with insurance or finance companies to provide customer financing or credit life insurance for the dealer's customers.
- If so, how much of a commission or fee does the dealer receive from the insurance or finance company?
- Are the fees or commissions included in the dealer's income, and if so, where on the return are they included?
- Scan the cash receipts journal or ledger for recurring receipts from insurance and finance companies.

Be aware of the proper timing for inclusion into income any amounts held as finance reserves.

Review statements for all checking, savings and other investment accounts for the period under examination. It may be necessary to obtain personal account information as well as the business accounts.

Compare samples of entries in the used car log with dealsheets to assure all cars sold were included in gross receipts.

Review the cash receipts journal for unusual and small recurring entries. Recurring entries may indicate the dealer is reporting income under the installment method or receiving commissions from insurance or finance companies. Such entries may also indicate the dealer is leasing vehicles.

Review State Sales Tax returns to see if what is being reported for sales tax is in line with what is on the income tax returns.

Ask to see any Forms 8300 filed -- these may provide leads to additional audits. This should be done as part of the package audit. See Chapter 7, Required Filing Checks, for details on Form 8300.

Scan deposit slips for recurring deposits from individuals that may be on an installment sale plan or commissions from insurance and finance companies. The receipt of large amounts of cash from one individual may indicate an attempt to circumvent the large cash transaction reporting requirements by leasing out vehicles and then selling at the end of the lease for a minimal amount.

Trace auto jacket and dealsheets to accounts receivable and sales. If there is a large number of sales, use a sample to check the accounts receivable and sales.

Sample dealsheets for other sources of income such as fees, warranty plans, finance charges, etc.

Sample dealsheets for items such as boats, camper trailers, recreational vehicles, and snowmobiles that may have been taken as a trade-in. Look for personal use by the owner and eventual sales of these items.

Review other documents in the car jacket and customer file for financing, warranty, agreements, service tickets, and other possible sources of income.

Obtain the number of title transfers from your state Department of Motor Vehicles to cross check records. This technique should be used when there is evidence of unreported income. In most states, this information is easy to obtain.

Determine whether the dealership is selling notes receivable to a related finance company. See Chapter 8, Related Finance Company, for details on transactions between the dealer and the related finance company.

Inquire about any previous state and local examinations the dealer may have had, including Department of Motor Vehicle examinations of used car records.

Obtain a listing of title transfers from the State Department of Transportation/Motor Vehicles for a selected period of time (week or month) which can be used to verify these sales were recorded. This should be used when records are incomplete or the examiner suspects unreported sales.

When there is a firm indication of unreported sales, consider issuing a summons for records not provided by the taxpayer. This should include not only bank records, but also include, purchase contracts, and other source documents from auto auctions.

Recognition of gain or loss from the repossession of property reported under a deferred payment method is measured by the difference between the Fair Market Value of the property on the date of a repossession and the seller's obligation satisfied by receipt of the property.

Secure all car jackets pertaining to that particular journal entry where repossession occurred. Also secure the original sales documents in order to determine if the basis of the obligation at the time of repossession is correct.

Subsequent year's sales of the vehicles should be inspected to determine if the Fair Market Value assigned to the repossessed vehicle was accurate. Any material differences should be adjusted.

Test the correctness of the gain or loss reported on the sale.

The following formula can be used as a guide when testing the correctness of the gain or loss upon repossession:

Full Face Value of Obligation	\$	
Less: all payments of principal received	<u>\$</u>	
Equals Basis in obligation	\$	
Plus: any repossession expenses	+\$	
	+\$	
Less: Fair Market Value	<u>-\$</u>	
Gain (Loss) on repossession	\$	+ or -
	=====	

If Fair Market Value is greater than basis plus expenses, there is a gain on the repossession. If the Fair Market Value is less than the basis in the obligation and repossession expenses, there is a loss on the repossession and a bad debt is incurred.

To save time in examining repossessions, consider the following short cut approach:

- A. Determine which vehicles are out on a finance contract at year-end. Verify the proper tax accounting for the final sale of these vehicles during the year (straight accrual method). Adjust as necessary.
- B. For each vehicle above, verify that the taxpayer's original tax basis was used in the last sale during the year. Adjust as necessary.
- C. Instead of making detailed recomputations of each repossession, determine the net cash received (exclusive of interest) on each repossession transaction during the year.



- D. Steps a and b result in the proper gross profit on the final sale during the year. Step c reflects the net repossession gain or loss during the year on sales not outstanding at yearend.

Audit techniques for Cash and Accounts Receivable are discussed in depth in Chapter 5, Balance Sheet.

## Chapter 4

# COST OF GOODS SOLD/INVENTORY

## INTRODUCTION TO COST OF GOODS SOLD/INVENTORY

The accounts associated with the cost of goods sold (that is, inventory, purchases, costs of labor) constitutes the largest deduction on a used car dealer's tax return. The base cost of the car will be increased by any reconditioning costs incurred by the dealer in preparing the car for sale. Shown below is a sample computation of the cost of goods sold from Form 1120, Schedule A or Form 1040, Schedule C:

Inventory at beginning of year:	\$ 190,100	
Purchases:	3,194,700	
Cost of Labor:	15,000	
Other Costs:	<u>48,743</u>	
Total:	3,448,543	
Inventory at end of year:	<u>256,500</u>	
Cost of Goods Sold and/or Operations:		<u>\$ 3,192,043</u>

Most of the journal entries and adjusting entries to the cost of goods sold and related accounts will be examined through the inventory account. The examiner may encounter poor records for purchases and inventory valuation.

### Purchases

The purchase figure reported on the return may frequently be a "plug" in order to balance the cost of goods sold computation. This makes it very difficult, if not impossible, to reconcile the account. Instead of accepting the "plug" figure, it may be necessary to reconstruct the purchases and inventory from dealer data. This means taking the dealer's invoices, vouchers, and other source data, and creating your own set of books for purchases.

If there is a purchase journal or similar documentation available, scan for unusual items. The unusual items may include personal items and capital expenditures, which will result in exam adjustments.

### Auctions

Vehicles purchased at auction are purchased for a bid price. Most auctions use a combination purchase and sales document that will show the purchase price and any related auction fees.

## **Purchases from Other Dealers**

Purchases from other dealers are generally similar to purchases from auctions. However, there may be no written record of the transaction, and the transfer of title probably will be by a reassignment of title to the purchasing dealer. Frequently, the dealer may make a package purchase. This is a purchase of several cars for a lump sum. The purchasing dealer should record the cost of the cars based on the Actual Cash Value (ACV) of each car to the total purchase price. The ACV of cars sold in a package can vary greatly since it is common to put one or two cars that are difficult to sell in a package, with the expectation that the purchaser will want the other cars enough to accept the entire package. As with cars purchased at auctions, the cost of the car will be increased by any reconditioning costs incurred in preparing the car for sale.

## **Cost of Labor**

Labor costs involved in reconditioning and delivery of autos are required to be included in cost of goods sold. The costs attributable to vehicles in ending inventory should be included as part of the inventory value. Labor costs may be incorrectly included in "outside services" or other such accounts.

## **Other Costs**

Other costs may include reconditioning, parts, delivery, detailing, outside services, repairs, and subcontracting. This is another area in which capital or personal items may be hidden.

## **Reconditioning Expenses**

A dealer will generally have substantial reconditioning expenses. These are the costs that must be incurred to get the traded car ready for sale. The total dollars spent on reconditioning cars may be one of a dealer's largest expenses, depending on the condition of vehicles normally purchased. The cost of reconditioning each car should be added to the inventory cost of the car.

## **Remanufactured Cores**

If your dealer is engaged in servicing vehicles for repairs and/or warranty work and even reconditioning, he or she may purchase remanufactured parts (for example, carburetor, alternator). Generally, the price of the remanufactured part includes a charge for the "core." This is an amount that will be refunded to the dealer once the old part is returned. If the dealer has any cores on hand at year-end, they should be inventoried. For example, a part may cost \$ 100 divided into two costs: \$70 for the cost of rebuilding the part and a \$30 core charge. The \$70 may be an inventoriable cost if part of reconditioning a vehicle or a current expense for repairs or warranty work. The \$30 is inventoriable separately with other parts until the core is returned for credit. Although it is improper, the dealer may expense the entire \$100 when

the part is purchased and include the \$30 core charge as income only when the core is returned.

## INVENTORY VALUATION

Inventory valuation is a complex issue for a used car dealer. A dealer generally buys used cars from new car dealers, other used car dealers, wholesalers, or at auctions. In addition, a dealer also acquires cars when he or she sells a car and takes a trade-in. The cost of the vehicles will be increased by the costs incurred to prepare the car for resale. However, the method of determining the initial cost of an inventoried car will vary, depending on the source of the purchase.

## ACCOUNTING RECORDS

The industry custom is to maintain a file of cars in inventory by stock numbers. A stock number should be assigned as each car is purchased. A list of the stock numbers on hand is maintained. The stock number of the car will be recorded in the customer file at the time of sale. The dealer will note other dispositions of the cars, for scrap, at auction, etc. Special issues arise for consigned cars, as discussed later. Many smaller dealers do not assign stock numbers to their inventory, since the amount of inventory on hand at any given time is small.

Most dealers turn inventory quickly, selling acquired cars to retail customers, other dealers, wholesalers, or at auctions. Cars are sold at auction if the car is not sold off the lot in a very short period of time (90 to 120 days). It is also common for dealers to use the periodic inventory method, whereby inventory is taken at the end of the year. This is particularly true where lower priced cars are involved. It is also an industry custom to use the lower of cost or market method of inventory valuation. This usually results in some adjustment at year-end being made to the inventory. This adjustment may increase or decrease the cost of goods sold, depending on the inventory level. For dealers using the periodic method of inventory and the lower of cost or market, the following entry will generally be made each year-end to record any write-down of the inventory to market. In this example, the reduction is assumed to be \$2,500:

	DR	CR
Cost of sales	2,500	
Inventory		2,500

Dealers that maintain stock numbers and record the costs on the individual cars can also have a write-down of inventory to market if they are using the lower of cost or

market method. While the reduction should be noted on each vehicle, one entry, similar to the one above, may be made in the accounting records.

## **TRADE-INS**

Some of the most complex inventory issues arise in the valuation of trade-ins. These complexities arise because the amount allowed as the trade-in does not usually equal the ACV, which is the initial inventory cost to the dealer. The various factors make the determination of value very difficult.

### **Cost Basis of a Trade-in**

The starting point for determining the cost of a car taken in trade is the Actual Cash Value (ACV). It is a common industry practice to determine the ACV by the following steps:

1. Refer to a valuation guideline. While the Kelley Blue Book and N.A.D.A. Used Car Guide are two of the more common valuation guidelines, any guideline approved by the Department of Transportation is acceptable, including Auction guidelines. However, these books serve only as the starting point, as a guideline for the value of the car. Even the valuation guidelines point out that adjustments must be made for the actual condition of the car, since the guideline assumes an average condition. Many dealers may not follow proper tax procedures through the use of a published guideline, instead basing their determination on the actual market conditions existing at that time in their location.
2. The dealer will then adjust the value to take into account specific features of the car that add to or subtract from the guideline value. Some of these factors include:
  - Actual wear and tear on the car,
  - Mileage,
  - Accessories,
  - Any hidden damage such as frame damage,
  - The cost of complying with Environmental Protection Agency (EPA) requirements,
  - Whether the car has been in an accident.

The dealer will also consider another intangible factor, the market conditions. This is a factor to carefully examine because it deviates from valuations provided in the published guidelines. For example, a convertible offered as a trade in November may have less value than one offered as a trade in April or July, since the opportunity to quickly resell the convertible depends on the season. (Clearly it is harder to sell a convertible when snow is falling than it is on a warm spring or summer day). There are three problems with this type of write-down:

- a. The actual cash value of the convertible will not change dramatically between November and December.
- b. The car can be sold in a warmer climate for what it is worth, or more, because of greater demand for convertibles in warmer climates.
- c. Tax law will not allow a write down of a vehicle when the facts show it will be worth substantially more only 4 or 5 months later.

Other conditions such as the overall market for the particular car being offered for sale, safety recalls, or changes in the automobile industry can all impact the value of a car.

See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) and *Pearl v. Commissioner*, T.C. Memo 1977-262 for legal authority on inventory accounting. (under References in this chapter for more information on inventory write-down).

3. The value of the car is then adjusted for reconditioning costs and other expected expenditures that the dealer will have to make to get the car ready for resale. Some common expenditures include:
  - Cleaning the car
  - Mechanical repairs
  - Body damage repairs
  - Interior and upholstery repairs
  - Safety inspection
  - Required state inspection
  - Emissions control inspection
  - Painting
  - Tires
  - Finder's Fees.

This is not intended to be an exhaustive list, but rather illustrative of the types of work that the dealer may have to perform to get the car ready for sale. Reconditioning work may or may not be done by the dealer. In many cases, the work will be subcontracted out.

## **Trade-in Valuation**

The valuation of a trade-in is an art, not a science. This outline of the valuation process may or may not be followed by a particular dealer. Many dealers, for example, rely more on experience and personal judgment than on a valuation guide. Others may rely solely on their professional judgment of the value of the car in that area at that time. However, every dealer values a car for the sole purpose of making a profit on both the cars in inventory and the trade-in, when it is ultimately sold.

Revenue Ruling 67-107, 1967-1 C.B. 115, states that used cars taken in trade as part payment on the sales of cars by a car dealer may be valued, for inventory purposes, at valuations comparable to those listed in an official used car guide (as the average wholesale prices for comparable cars). Prices, which vary materially

from the actual market prices during this period, will not be accepted as reflecting market.

Some Dealerships may undervalue their year-end inventory to overstate the cost of goods sold by using unacceptable methods of valuation. For example, one dealer used personal knowledge and year-end auction prices for similar cars as the means of valuing inventory. His reason for using auction value was that this was the price he could get for his cars if forced to sell his inventory at auction and close the business. However, this was not the dealer's primary market.

Another dealer used loan values to determine inventory value. This dealer stated he could get better loans from the bank by using the loan value of the cars as his inventory value.

While the industry may recognize the use of experience and personal judgment to value inventory, the Internal Revenue Service and the courts do not accept such methods of valuation. Valuations must be comparable to those listed in an official used car guide. Courts have ruled that an officially recognized valuation guide would be accepted for tax purposes. See *Brooks-Massey Dodge, Inc. v. Commissioner* 60 T.C. 884 (1973) and Revenue Ruling 67-107, 1967-1 C.B. 115 under references in this section for more information concerning proper inventory valuation.

Once the ACV of the trade-in is determined, then the trade-in allowance that will appear on the sales contract must be negotiated with the buyer. These negotiations often result in an over-allowance, for various reasons. As indicated earlier, the sales price is usually adjusted to take the over-allowance into account. Properly determining the ACV of a trade-in is critical to the dealer's success since the profit on sale of both the inventory and traded vehicles will ultimately be determined by how accurate a value is placed on the trade-in.

A problem may arise when there is a loan outstanding on the trade-in. Some transactions will be upside down, with the outstanding loan amount greater than the ACV of the car. In those cases, the dealer will give the buyer a trade-in allowance equal to the loan balance. The excess of the loan amount over the vehicle's ACV is an over-allowance which, in the industry, is treated as a discount to the sales price. The dealer will pay off the outstanding loan balance.

The smaller dealers may use single entry systems. Records may be a check register or ledger sheet showing the purchases of inventory and other expenses listed together.

Some dealers will use a perpetual inventory method, whereby the inventory account is updated with each sale and purchase. With this method, the dealer will know the value of his or her inventory at any given time during the year. Adjustments to the inventory account and cost of sales may be made throughout the year, or one adjustment may be made at the end of the year. A majority of dealers will take a

periodic inventory, usually at the end of the year, and adjust the purchase, inventory and cost of goods sold accounts at that time.

When dealer uses the periodic inventory method, a physical inventory is taken at year-end. The dealer may write the inventory down at this time and make one entry to record the inventory value less the write down. In such instances, that will be the only entry at year-end to establish inventory at the lower of cost or market. The dealer should maintain a record of the write down taken on each vehicle in inventory.

Year-end write-downs on used vehicles are allowable when certain requirements are met. Revenue Ruling 67-107 allows a car dealer to value his or her used cars for inventory purposes at valuations comparable to those listed in an official used car guide adjusted to conform to the average wholesale price listed at that time. (See also *Brooks-Massey Dodge, Inc.*, 60 T.C. 884 (1973).) Although this is a practice recommended by the industry and used by nearly all car dealers, there are some additional requirements.

Treas. Reg. section 1.446-1(a)(2) states in part that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. Treas. Reg. section 1.471-2(d) provides that the method must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business. There is a lack of consistency if more than one official valuation guide is used simultaneously.

IRC section 471 provides that inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income. These regulations under IRC section 471 prescribe two instances where inventory may be written down below cost to market. The first instance allows a taxpayer to write down purchased goods to replacement cost (Treas. Reg. section 1.471-4(a)).

The second instance is contained in Treas. Reg. section 1.471-4(b) which states in part that inventory may be valued at lower than replacement cost with correctness determined by actual sales for a reasonable period before and after the date of inventory. Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market. (See also *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) and *Pearl v. Commissioner*, T.C. Memo 1977-262.)

Review the sales of vehicles that have been written down and has unusually large profits.

The independent used car dealers may not keep accurate inventory records. They take a physical count of the cars on hand at the end of the year and place a value on them. The total value is given to their accountant who prepares the returns based on



the amount provided. It may be necessary to have the dealer go back and physically reconstruct the inventory value from other records. Inventory and purchase records may consist of a folder or pile of purchase receipts, index cards, or a three-ring binder containing the purchase information on each vehicle. For book purposes, cars and trucks are accounted for on a specific identification method. For tax purposes, most taxpayers use either the lower of cost or market method or the cost method. Used car dealers very seldom use LIFO, but you may come across it. The Service holds that a taxpayer may use an official used car guide such as the Kelley Blue Book in determining its LIFO cost of trade-in vehicles.

With respect to the taxpayers index computation method, the proper method for computing the index for used vehicles is:

- 1 To use the taxpayer's own cost (actual for vehicles purchased and blue book value as of the trade-in date for vehicles obtained in a trade-in); and
- 2 To use the taxpayer's own cost (as described in #1) for the same type vehicle in the ending inventory of the preceding year, or, if there was no such vehicle in the ending inventory of the preceding year, use the "reconstruction" techniques contained in Treas. Reg. section 1.472-8(e)(2)(iii) for items not in existence and items not stocked in the prior year -- that is, the blue book value for the same type of vehicle at the beginning of the year.

As with any method, problems can and do arise which were not originally anticipated. Included among these are program cars with a much higher value than "book" and there is no requirement to increase trade-in value to equal "book" value. In addition, the costs of improvements are expensed and there is difficulty with objectively defining a comparable vehicle. If you find a LIFO inventory case, request assistance from a resource person.

Sometimes the independent used car dealers may drive cars from their lot for personal use such as commuting and vacations. Family members may also drive cars from the lot. These cars should be carried on the books as inventory available for customers; however, such cars are sometimes overlooked in determining the year-end inventory value.

Occasionally, vehicles will "disappear" from inventory. Several reasons for this may exist. Older cars or cars in poor condition because of accidents or rust may have parts removed for repairs to other cars; then the body is scrapped. Such cars may be included in Cost of Goods Sold, but any income from the sale of the scrap metal etc., may not be reported in income. The same car may still be showing in inventory, but is not on the dealer's lot. Another reason for disappearing inventory is that cars may be sold out of state, and thus, never shows up on the Department of Motor Vehicle records for your state. Also the possibility exists that the dealer or his or her family is using one of these cars for personal use.

**Example 1**

Customer #1 wants to buy a car with an asking price of \$5,000 (and a dealer cost of \$4,000) and offers a trade in with an ACV of \$2,500. The dealer wants to make \$500 on the transaction. However, the payoff on the original loan on the car is \$3,100. Thus the vehicle is upside down by \$600. The dealer may well give the buyer a \$3,100 trade allowance (the dealer will pay off the loan) to make the sale. If this occurs, the dealer's gross profit will only be \$400, computed as follows:

Cash Received	\$ 1,900	(\$5,000 - \$3,100)
ACV of Trade-in	<u>2,500</u>	
Total Received	\$ 4,400	
Cost of Car	<u>(4,000)</u>	
Gross Profit	\$ 400	

Thus, in this example, the dealer did not make his \$500 gross profit, instead settling for only a \$400 gross profit, due to the loan payoff on the trade-in. Another way to calculate this is as follows:

Asking Price		\$ 5,000
Less:		
Trade Allowed	\$ 3,100	
Less: Payoff	<u>(3,100)</u>	
Net to Pay	\$ 5,000	
ACV on Trade		<u>2,500</u>
Total Value to the Dealer	\$ 7,500	
Less: Loan Payoff	<u>(3,100)</u>	
Net Value to the Dealer	\$ 4,400	
Less: Inventory Cost	<u>(4,000)</u>	
Gross Profit	\$ 400	

However, the cost of the car to the dealer should be the \$2,500 (the ACV), and the \$600 excess of the trade-in allowance over the actual ACV should be treated as a sales discount. The entry shown below for customer 1 is a proper accounting entry. The entry for customer 2 is the entry more commonly found in books and records for the example above.

	CUSTOMER 1		CUSTOMER 2	
	<u>DR</u>	<u>CR</u>	<u>DR</u>	<u>CR</u>
Cash	1,900		1,900	
Purchases	2,500		2,500	
Discount	600			
Sales		5,000		4,400

Another common occurrence is that a vehicle acquired as a trade-in will be sold and another trade-in will be acquired. It is a common industry practice for the new trade-in to be assigned a new stock number that is based the original stock number.

For example, a trade-in acquired in the sale of stock #100 will be assigned stock #100A. A trade-in acquired in a subsequent sale of stock #100A will be assigned stock #100B and so forth.

There are several ways to record the purchase of inventory items. A typical entry for a dealer using a double entry accounting system would be:

	<u>DR</u>	<u>CR</u>
Purchases	2,300	
Cash		2,300

## REPOSSESSIONS

Generally, used car dealers do not finance the sale of their automobiles. However, some dealers offer this service in an attempt to reach a segment of the market that cannot pay cash or secure other financing because of bad credit or no credit. The decision to offer financing is one that is made on a dealer-by-dealer basis and reflects the dealer's perception of the dealer's market.

When dealers provide a deferred payment plan (in-house financing), also called "Buy Here/Pay Here," there is the potential for repossession to occur. When a car is repossessed, the dealer must bring it back into inventory at its fair market value (FMV) and a gain or loss may result. The dealer should treat any gain or loss on repossession as ordinary income. For more detailed information on repossessions, see Chapter 3, Gross Receipts.

A demonstrator, which may include a vehicle driven for personal use, is a car that must be in current inventory and available for demonstration use while the employee is working. In *Luhring Motor Co. v. Commissioner*, 42 T.C. 732, 753 (1964), "The 42 vehicles in question [included in the demonstrator inventory account] never lost their inventory character and remained, even after several thousand miles of business use to which they were assigned by petitioner, automobiles properly includible in the stock in trade and held for sale to customers in the ordinary course of business" and were not depreciable. Further, in Rev. Rul. 75-538, 1975-2 C.B. 35, the Service ruled that a vehicle is not property used in the trade or business if it is merely used for demonstration purposes and thus a depreciation deduction under IRC section 167 is not allowable.

Generally, if a dealer is leasing vehicles, the leased vehicles are capital items subject to depreciation. The Service holds that "dual-purpose" property, that is, property offered for lease or sale, is properly includible in inventory. The taxpayer's main source of income is from sales not leasing. The Service considers whether the taxpayer's intent is to convert the use to leasing so that the items are no longer held for sale.

Rev. Rul. 55-540, 1955-2 C.B. 39, contains guidelines to be used in determining the tax treatment of leases of equipment. If the lease agreement is, in substance, a

conditional sales contract, the lessee is to be considered the owner of the equipment.

IRC section 263A and Treas. Reg. section 1.263A-1T detail the expenses to be included as part of the cost of the product. (Treas. Reg. sections 1.263A-1, 1.263A-2 and 1.263A-3 effective for tax years beginning after 1993.) These sections apply to real, tangible and intangible property acquired for resale. In most cases, IRC section 263A will not apply to an independent used car dealer because Gross Receipts fall under the \$10,000,000 exemption.

## **ISSUES**

- Is the cost of goods sold properly reported?
- Are all required costs included in the inventory? (Treas. Reg. section 1.471-2)
- If IRC section 263A applies, have all required direct and indirect costs been applied to the inventory costs?
- Are approved methods used to determine inventory values?
- If Lower of Cost or Market is used, has the "Market" been properly reflected as defined in Treas. Reg. section 1.471-4(a)?
- Is the write-down proper?
- Are gains on repossessions properly reported?

## **GENERAL AUDIT TECHNIQUES**

Not all dealers maintain accurate records, especially when it comes to ending inventory. Many dealers will take a count and give the amount to their accountant, who will enter the amount on the return. The dealer may not have a written record of what he or she had in inventory at the end of the year. It is the dealer's responsibility to reconstruct the inventory valuation. Refer to the section on dealer licensing requirements to see what information your State Department of Motor Vehicles can provide concerning what the dealer has in inventory at the end of the year.

The initial document request for inventory information should include

1. The car jackets, which should include all purchase documents, sales documents, title transfers, odometer statements, and any other information pertaining to each car, such as receipts for all repairs and parts that apply to each car purchased during the year, or
2. If the dealer does not maintain a jacket on each car, request all invoices relating to the purchase of each car, any additional costs such as repairs, and the odometer statements from the previous owner and the sale of the vehicles in inventory.
3. Any stock records, inventory cards, etc., that the dealer used to establish his inventory valuations.

4. Review entries in the general ledger control accounts. Note and verify entries, which originate from other than usual sources (general journal entries, debit and credit memos, etc.).
5. Review the cost of sales accounts and examine accounts that are material in accordance with standards set forth in the Expense Audit Guidelines (see SAIN Program 500,843: (1)).
6. Review the adjusting journal entries for proper treatment of cost of goods sold and inventory at year-end, as well as personal items purchased with business funds for proper reclassification of personal items. Be sure to understand the nature of the adjustment.
7. Sample dealsheets for trade-ins. Cross-reference to the inventory and purchase accounts for proper inventory valuations.
8. If sales are recorded net of trade-ins, verify that the trade-ins are not included in cost of goods sold. The taxpayer should not be allowed to record sales at net. Net trades frequently occur in single entry accounting systems. The dealer will deduct the trade-in value from the sale price of the vehicle being purchased, resulting in a decrease in sales for the period. He or she may then include the trade-in value as a cost of goods sold when the trade-in is sold to another customer. Thus, the dealer gets to take the deduction of the trade-in twice, once when purchased and again when sold. To stop this from happening, require the taxpayer to record sales at gross, not at net.
9. If purchases are made from related taxpayers, review a representative number of these transactions to determine if the following are present:
10. Excessive rebates and allowances, or goods or services not received (this would be a good device to improperly withdraw funds and receive a tax deduction).
11. Look for voided inventory transactions. Such transactions could be legitimate or they could be a wholesale trade off the books. Find out whom the car was purchased from and ask them for third party verification on whether the vehicle was returned.
12. Trace beginning inventory to final sale by looking at the sales jackets. Look for unreported and underreported income.
13. Reconstruct purchases and sales from the taxpayer's source documents. This may take some time, but you should feel comfortable that all sales data is there. Use this procedure when the taxpayer keeps very poor books.
14. Be wary of consignment sales. These vehicles may not have a stock number.
15. Look for personal vehicles included as purchases but not in ending inventory (jet ski's, boats, snowmobiles, etc.)

## **SPECIFIC AUDIT TECHNIQUES**

1. Obtain any workpapers used in determining the year-end inventory valuation in addition to invoices and pricing guides.
2. For taxpayers using periodic inventory, concentrate your efforts on year-end inventory valuations for all vehicles on hand, regardless of the source.

3. Question the taxpayer as to how year-end valuation was determined, and verify the method used conforms to prescribed methods found in Treas. Reg. section 1.471-2.
4. If lower of cost or market is used, ascertain whether the method used to determine inventory values is at the acceptable industry market values. An accepted industry guidebook may be used in arriving at this valuation. Two of the most common industry valuation guides are the NADA Official Used Car Guide and the Kelley Blue Book.
5. Assure the valuation guides are used properly and consistently. The dealer should be using the same guide for valuing all inventory items, and not using a different guide for different cars because of a lower value shown in one guide for a certain car.
6. Review the jackets and invoices for repairs, parts, and labor to assure that all the costs incurred during the year of audit are included in inventory. These costs should be included in the year the work was accomplished or the parts purchased, not when the dealer paid for these items. Hiking or delivery costs should also be included as part of the inventory costs.
7. Compare a sample of the inventory values to the Blue Book or other valuation guide used by the dealer. In order to know which of the various models, trim level, and engine size to use in the Blue Book, you will need to look at the car's serial number. The Blue Book will tell you which positions in the serial number are used for the different makes to determine the model, trim level, and engine size.
8. Drive or walk by the business location to observe the level of business activity and inventory the business maintains. You may also find the dealer will have other items such as boats, recreational vehicles, motorcycles, and campers on the lot. Follow-up to find out if these items was ever made available for resale.
9. If your state requires all wholesale and retail transactions to be reported, the Department of Motor Vehicles may be able to assist in establishing year-end inventory count.
10. Independent used car dealers may sell cars on consignment as well as from their own inventory. The initial interview should therefore include questions concerning consignment sales. Verify proper inventory treatment of cars on consignment at year-end.
11. Drive by the owner 's residence to make a preliminary determination of the standard of living and whether cars from the inventory are kept at home.
12. Scan the inventory cards for voids and out of sequence stock numbers. Question any missing or out of sequence stock numbers.
13. Check the cutoff date. Determine if year-end purchases have been recorded in the proper accounting period.
14. Review title transfer date and the date the sale was entered in the books for proper timing of sales and purchases.
15. Confirm the accuracy of the inventory count, especially regarding cars driven by the owner and family members. The initial interview should help uncover any irregularities.

16. Determine if the owners withdraw merchandise for personal use, such as parts or cars. If so, proper reductions should be made to purchases or cost of sales. Consider possible tax effect of such withdrawals to the recipients.
17. Review the odometer statements, comparing the mileage when the dealer purchased the vehicle to the mileage when sold. Large differences may indicate unrecorded personal use.
18. Review purchases for items remaining in the inventory for extended periods. Such items may indicate personal use.
19. Scan depreciation schedule to assure no inventory items are being depreciated.
20. Ascertain whether demos are included in the inventory count. Demos are to be available for sale at all times, and as such are to be included in the inventory count. Demos should not be treated as a capital item, subject to depreciation.
21. Leased vehicles may or may not be treated as a capital asset subject to depreciation. Review a sample of lease documents. Determine whether these cars are actual leases, conditional sales contracts, or vehicles properly includible in inventory (for example, used by family members, employees, etc.).
22. Inventory turnover rates will vary from dealership to dealership. The National Independent Automobile Dealers Association does not have any statistics on average inventory turnover rates. These rates vary, depending on the dealer's location, market and types of cars sold.
23. Review auction acquisition dates to assure purchases are included in the proper accounting period.
24. If inventory and repair records are poor or nonexistent, suggest a percentage of the total repairs be included in inventory costs rather than attempting to reconstruct the repairs done to the cars in ending inventory.
25. Scan the purchases account in the disbursements journal, check register, etc., looking for items unusual in amount and to payee or vendors not generally associated with products or services handled by the taxpayer.
26. Be aware there may be acquisitions from private individuals that are not recorded on the books.
27. Determine whether repossessed vehicles are carried at the proper values and any gains/losses are properly recorded.
28. Secure all car jackets pertaining to that particular journal entry on which repossession occurred. Also secure the original sales documents to determine if the basis of the obligation at the time of repossession is correct.
29. Subsequent year's sales of the vehicles should be inspected to determine if the fair market value assigned to the repossessed vehicle was accurate. Any material differences should be adjusted.
30. If the number of repossessions is small compared to the sales, do not waste examination time in this area.

## REFERENCES

- Treas. Reg. section 1.471-1 requires the use of inventories whenever the production, purchase or sale of merchandise is an income-producing factor, with exception for certain farmers.
- Treas. Reg. section 1.471-2 covers the acceptable methods of inventory valuation. The acceptable methods are Cost, Lower of Cost or Market, and LIFO. This regulation also states that costs incurred in preparing inventory items for sale are to be included in the inventory value.
- Treas. Reg. section 1.471-4(b) states that where the taxpayer in the regular course of business has offered for sale merchandise at prices lower than the current price defined in Treas. Reg. section 1.471-4(a), the inventory may be allowed at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory.
- IRC section 263A and Temporary Treas. Reg. section 1.263A-1T detail the direct and indirect costs that are required to be included in the cost of the product. (Treas. Reg. sections 1.263A-1, 1.263A-2 and 1.263A-3 effective for tax years beginning after 1993.) The rules apply to real, tangible and intangible property acquired for resale. The regulations provide that IRC section 263A applies to inventories valued at cost, lower of cost or market (LCM), market, or LIFO. IRC section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. However, IRC section 263A does apply in determining the market value of any inventory for which market is determined with reference to replacement cost.
- ***Thor Power Tool Co.*, 439 U.S. 522 (1979)**, The Supreme Court ruled an inventory write-down was not allowed where it was based on subjective estimates rather than objective evidence and the inventory items continue to be held for sale at their original prices.
- ***Brooks-Massey Dodge, Inc.*, 60 T.C. 884 (1973)**, The valuation of a used car inventory at 80 percent of the National Auto Dealer Association (NADA) wholesale values was improper. Adjustments to 100 percent of NADA values were approved.
- ***S&R Chevrolet Co. v. Birmingham*, 93 F. Supp 950 (N. D. Iowa 1950)**, An automobile dealer could not value its closing inventory of used cars by deducting from the amount paid or allowed the customer as a trade-in, a reserve which represented the difference between the cost and estimated value of each car a year later.
- ***Complete Finance Corp, v. Commissioner*, 80 T.C. 1062 (1983)**, The taxpayer corporations were writing down inventories of small auto parts to reflect an estimated decline in value due to "damaged, shopworn, or imperfect items," but did not offer the inventory for sale at a lower price to reflect the write down. The court held the write-downs did not clearly reflect the corporation's income.



- *Pearl v. Commissioner, T.C. Memo 1977-262*, The lower of cost or market value method used by a new and used machinery dealer failed to properly value inventory where the dealer had marked down machinery and consistently sold the items for prices greatly exceeding the assigned inventory values.
- Revenue Ruling 67-107, 1967-1 C.B. 115, states that used cars taken in trade as part payment on the sales of cars by a car dealer may be valued, for inventory purposes, at valuations comparable to those listed in an official used car guide (as the average wholesale prices for comparable cars). Prices, which vary materially from the actual market prices during this period, will not be accepted as reflecting market.

## **SAMPLE WORKPAPERS**

The following pages show one method of developing workpapers for the adjustments to inventory. These are based on a case in which the dealership marked down its inventory from cost to salvage value at a local auto auction using the owner's personal knowledge of the industry and end-of-year auction reports to arrive at the year-end inventory value. The taxpayer was unable to produce any verification of these values through records or auction reports for the years under audit.

### **Workpaper 1**

Workpaper 1 is a sample document request for information concerning inventory records and valuation procedures. Some states require used car dealers to maintain a log of all used car transactions. If your state requires these logs, include them as part of your initial document request.

The following information is required to make an evaluation of your inventory valuation for the year under examination:

- 1 Jackets for the inventory items listed on the attached sheet, including all documents associated with each vehicle.
- 2 Invoices for repairs and other costs associated with preparing the cars for sale for all cars in inventory at the end of 19XX.
- 3 Purchase documents for a sample of the cars in inventory at the end of 19XX.
- 4 Purchase documents for a sample of cars purchased in the months of October, November, and December 19XX.
- 5 State used car record book for 19XX.
- 6 Stock records, inventory cards, valuation guides, work sheets and all other documents used to determine year-end inventory valuation for 19XX.

**Workpaper 2**

Workpaper 2 shows the summary of the adjustments to inventory as well as other adjustments affecting Cost of Goods Sold. Workpaper 2 compares the return to the audit results and shows the final adjustment to Cost of Goods Sold for the years under audit.

	19AA	19BB
	-----	-----
ACTUAL COST	48,050.00	2,655.00
REPAIRS NOT CAPITALIZED	13,208.05	27,485.66
	-----	-----
INVENTORY AT COST 12/31	58,842.59	80,140.66
INVENTORY AT MARKET 12/31	83,205.39	91,575.32
	-----	-----
DIFFERENCE COST/MARKET	(24,362.80)	(11,434.66)
	=====	=====

	19AA		19BB	
	PER RETURN	PER AUDIT	PER RETURN	PER AUDIT
	-----			
---				
INVENTORY 01/01	19,225	19,225	24,775	58,842.59
PURCHASES	344,429	344,429	304,699	304,699
COST OF LABOR	46,521	46,521	13,825	13,825
MATERIAL/SUPPL	0.00	0.00	0.00	0.00
OTHER COSTS	0.00	0.00	0.00	0.00
	-----	-----	-----	-----
INVENTORY 12/31	410,175	410,175	343,299	377,366.59
	24,775	58,842.59	32,720	80,140.66
	-----	-----	-----	-----
COST OF GOODS SOLD	385,400.00	351,332.41	310,579.00	297,225.93
	=====	-----	=====	-----
ADJUSTMENT:		34,069.39		13,353.07
		=====		=====

**Workpapers 3**

Workpapers 3 is a sample write-up of a Form 886A submitted to the taxpayer explaining inventory adjustments.

The proposed adjustments represent an increase in the value of this taxpayer's Used Car Inventory.

	<u>12-31-</u>	<u>12-31-</u>
Increase ending inventory		
Increase beginning inventory:		
Net proposed adjustment:	=====	=====

## **Issue**

Does this taxpayer's value of the used vehicle inventory properly reflect "Market" as defined in Treas. Reg. section 1.471-4(a) as the "current bid price prevailing at the date of inventory for the particular merchandise in the volume in which is usually purchased by the taxpayer?"

## **Facts**

The taxpayer, \_\_\_\_\_, Inc. is a corporation organized and existing in the state of \_\_\_\_\_, with its principal office located in xxxxxxxx, xx. During the years in issue, the taxpayer filed its federal corporate income tax returns on a calendar year basis with the Internal Revenue Service Center, reporting its income primarily under the accrual method of accounting.

The corporation has been in existence since 19--, and had an opening inventory of \$\_\_ in 19--. The corporation operates primarily as a retail used car dealership, but does sell some used cars on the wholesale market. The wholesale market comprises approximately ten (10) per cent of its sales.

At the end of each calendar year of operations, including the years ended December 31, 19-- and December 31, 19--, the taxpayer takes a physical inventory of all used vehicles on hand and marks the inventory value of each vehicle at what they estimate to be the average wholesale value. They do not use the National Automobile Dealers Association (NADA) average wholesale value. They do not use actual fair market value based on current sales of similar automobiles, or the most recent sales as a guide in establishing fair market value. They also do not use the most recent purchases as a guide in establishing market values based on most recent purchases. The returns show the inventory as being reported for tax purposes at cost.

The taxpayer appraises the inventory as an estimate of what he thinks he could sell that inventory at with only his experience to rely on, if the inventory had to be sold as a bulk sale referencing some auction values.

The closing inventory thus determined becomes the opening inventory for all of the used vehicles carried into the succeeding year. The used vehicle inventory values determined are used to compute the taxpayer's gross profit or loss from operations.

The taxpayer also takes trade-ins on the sale of used vehicles and uses NADA as a guide to acquire the used cars taken in on trade.

During the years in issue, the taxpayer's valuation of its ending inventory was substantially lower than NADA valuations and the subsequent actual sales price of the used vehicles. The valuation was also substantially lower than most recent purchases.

The NADA average wholesale values used to compute the value of the taxpayer's ending inventory in 19-- and 19-- were taken from the December 19-- and 19-- issues of the Official (STATE) Automobile Valuation Guide. This guide is published eight times a year in collaboration with the (State) Automobile and Truck Dealers Association, and is an edition of Red Book. The guide sets out the average wholesale price for each make and model based on a thorough study of the used car market and does not apply to fleet, police or taxi cab sales.

The Government, in its review of this taxpayer's inventory values contends that the taxpayer's valuation technique is improper as it does not reflect the full market value of the used car inventory. Consequently this affects the year-end computation of profits or losses; thus, the taxpayer's annual income is not clearly reflected. The NADA values, as computed, do accurately reflect true market value and the taxpayer's technique has not been established as a method sanctioned or widely used by members of the automobile industry.

### **Law and Arguments**

IRC section 471 gives the Government broad discretion in determining matters concerning accounting methods and the Government's discretion expressly extends to the proper use of inventories. *Photo-Sonics, Inc. v. Commissioner*, 42 T.C. 926 (1964); *Dearborn Gage Co. v. Commissioner*, 48 T.C. 190 (1967). Under the provisions of IRC section 471, the Government is delegated authority to decide which inventory accounting method is most suited to the taxpayer's business. The section additionally provides that in making this determination, the Government must be guided by two considerations:

the best accounting practice in the taxpayer's trade or business, and  
the most accurate method of reflecting income.

The Government believes there is ample evidence in the record to raise questions about the effect of the taxpayer's valuation on the clear and accurate disclosure of its annual income. The increase in the taxpayer's taxable income attributable to the Government's change in the inventory indicates that the taxpayer, an accrual basis taxpayer, was unduly deferring a sizeable amount of income, which should have been recognized in these years. Even stronger evidence of the imperfection inherent in the taxpayer's accounting system is the wide divergence between the value attributed by the taxpayer to its inventory and the NADA wholesale value of the inventory or the actual cash receipts realized from the sale of the same inventory. Moreover, the Government's choice of valuation in fact does clearly reflect income. Our findings of fact disclose that the computation of NADA wholesale values takes into account the wear and obsolescence of an automobile of a particular make, model and year in average condition. On the whole, the taxpayer's used car inventory during the years in issue was in average condition. Finally, the Government's position with regard to proper valuation of used car inventory has been on record for a reasonable length of time (see Revenue Ruling 67-107, 1967-1 C. B. 115), and the taxpayer is deemed to have known the Government's position.

The taxpayer states that he purchases 30 percent to 50 percent of his used vehicle inventory at automotive auctions at various locations throughout the central states. Since this is the market in which the taxpayer purchases a substantial amount of its inventory, it seems most appropriate to value the ending inventory by values on this same market. The taxpayer states he is using lower of cost or market rather than cost as shown on the returns.

The taxpayer does not use the NADA guide as the sole guide in the determination of value as vehicles are taken into inventory. The NADA guide is consulted, but the value is further adjusted by the condition of the individual vehicle, demand for the vehicle in the resale market and the estimated time to sell it wholesale or retail. This value approximates the cost to purchase a similar vehicle at automotive auctions held in the geographical area where the taxpayer normally purchases vehicles.

**Conclusion**

The taxpayer's values of used car inventory for 1990 and 1991 do not clearly reflect income, nor is it a generally accepted practice to account for used vehicle inventory. The industry accepts and fully utilizes the NADA values. As such, the following adjustments to increase the taxpayer's ending used vehicle inventory are proposed.

The net adjustments to inventory/cost of goods sold are calculated as follows:

	<u>12-31-</u>	<u>12-31-</u>
Increase ending inventory:		
Increase beginning inventory		
Net proposed adjustment:	=====	=====

## Chapter 5

# BALANCE SHEET

### INTRODUCTION TO BALANCE SHEET

Independent car dealerships that are sole proprietorship will not have a balance sheet with the return. The corporations and partnerships will usually have a balance sheet showing cash balance, inventory, fixed assets, other assets, short and long-term liabilities, capital stock, and retained earnings. Dealerships not using a hybrid accounting method should have accounts payable showing the balance sheet. Accounts receivable may not be a factor if the dealership required all payments in full upon delivery of the vehicle to the customer.

Examination of the balance sheet for a used car dealership will not be as extensive as for a new car dealership. However, the balance sheet can reveal certain activities that may require examination. This section will focus only on those areas, which may provide information leading to such adjustments as unreported income and personal use of assets.

### CASH

Unlike new car dealerships, independent used car dealerships may not have sophisticated internal controls. The entire amount of checks and cash may not be deposited in the business accounts. Some dealerships provide financing or allow installment payments; however, the majority requires payment in full upon delivery of the vehicle.

As a rule, an independent used car dealership has only one or two bank accounts for the business. A checking account is the standard account for all used car dealerships. Some may also have a business savings account, but this is rare. Most dealerships have a line of credit or other loan arrangement with a financial institution and deposits will be made into the checking account as needed. Loans from the shareholder(s)/owner(s) are also frequently found in the used car business as a source of ready cash.

#### Issues

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

## **Audit Techniques**

1. For a detailed discussion of the filing requirements for Form 8300, see Chapter 7.
2. Reconcile bank statements to the books and the books to the return.
3. Review deposits slips for recurring payments from individuals. Be aware that many dealerships list only the amounts of the checks on the deposit slips; therefore, it may be difficult to check for recurring payments using the deposit slips.
4. Perform indirect methods such as the bank deposit analysis as necessary:
  - a. One complication you may find is that many dealerships will not include such collected items as sales tax and registration fees in gross receipts, but these fees will be deposited in the business checking account prior to payment to the state. These amounts must be taken into consideration when applying indirect methods.
  - b. Another complication in performing indirect methods such as the bank deposit analysis is that most dealerships will have a line of credit with a local bank. Money from the credit line is frequently deposited in the business account to cover the purchase of inventory and to cover operating expenses. These loans must be considered when applying indirect methods.
  - c. An independent used car dealership should be on the accrual method of accounting, however, unless the dealership is providing financing or allowing installment payments to be made, the cash account will be a reasonable measure of the sales activity.

## **ACCOUNTS RECEIVABLE**

While new car dealerships have very detailed receivables and separate schedules for each type, the independent used car dealership may have no detailed receivable information. Many used car dealer returns show no account receivable. They will not accept any terms other than cash on delivery of the vehicle. Others may allow selected buyers to pay a portion of the purchase on delivery and accept payments for the rest. The full amount may not be shown in gross receipts when the sale is made. Frequently, the sales are recorded as the payments are received. The balance due may be kept in a separate book, index cards, or recorded on the dealsheets. IRC section 453 does not permit the deferral of income from an installment sale for a dealership that regularly sells or otherwise disposes of personal property.

The absence of accounts receivable or an unusually low amount may indicate that the dealership has discounted its receivables. See Chapter 8, Related Finance Companies, for information concerning discounting of accounts receivable.

## **Issues**

- Are all sales reported?
- Are all sales reported in the proper tax year?

## **Audit Techniques**

1. Sample deal sheets, checking for terms of the sale.
2. Review sales recorded in the opening days of the next tax year to determine whether sales are includible in the year under examination.
3. Determine whether the full amount of the sales price involving payment plans was recorded as income at the time of the sale.

## **Inventory**

For a detailed discussion of inventory audit issues and techniques, refer to Chapter 4, Cost of Goods Sold.

## **Loans to Shareholders**

Most of the incorporate used car dealerships are closely held. You may find that these closely held corporations have loans to shareholders.

There are two major items to be considered if loans to shareholders are found on the books. First, consider if the "loans" are bona fide loans. Often funds are withdrawn by the shareholder and treated as a loan to avoid taxes on the distribution. Care should be taken during examination to determine if a loan actually exists. If not, the withdrawals should be treated as constructive dividends provided the corporation has current or retained earnings.

Second, if a loan exists on the books, check for imputed interest. Determine if the loan is non-interest-bearing or at below-market rates. Since the Tax Reform Act of 1986 has phased out the deduction for personal interest expense, the income related to the loan cannot be offset dollar for dollar. Therefore, there will be additional income to the corporation, dividend income to the shareholder, but no deduction to the shareholder.

## **Issues**

- Is Interest Income being reported?
- Are the transactions actually Constructive Dividends?



## **Audit Techniques**

Refer to the INTERNAL REVENUE MANUAL and other training materials for specific audit procedures. Courts have considered various factors when deciding whether withdrawals are constructive dividends or loans. The absence of one or all of these factors may indicate the loan was made at less than in an arm's-length transaction and may be construed to be a constructive dividend and/or interest income.

## **Loans Versus Constructive Dividends**

The following is a list of the factors the courts take into consideration when deciding whether withdrawals are constructive dividends or loans. No one factor alone is determinative.

1. The extent to which the shareholder controls the corporation.
2. The corporation's history of paying dividends.
3. The existence of earnings and profits.
4. The amount of the advances and whether a ceiling existed to limit the amount the corporation advanced.
5. How the parties record the advances/withdrawals on the books and records.
6. Whether the parties executed notes.
  - a. Are there written notes with maturity dates and interest charged? If interest was charged, was it at the market rate.
  - b. Was security/collateral provided for the advances?
7. Was there a fixed schedule of repayment?
8. Evidence of the shareholder's intent to repay the loan.
9. Are there regular payments made toward reducing the loan balance?
10. Was interest paid or accrued?
11. The shareholder's ability to repay the loan/advances.
12. Were the withdrawals/payments made in proportion the shareholder's stock holdings?

The factors listed above are also applicable in determining whether advances from the shareholder should be treated as loans or contributions to capital.

## **References**

IRC section 7872 covers the treatment of loans with below-market interest rates.

## **FIXED ASSETS**

Ownership of fixed assets by independent used car dealerships is reports similar to that of the new car dealerships. The shareholder/owner of the business often owns the property at which the dealership does business, and rents to the dealership. The business claims a rental expense and the owner shows income on Schedule E. The dealership generally owns any equipment, furniture, and fixtures. See the Chapter 6,

section on Rent Expense for a discussion of treatment of this issue by sole proprietorships.

### **Issues**

- Is the proper basis being used?
- Is depreciation being properly determined?
- Are personal assets included?

### **Audit Techniques**

Reconcile the schedule of assets and accumulated depreciation to the tax return. If reconciling individual assets to the return is difficult, have the taxpayer reconcile his or her workpapers to the return.

- Request invoices for large items for the years that have not been examined.
- Physically inspect the assets to ensure they are being used as business assets.
- Due to poor internal controls, the taxpayer may have difficulty locating some of the assets.
- Be aware that in closely held businesses, the owner may purchase personal assets and deduct them through the books.
- A request for an immediate inspection of assets may uncover assets located at the owner's residence.

## **LOANS FROM SHAREHOLDERS**

Frequently, auto dealers will disguise capital stock as Loans from Shareholder(s). Special attention should be given to these loans if a company appears to be thinly capitalized. See IRC section 385. See the Loans v. Constructive Distributions section above, p. 5-3, for 12 points to be used when determining whether advances from the shareholder are loans or contributions to capital.

### **Issues**

- Are interest expenses properly computed and accrued?
- Is the business adequately capitalized?

### **Audit Techniques**

Analyze transactions involving loans from shareholders to ensure they are not shams designed to give the corporation a tax benefit. For example, the shareholder(s) may not want to have all their contributions classified as capital stock; therefore, they would classify a portion of this capital contribution as a Loan

from Shareholder(s). In this situation, the shareholder(s) would receive a return on capital in the form of interest income, and the corporation would deduct this portion as interest expense. See the Internal Revenue Manual and other training materials for specific audit procedures.

### **References**

IRC section 385 deals with the treatment of certain interests in corporations as stock or indebtedness.

IRC section 7872 covers the treatment of loans with below-market interest rates.

## **SHORT TERM LIABILITIES**

This account generally consists of amounts borrow for the purchase of inventory (flooring costs) which are due within one year. Other liabilities such as payroll taxes, sales taxes, pensions, and reserves may also be classified as short-term liabilities. Customer deposits may also be reported as a short-term liability.

### **Issue**

Are interest expenses properly computed and reported?

### **Audit Techniques**

Ask the taxpayer to provide a reconciliation of the account. Consider vehicles added or deleted that were purchased or sold during the period for the interest accrued.

1. Review the obligation arising from other than cash advances.
2. Make a test computation of related expenses such as interest, payroll, and sales taxes, and trace them to the expense account.

## **OTHER CURRENT LIABILITIES**

Generally, this account will include various accrued liabilities such as payroll taxes, sales tax, pension, and reserves. It is similar to the accounts payable and short-term liabilities accounts. Dealerships may arbitrarily classify amounts in any of these accounts.

Customer deposits may pose an income issue when they are associated with leasing. They may in fact be taxable as an advance payment. It is common for customers to make an up-front payment called a "capital cost reduction" to lower their monthly lease rate. The Supreme Court's decision in *Indianapolis Power & Light Co. v. Commissioner*, 493 U.S. 203 (1990), contains a discussion of the distinction

between a deposit non-taxable as security collateral and taxable an advance payment.

### Issues

- Are reserves for contingent liabilities included in the account?
- Are expenses properly accrued?
- Should customer deposits be included in income?

### Audit Techniques

Review reserve and allowance accounts to determine if they are for contingent liabilities, which are not deductible.

Review the customer deposit account to ensure that deposits are included in gross income either when the sale is completed or if a "capital cost reduction" payment is made. Verify that any refunds of customer deposits are not deducted unless they were previously reported in gross receipts.

Review the accounts for unusual items that may indicate other business activities or personal items such as boat insurance paid for by the car dealership.

Trace unusual items to the related expense account.

## DEFERRED INCOME ACCOUNTS

During examination you may find deferred income accounts contained in the balance sheet. Usually these accounts are associated with the dealer's accounts receivable. They may have been netted against the receivables for presentation purposes.

Generally when a sale is financed by the dealership will pick up the entire sale at the time it is made (assuming he or she is using the correct accounting method). However, when the entries are made to record the retail sale of, for example, a \$7,000 auto; down payment, the accounts receivable, and the related deferred income, they may generally be made similar to:

	<u>DR</u>	<u>CR</u>
Cash	1,000	
Accounts Receivable	9,000	
Sales		7,000
Deferred Interest Income		1,500
Deferred Contract Charges		1,500

The "contract charges" are usually separate charges for things such as procurement fees, processing fees, charges for investigation, appraisal and identification, etc.

These fees are generally financed into the principal amount of the contract, and the customer is liable for them in total, with no discounting applicable for early pay-off. Interest on the contract is computed on the contract charges and unpaid selling price.

### **Example 1**

An accrual basis auto dealership finances vehicles it sells. It includes the following three separately stated items in the purchase price:

1. Selling price of the vehicles,
2. Interest to be earned on the unpaid principal, which includes the selling price of the vehicle and the related contract charges, and
3. Contract fees associated with the sale, which vary with each sale.

The financing notes, with interest rates of 24 percent or the maximum allowed by State laws, are subsequently assigned to a cash basis finance company. The finance company pays the auto dealership the unpaid balance on the selling price, and obtains rights to all unpaid interest and contract fees. The auto dealer and finance company are related parties.

The finance company reports the contract fees as income at the time of payment, as if the contract fees are analogous to interest income. Treas. Reg. section 1.451-1 reaffirms that, under a proper accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Thus, the dealership must include the contract fees in income at the time of sale. If the auto dealership or finance company argue that these fees are actually interest, then the taxpayers breaks the truth in lending laws by charging interest far in excess of the rates disclosed in the contracts.

### **Issues**

- Are the deferred contract charges taxable income to the used car dealership in the year the sale is consummated?
- If so, would the assignment of this income be considered a deemed distribution to the common shareholders, taxable to them as dividends?
- Does the assignment of this note, at a discount to a related finance company, represent an arm's length transaction at fair market value?

### **Conclusion**

The conclusion to be reached by the analysis of the facts cited above is that the deferred contract charges are not unstated contract interest, and therefore, are not amortizable over the contract terms. In addition, if the taxpayer contends that these fees are interest, then he is in violation of the truth in lending laws by charging better than 100 percent interest when the contract disclosure shows a much lower rate of interest.

The proper result is to include the charges in the amount realized under IRC section 1001 per Rev. Rul. 79-292, 1979-2 C.B. 287, for transactions consummated prior to

April 4, 1994, and Treas. Reg. section 1.1001-1(g) for transactions consummated after April 4, 1994.

## **RETAINED EARNINGS**

Retained earnings will be examined through Schedules M-1 and M-2 on the tax return. Schedule M-1 reconciles book income with return income. Schedule M-2 provides an analysis of retained earnings per books. Any dividend distributions and/or stock redemptions and retirement of treasury stock are reflected on Schedule M-2 as a reduction of retained earnings.

An examination regarding the applicability of the accumulated earnings tax (AET) should be considered. For an independent used car dealership doing business as a subchapter C Corporation, the AET is a potentially significant issue. If a dealership is financially successful, it may decide to retain earnings at the corporate level, after paying the corporate tax, as a mean of avoiding individual income tax at the shareholder level.

The M-1 adjustments are the differences between book income for financial purposes and taxable income for Federal tax purposes. Most of the adjustments are shown as adjusting journal entries on the accounting workpapers. These adjustments include:

- Federal Tax Liability
- Officer's Life Insurance Premiums
- ACRS over book depreciation
- Penalties
- 20 percent of the business meals and entertainment (Note: for tax years beginning after December 31, 1993, the amount allowable as a deduction for meal and entertainment expenses is limited to 50 percent of such expenses).
- Restoring a portion of the reserves for bad debts and repossessions.
- Installment sales and income reported using the installment sales method in prior year. Installment sales do not include dealer dispositions, and inventories of personal property.

### **Issues**

- Is the accumulated earnings tax applicable?
- Are income and expense items properly adjusted and accounted for?
- Are stock transactions properly accounted for?

## **Audit Techniques**

- Reconcile income per books with income per return.
- Reconcile opening balance with year-end balance of retained earnings on Schedule M-2.
- Analyze all increases and decreases.
- Consider imposition of the Accumulated Earnings Tax (IRC section 531)

## Chapter 6

### EXPENSE ISSUES

#### GENERAL

A used car dealership is generally owned by only one or two individuals doing business as a sole proprietorship or a corporation. Internal controls tend to be very loose. Many owners treat the business funds as their own, occasionally using these funds for personal expenses. At times the personal expenses are deducted as business expenses on the books and tax return.

Regardless of the expense account being examined, certain techniques should be applied. The list of techniques below is not exhaustive. General techniques that should be used include the following:

- Reconcile the expense per return to the books.
- Scan the account and note any large or unusual items, such as payments to the taxpayer's church, political parties, candidates, school tuition, and other personal expenses.
- Look for items of a capital nature that have a life of more than one year.
- If an account contains expenditures for gifts or entertainment, review for compliance with IRC section 274.
- Review questionable checks and receipts or statements, if available, for payments that may be to a political party or candidate, or other personal expenses or capital items.
- Determine the business purpose behind any material item.
- Determine the accuracy of accruals.

There are several expense accounts in which issues may be found that apply to all types of businesses. The examination of advertising, amortization, contributions, dues and subscriptions, legal and professional fees, and employee benefit accounts will not be fully detailed in this manual. Short descriptions of these accounts immediately follow this paragraph.

#### ADVERTISING EXPENSE

Most advertising expenses are for Yellow Page and newspaper ads. Other common forms of advertising include direct mail and sponsorship of recreational sports teams. Some of the larger dealerships may also advertise on local radio and television stations. Ads in local church bulletins are a common form of advertising expense that needs to be carefully reviewed. As use of the Internet grows, this area should also be considered.



Taxpayers may occasionally include entertainment expenditures such as tickets to professional sporting events in advertising expense. The record-keeping requirements and limitations of IRC section 274 apply to these expenditures.

### **References**

IRC section 162(e)(1) denies a deduction to certain lobbying and political expenditures.

IRC section 276(a)(1) limits the deductibility of certain advertising expenditures related to political parties.

## **AMORTIZATION**

There is a possibility that a used car dealership will acquire an existing dealership. If an acquisition of assets occurs, goodwill or going concern value may also be acquired. If the taxpayer keeps financial statements, as required either by the tax return or a bank or other financial institution, goodwill may be indicated on the balance sheet. Another indication of goodwill is a Schedule M-1 adjustment for a corporate taxpayer.

It is important to analyze any acquisitions. Prior to the Omnibus Reconciliation Act of 1993, the acquisition of goodwill and going concern value were not amortizable for tax purposes. With the enactment of IRC section 197, the acquisition of goodwill, going-concern value, and other intangibles have an amortizable life of 15 years. IRC section 197 is generally effective after August 10, 1993. There are exceptions to the effective date for binding contracts in existence on August 10, 1993, and a retroactive election for property acquired after July 25, 1991. IRC section 197 can make it advantageous for taxpayers to allocate the purchase price to intangibles, as opposed to land and buildings. In addition, be alert to the potential overvaluation of inventory and/or short-lived depreciable tangible assets in which taxpayers may seek an even shorter period to recover their investment.

Case developments, most notably *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), and the enactment of IRC section 197 have necessitated the revision of outstanding ISP papers on amortization of the following intangible assets:

- Customer based intangibles,
- Core deposits,
- Assembled workforce,
- Order backlog,
- Employment contracts,
- Covenants not to compete,
- Market based intangibles.

### **Audit Procedures**

- Request schedule to identify assets being amortized.
- Analyze current year's acquisitions. Analyze prior year acquisitions dependent upon the remaining life and adjusted basis of assets. The Service is not bound by prior accounting methods merely because the tax returns may have been examined and no deficiency was asserted (*Lincoln Electric Co. v. Commissioner*, 444 F.2d.491 (6th Cir.); *Carver v. C.I.R.*, 173 F.2d 29 (6th Cir. 1949); *Fruehauf Corporation v. C.I.R.*, 356 F.2d 975 (6th Cir. 1966), cert. denied, 385 U.S. 822 (1966). See *Standard Oil Co. v. Commissioner*, 77 T.C. 349, 1971 (1981); *Kilgrove v. United States*, 664 F.2d 1168 (10th Cir.1981) regarding the Service's authority to correct the amount of allowable depreciation deductions in earlier years.
- Inspect contracts relating to the acquisitions.
- Determine if any goodwill or going concern value exists, and compare to the values reported. Consider requesting engineering assistance where it appears the taxpayer is under-valuing land and buildings and/or overvaluing inventory and short-lived depreciable tangible assets.
- If an election has been made under IRC section 197, check for compliance with Temp.Treas. Reg. section 1.197-1T.
- Determine through review of contracts that proper life is being used on amortizable assets.
- Test check the extensions and proof footings to determine if correct amortization has been computed.
- Determine if start-up expenses as defined in IRC section 195 have been properly amortized over at least a 60-month period.

## CONTRIBUTIONS

Both corporations and sole proprietors may deduct charitable contributions. Corporations may take a limited amount of charitable contributions as a business deduction on Form 1120. However, S-Corporations and partnerships may only show charitable contributions as a deduction on Schedules K and K-1. The sole proprietor may only deduct a charitable contribution as an itemized deduction on Schedule A, not as a business deduction on Schedule C.

### References

IRC section 170 allows charitable contributions as a deduction to corporations and individuals if verified under regulations prescribed by the Secretary. This section also sets limits on the amount that may be deducted and defines a charitable contribution.

## **DUES AND SUBSCRIPTIONS**

While examining most used car dealer returns, you will encounter a deduction for dues and subscriptions. This deduction may be shown on the return as dues and subscriptions, or included in other accounts such as other expenses. Most dealerships will take deductions for subscriptions to The Kelley Blue Book or similar pricing guidebooks. You will also find subscriptions to various industry magazines and newsletters such as Used Car Merchandising.

Other items a used car dealer may be deducting as dues and subscriptions include membership in local business community organizations such as the Chamber of Commerce. They also may be members of state and local Independent Automobile Dealers Associations as well as the National Independent Automobile Dealers Association.

## **INTEREST EXPENSE**

Most used car dealers have a line of credit or business loans with a local bank or other financial institution. Most of the loans will be for the purchase of inventory (a.k.a. Flooring, floor planning).

Sometimes there are miscellaneous interest payments for capital assets, loans from shareholders or personal expenditures. If the taxpayer indicates that a capital asset was purchased, verify that the taxpayer owned the asset. On a corporate return, this can be done through the balance sheet audit approach.

## **LEGAL AND PROFESSIONAL**

Legal fees should be audited. Personal legal or professional expenses may have been paid by the dealership. Tax preparation fees are an example of such expenses. For a sole proprietor, only the portion pertaining to the business is deductible on the Schedule C. See Rev. Rul. 92-29, 1992-1 C.B. 20. For a corporation, any corporate payment for the preparation of the shareholder's return will be disallowed as a deduction to the corporation, and included in gross income as a dividend to the shareholder.

The taxpayer incurred may have some legal and professional fees that should be capitalized, such as acquisition fees or start-up costs.

## **EMPLOYEE BENEFITS**

Employee benefits may be a major expense on the tax return. The employee benefits account may consist of a number of expenses, such as worker's compensation, life insurance, and employee accident and health plans. It may also

include expenditures for Christmas parties, company picnics, etc. Since personal expenses can be hidden in some of these items, pay careful attention to anything that appears to benefit the owner.

### **Audit Procedures**

Health insurance premiums paid by an S-Corporation for owners of more than 2 percent of the S-Corporation stock are deductible by the corporation, but must also be reported as income to the shareholder. In examining this issue, ensure that the shareholder's Form W-2 includes the value of the premiums paid by the corporation.

If the employee benefits account contains gifts to employees, inspect for compliance with the limitations of IRC section 274.

## **FREIGHT AND DELIVERY**

Expenses usually titled freight or delivery are associated with the shipping or delivery of cars or car parts. Costs associated with the delivery of cars should be included in inventory. If these costs are not inventoried, consider proposing an adjustment if the amounts are other than de minimis.

If dealership also repairs cars, freight charges for parts are inventoriable. Any parts in inventory that have not been paid for by the customer should have freight included in their inventoried cost.

### **Audit Techniques**

In addition to the general techniques used to examine all expense issues, the following techniques should be applied:

- Scan accounts for any material freight and delivery charges. Pay particular attention to expenses incurred at fiscal year-end.
- If year-end amounts are material, reconcile these amounts to inventory. If these amounts are not included in inventory, an adjustment should be proposed.

## **COMMISSIONS AND FEES**

Many used car dealerships are operated solely by their owners, so the dealership will not have commission expenses for payments to drivers. In cases where the dealership employs salespeople, the salespeople likely will receive commissions, which are considered wages and salaries for employment tax purposes from the sales of vehicles. Contracts between employer and employee should specify how commission wages are determined.

Dealerships may also pay commissions or finder's fees to other dealers or individuals for locating a specific make or model the dealer needs on his or her lot. Normally, these finder's fees are not considered wages since the amount is paid to someone outside the dealer's business. These expenses should be included as part of the inventory costs. A Form 1099 Miscellaneous must be issued if the amount paid to an individual is over \$600.

Dealers may incur charges referred to as "hiking" or "shuttling" for the transportation of vehicles. Generally, these expenses are paid to individuals who are hired to drive cars between dealers' lots and to or from auctions. These costs should be inventoried under IRC section 263A if they are associated with moving or shipping property acquired for resale. They also may be subject to employment taxes, depending on the facts and circumstances. See Chapter 7, Required Filing Checks, for additional information concerning employee/independent contractor issue on hiking and portering activities.

### **Audit Techniques**

IRM 4231 and 4233 cover some procedures to consider when examining this issue. These procedures include:

- Review account and determine that Forms 1099 are being filed when required.
- Reconcile Forms 1099 issued to Form 1096, Annual Summary and Transmittal to U.S. Information Returns.
- Determine whether an employer-employee relationship exists for any payments made to individuals that are not treated as wages. Commissions paid to salesmen (employees) are to be included on Forms W-2 along with their salaries.
- Examine vouchers and determine if commissions represent capital expenditures or inventoriable costs.
- Examine contracts and determine that commissions are being paid in accordance with contractual obligations.
- Verify accuracy of accruals.

## **DEMONSTRATION EXPENSE**

Generally a used car dealer will not have any demo expense. It is likely that the owner of the dealership will use vehicles on the lot for commuting and other personal purposes. If this is the case, corporations should report income on Forms W-2 for the personal use of the cars, and the sole proprietor should be reduce expenses.

The taxpayer may argue that an owner's use of dealership vehicles is tax-free because the owner qualifies as a full-time salesperson under Treas. Reg. section 1.132-5(o). This section defines who is a full-time salesperson, and what is qualified automobile demonstration use. The taxpayer may also make other

arguments to justify using inventory for personal use, such as: he or she had the car repaired and was test-driving the vehicle to make sure the repairs were properly made, or he or she was driving the car around with a for sale sign as advertising. These arguments will have to be addressed on an individual basis, taking into account the facts and circumstances involved.

### **Audit Techniques**

Obtain a list of people that used any of the vehicles in inventory, along with the automobiles used.

Inquire about the use of the vehicles. Ask for logbooks. If no logs were kept, ask the taxpayer to reconstruct keeping in mind that Treas. Reg. section 1.274-5(c)(2)(ii)(a) requires that the elements of an expenditure are recorded contemporaneously when the taxpayer has full and present knowledge of each element of the expenditure.

Check with the Department of Motor Vehicles to verify if the owner of the dealership personally owns any autos. If not it is likely that he or she uses the business auto for personal purposes.

Check whether any amounts were included on Forms W-2 for personal use. If the audit is of a Schedule C, look for a reduction in cost of sales or some other expense to reflect the value of personal use by the owner.

There are four acceptable methods of establishing the value placed on personal use of autos owned by the business. Each method; is subject to certain requirements.

The Annual Lease Values do not include the fair market value of fuel provided by the employer, whether fuel is provided in kind or its cost is reimbursed by or charged to the employer. The fuel must be accounted for separately for inclusion in income.

### **References**

IRC section 274(d) -- Substantiation Required.

Treas. Reg. section 1.61-21 provides details on the acceptable methods of establishing the value placed on personal use of automobiles owned by a business. The acceptable methods are:

1. General Method -- Treas. Reg. section 1.61-21(b)(4).

The general method appears to be based on the assumption that an employee will have only one car available during the course of the year. Under this method, the value of personal use generally is the car's fair market lease value less the portion attributable to business use. It can be very difficult for a dealer

to use the general method to determine the value of the employee's personal use of cars during the year.

2. Annual lease value method -- Treas. Reg. section 1.61-21(d).

Under the annual lease value method, the value of personal use generally is the car's annual lease value less the portion attributable to business use. Annual lease value is intended to reflect the cost of leasing the car for a 4-year term. The rules impose a substantial administrative burden on a dealer when an employee has unrestricted access to more than a few cars during the course of the year.

If it is determined that the annual lease value method should be used, consideration must be given to what auto value should be applied to the table. If the dealer always uses the most expensive cars on the lot, use an average value of these cars as the annual value. If the owner uses any car on the lot, use the average inventory value as the annual value. If you encounter this issue, obtain a copy of Treas. Reg. section 1.132-5(o), which provides examples for the use of the annual lease value method.

3. Cents-per-mile value method -- Treas. Reg. section 1.61-21(e) -- Available only in limited circumstances.

4. Commuting value method -- Treas. Reg. section 1.61-21(f) -- Available only in limited circumstances.

Treas. Reg. section 1.132-5(o)(2) defines a "full-time automobile salesman" as any individual who --

- a. Is employed by an automobile dealer;
- b. Customarily spends at least half of a normal business day performing the functions of a floor sales person;
  - (1) Directly engages in substantial promotion and negotiation of sales to customers;
  - (2) Customarily works a number of hours considered full-time in the industry (but at a rate not less than 1,000 hours per year); and
  - (3) Derives at least 25 percent of his/her gross income from the automobile dealership directly as a result of the activities described above.

This regulation also states "**An individual will not be considered to engage in direct sales activities if the individual's sales related activities are substantially limited to review of sales price offers from customers.** \*\*\*[A]n individual who is an owner of the automobile dealership but who otherwise meets the requirements of this paragraph \*\*\* may exclude from income the value of qualified automobile

demonstrator use. However, the exclusion \*\*\* is not available to owners of large automobile dealerships who do not customarily engage in significant sales activities."

## **INSURANCE EXPENSE**

The insurance expense account may consist of several different types of insurance. Typical for a used car dealership are a multi-line policy for liability and personal property, and a worker's compensation policy. A dealership may also have group medical coverage, group or officer's life insurance, or extended service warranty plans. The larger dealers may also be paying premiums directly or indirectly to a captive offshore insurance company. The New Auto Dealerships Audit Technique Guide provides detailed information concerning the proper treatment of warranty insurance income.

### **Issues**

Numerous issues exist, including:

- deduction of premiums on officer's life insurance,
- deduction of premiums for personal policies,
- self-insurance through a variety of plans, including, but not limited to, producer-owned reinsurance companies, related management companies, and trusts or escrow accounts established by related or unrelated insurance companies, and
- Insurance purchased to insure risks under vehicle service contracts.

### **Audit Techniques**

- Review insurance register and cross-reference with fixed assets and inventory.
- Determine that any non-deductible life insurance premiums were eliminated.
- Review expense for accuracy of accruals. Big fluctuations should be questioned.
- A number of procedures specific to certain issues exist. The procedures are listed below under the issue headings.

## **Group Health Insurance**

Health insurance premiums paid by an S-Corporation for a greater than 2 percent shareholder/employee are deductible in part by the corporation per IRC section 162(1)(5); and are to be included in the shareholder's gross income per IRC sections 61 and 1372. (See Rev. Rul. 91-26, 1991-1 C.B. 184). The New Auto Dealerships Audit Technique Guide provides detailed information concerning the proper treatment of warranty insurance income. These premiums are not considered wages for social security or Medicare tax purposes. (See Announcement 92-16, 1992-5 Internal Revenue Bulletin 53.)



When examining an S-Corporation, look for this income to be shown on the shareholder's Form 1040. If none is reported, review the policy and premium notices to identify any portion of the premiums applicable to the shareholder. A deduction for 25 percent of health insurance premiums is available for self-employed individuals treated as partners under IRC section 1372. The deduction under IRC section 162(l)(5) was originally scheduled to expire after December 31, 1993. The deduction was extended permanently (retroactive to January 1, 1994), and increased to 30 percent for taxable years beginning after December 31, 1994. (Section 1, Self-Employed Health Insurance Act of 1995, P.L. 104-7 (H.R. 31) signed into law on April 11, 1995.)

## **Vehicle Service Contracts (Extended Service Warranty)**

Used car dealers sell two basic types of extended service contracts. The first type is between the customer and an unrelated underwriter (a third party or administrator obligor contract). The dealer is merely an agent for the underwriter and keeps as profit the difference between the sales price of the contract and the "cost" paid to the underwriter.

The second type is a contract between the customer and the dealer (a dealer obligor contract). For this type the dealer may buy insurance covering his or her risk or be "self-insured." If the dealer buys insurance, the income and expenses should be reported according to Rev. Proc. 92-97 and/or 92-98. The Government's position is that all of the income must be reported in the year of receipt, and any prepaid insurance must be amortized over the life of the policy under IRC section 167(a) and Treas. Reg. Section 1.167(a)-3.

The taxpayer can elect to mitigate this situation by filing Form 3115 to request changes in accounting methods. Rev. Proc. 92-97 and Rev. Proc. 92-98 explain the filing procedures, which allow taxpayers to report income ratably as they expense the insurance ratably.

While interviewing the taxpayer, ask about extended service contracts or warranties. If the taxpayer sells warranties, determine if they are primarily liable for any service contracts, or if they just act as an agent. (You may have to read the actual contracts to determine who is the obligor.) If the taxpayer is primarily liable, ask if elections to change accounting methods were filed.

## **Corporate Owned Life Insurance**

The emerging issue of "leveraged corporate owned life insurance" has been identified. The issue has been found in both large corporate examinations and small corporations that employ the primary shareholders. The small corporation cases typically involve a life insurance product known as a "split-dollar" life insurance policy owned by the employer or a key person life insurance policy owned by the corporation. In the split dollar cases, the corporation may be claiming interest deductions on debt from the insurance company used to pay a premium to the insurance company. In reality, however, these interest payments may be more

properly characterized as premium paid on behalf of the employer, thereby producing taxable income to the employee. See *Young v. Commissioner*, T.C. Memo.1995-379. Any adjustments for this type of insurance would be a disallowance of interest deduction to the corporation and an increase of income to the shareholder(s). The interest paid on debt used to purchase key person insurance may be generated by the same "loan premium" transaction that might also be non-deductible under a similar sham loan analysis.

When examining the issue, it is necessary to determine the nature of all interest payments deducted on the return. If any interest is attributable to a loan from an insurance company, further inquiries should be made concerning the transaction to determine if the interest payment is actually a disguised insurance premium payment. If this type of issue is found or suspected, the examiner should contact the issue specialist for corporate owned life insurance ("COLI").

## **PAYROLL**

Payroll should be examined by reference to the returns filing checklist for employment taxes. In the audit of a new car dealer, an agent will often find in the vicinity of 8 to 10 separate payroll accounts, in addition to year-end adjusting entries. Used car dealers will not have as complex a system.

Dealers often include some of the payroll in cost of goods sold. You need to be aware of this when reconciling payroll from the employment tax returns to the income tax return. If you can not easily reconcile the two, ask the taxpayer to reconcile the difference for you.

Reconciling the employment tax returns to the income tax return will serve the purpose of identifying who was treated as an employee. This will prove helpful when an employee versus independent contractor issue arises, since you will know everyone who was treated as an employee.

### **Audit Techniques**

1. As part of the package audit procedures, reconcile employment tax returns to transcripts.
2. Scan non-payroll accounts such as legal and professional fees, repairs and maintenance, or other expenses for employment tax issues.

## **POLICY WORK OR ADJUSTMENTS**

The expenses charged to these accounts are for vehicle repairs, which are not covered under the automobile's standard warranty or an extended service contract. A dealer will pay for these expenses to create goodwill or sustain good customer relations.

## **Audit Technique**

Scan the ledgers for material items, looking for payments made for autos owned by the owner or his/her relatives or employees.

## **RENT EXPENSE**

In many cases, used car dealerships do not own the building and lot where they conduct business. In the case of corporations, the shareholder often owns the property and rents it to the corporation. Frequently, the owners of sole proprietorships will own the building and lot where they operate the business.

When dealing with the rental issue on Schedules C, you need to be aware of the *Cox v. Commissioner*, T. C. Memo. 1993-326 (see below). In this case, the spouse owning a business that pays rent to the couple was allowed a deduction of one-half of the rent as a business expense, even when filing a joint return.

A lease may also require a lessee to pay specified expenses of the lessor. Such leases, commonly referred to as "net leases" or "care-free leases," may require the lessee to pay expenses including the lessor's real estate taxes or insurance premiums. Treas. Reg. section 1.61-8(c) treats these payments as additional co-rent income to lessor. Treas. Reg. section 1.162-11(a) provides: "Taxes paid by a tenant to or for a landlord for business property are additional \*\*\* income to the landlord, the amount of tax being deductible by the latter." The same treatment is accorded insurance premiums and other deductible expenses of the landlord that are paid by the tenant. The treatment accorded the landlord depends on the landlord's method of accounting and whether the expenses are paid directly by the tenant/lessee or paid to the landlord/lessor.

If the lessor is a related party owning more than 50 percent of the lessee by attribution, IRC section 267(a)(2) must be considered. This section applies when the lessee is on the accrual basis and the lessor is on the cash basis of accounting. It requires a matching of income and expense; thus the lessor and the lessee are treated as if both are on the cash basis. In a case where this section applies, no expense deduction, is allowable in advance of payment. IRC section 267 overrides IRC section 461. Remember the correct expense category is rent even though the lessee may have deducted payment it as taxes, insurance, etc.

## **Issues**

- In the case of a corporation, are rental payments actually a disguised dividend?
- Is the amount paid at or above fair rental value?
- Is the owner paying himself rent to avoid self-employment taxes?
- Are real estate taxes accrued by a lessee relating to a "net lease" deductible?

## **Audit Techniques**

- Review account to determine reason for any fluctuations.
- Examine lease agreements and determine if correctly reflected.
- Determine reasonableness of rents paid to related parties.
- Determine accuracy of accruals.

## **References**

*Cox v. Commissioner*, T.C. Memo 1993-326, allows a married couple that filed a joint return and owned property as tenants by the entirety to include as income on Schedule E one half of the rent received from the husband's sole proprietorship. They were also entitled to deduct one half of the rent paid by the husband's business as a Schedule C business expense. The amount allowed as a deduction was considered to be his wife's portion of the rental income and expense. His portion of the rent expense on the Schedule C was not allowed as a deduction and was not included on Schedule E.

# **TRAVEL AND ENTERTAINMENT**

Travel and entertainment (T&E) is always an area of concern. Common forms of abuse include travel to national and state association meetings by the owners' family when there is no business requirement that they attend, taking family members on buying trips for the purchase of cars, and meals for family members. You may also find tickets to professional sporting events included in this account.

IRC sections 162 and 274 provide the requirements that must be met for travel and entertainment expenses. Failure to meet these requirements means no deduction for the taxpayer, and possibly constructive dividends for a corporate shareholder.

## **Audit Techniques**

- IRM 4231-5(10)(16) 0 suggests some guidelines to follow while examining Travel and Entertainment.
- Cash expenditures and checks payable to owners and employees closely related to owners should be closely examined as to the actual payment of the expenditures and the business purpose.

- Although prizes and awards are not prevalent in the used car industry, during the initial interview examiners should determine whether prize or contest awards in any form of remuneration have been made to an individual. If the recipient of the prize or award is an individual other than an employee of the business making the award, the examiner should ascertain whether proper Forms 1099 have been filed reporting the amount of money or fair market value of the prize or award given to each recipient. If Forms 1099 have not been filed, the procedures in IRM 4562.5 should be followed.
- Cash and noncash prizes or awards made to an employee by or on behalf of an employer are considered wages, and as such, should be included on an employee's Form W-2. Certain length of service and safety awards are excluded from FICA taxes if the provisions of IRC sections 74(c), 274(j), and 3121(a)(20) are met. There are additional exceptions for such things as Christmas turkeys, etc.
- The new auto dealership text refers to the 80 percent limitation to meals and entertainment for years ending in 1987. On corporate returns, there should be a Schedule M-1 adjustment reflecting the limitation. The Schedule C has a separate line to reflect the adjustment. If there are no entries of this type on either return, an adjustment is necessary. Remember that if an adjustment is made to reduce the deductible expense, an adjustment to reduce the limitation amount also is necessary.
- The SAIN audit procedures, numbers 526-07 and 526-08 of IRM 4233, provide the following procedure to consider.
- Determine if "sales conventions" and "meetings" have a business purpose or whether they are in fact employer paid vacations.

## References

IRC section 274(d)

SUBSTANTIATION REQUIRED. -- No deduction or credit shall be allowed—

\* \* \* \* \*

Unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation or use of the facility of property, or the date and description of the gift, (C) the business purpose of the expense or other item and (D) the business relationship to the taxpayers of persons entertained, using the facility or property or receiving the gift. \*\*\*

## Chapter 7

# REQUIRED FILING CHECKS

### GENERAL INFORMATION

Part of the standard examination for all types of business activities consists of the required filing checks. Agents should be aware of these procedures; therefore, this section will emphasize those issues pertaining specifically to independent used car dealers.

The following forms should be inspected as part of the returns filing checks.

<u>Forms</u>	<u>Notes</u>
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W-4	
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	Check for unusually large numbers of dependents or exemptions from withholding. Follow up with inspection of Forms W-2 as necessary.
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W-2	
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	Scrutinize all Forms W-2 for any withholding which appears to be small in relationship to the wages reported. If an employment tax audit is warranted; the W-2 information will be needed to determine if the FUTA and FICA limitations have been met. In many cases, the FUTA limit will have been met, but the FICA limit will not have been met. <b>Be aware that the ceiling on the Hospital Insurance portion of FICA was eliminated effective January 1, 1994.</b>
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1099	
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	Consider the issue of employee vs. independent contractor, particularly if outside individuals are used for shuttling and portering activities. Discussed in detail later in this section.
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940 and 941	
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	Issues may include employer/independent contractor status of hikers (shuttlers) and other outside workers (discussed later in this section) as well as personal use of business autos by employees. See Chapter 6, Expense Issues, on Demonstrators for detailed information.
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1040	Constructive dividends flow through items from partnership and S-corporation returns. Spouse's return if married, filing separately.
8300	Currency transactions over \$10,000. The review of these forms should be conducted in conjunction with the audit of the cash accounts.
5500 and 5500C	Review pension expenses and distributions. See Chapter 6, Expense Issues, dealing with Employee Benefits for a brief discussion of pensions and other benefits.  Other items that need to be considered as a part of the required filing checks include:
Bartering	Consider along with the audit of income accounts. Some used car dealers have been found to belong to bartering clubs. See the Chapter 3, Gross Receipts, for more information.
Political	Consider in conjunction with auditing contributions and dues and subscriptions. See Chapter 6, Expense Issues, dealing with Contributions and Dues and Subscriptions for details.
Inventory	See Chapter 4, Cost of Goods Checks Sold/Inventory, for details of inventory issues and techniques.
Excise Tax	Examiners are required to determine if the taxpayer has met the filing requirements for Federal excise tax.

## **FORM 8300**

Required filing checks include inspecting for cash transactions over \$10,000. Cash receipts must be examined to determine if all necessary Forms 8300 (Currency Transaction Report Over \$10,000) have been properly filed. If delinquent Forms 8300 exist, then penalties must be considered and the Revenue Agent's Report must have a comment regarding compliance and application or non-application of penalties.

## References

IRC section 6050I(a)

- (a) CASH RECEIPTS OF MORE THAN \$10,000. -- Any Person-
- (1) Who engaged in a trade or business, and
  - (2) Who, in the course of such trade or business, receives more than \$10,000 in cash in 1 transaction (or 2 or more related transactions), Shall make the return described in subsection (b) with respect to such transaction (or related transactions) at such time as the Secretary may by regulations prescribe.

Treas. Reg. section 1.6050I-1(c)(1)(ii) details the reporting requirements for single and multiple payments.

### Extract

Treas. Reg. section 1.6050I-1(c)(1)(ii)

(ii) \*\*\* For amounts received on or after February 3, 1992, the term "cash" means-

- (A) The coin and currency of the United States or any other country, which circulate in and are customarily used and accepted as money in the country in which issued; and
- (B) A cashier's check (by whatever name called, including "treasurer's check" and "bank check"), bank draft, traveler's check, or money order having a face value amount of not more than \$10,000 --
  - (1) Received in a designated reporting transaction as defined in paragraph (c)(1)(iii) of this section (except as provided in paragraphs (c)(1)(iv), (v), and (vi) of this section), or
  - (2) Received in any transaction in which the recipient knows that such instrument is being used in an attempt to avoid the reporting of the transaction under section 6050I and this section.

## EMPLOYEE/INDEPENDENT CONTRACTOR STATUS

Employment taxes can amount to a significant tax liability. The treatment of drivers (also known as hikers or shuttlers), salesmen/buyers, and porters as independent contractors should not be overlooked during the audit of retail or wholesale used car dealers and brokers.

Most dealers will pay salesmen a commission based on sales. There usually will be a written contract stating how the amount of commission will be determined. The majority of used car dealers will treat salesmen as employees for tax purposes; however, some dealers will treat their salesmen as independent contractors. Rev. Rul. have determined car salesmen are employees whose commissions are subject to FICA, FUTA, and Federal tax withholding requirements.



Some dealers find individuals, called porters, who will clean the autos before resale. Many of these porters will earn less than \$600, so you may find no Forms 1099 filed on behalf of these people if they are treated as independent contractors. Regardless of the amount earned, if they are treated as employees, a Form W-2 should be filed. These individuals may or may not be employees based on facts and circumstances.

Many used car dealers will pay individuals to drive cars to the dealer's lot, auto auctions, or other dealers' lots. The drivers may be used on a regular or sporadic basis throughout the year. While some dealers may hire a friend or relative to drive the autos for no more than the cost of a meal, most dealers use outside individuals and pay them by a check or cash. These individuals may be employees or independent contractors, based on facts and circumstances of each case.

In many larger cities, there are companies that supply shuttle drivers to used car dealers. These drivers are not treated as employees of the car dealer as they are employees of the company providing the services.

Buyers or brokers may be employees or independent contractors. The facts and circumstances will be the determining factor. For example, some buyers or brokers will work for several dealers while others will work exclusively for one dealer.

### **Issue**

Are the drivers and porters independent contractors or employees?

### **Audit Techniques**

During the initial interview, question the owner about individuals from outside the business such as porters and hikers. It is essential that you determine the source of these individuals. There are companies that will provide drivers or porters to dealers and others in the community. If the dealer is getting his or her drivers and porters from such an organization, usually the drivers are controlled by the provider company and are treated as its employees. If the dealer contracts directly with the driver or porter, they are treated as employees of the dealer. Rev. Rul. 66-381, 1966-2 C.B. 449.

If the dealer hires drivers and porters directly, you may have an employment tax issue. The initial interview should provide you with the necessary information to determine if there is an issue. The usual common law rules should be applied as soon as it appears that there is an independent contractor/employee issue. While no one factor is dominant, control or the right to control the performance of duties plays a large role in the determination of whether an individual is an employee or independent contractor.

Guides for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations; namely, Treas.

Reg. sections 31.3121(d)(1), 31.3306(i)-1 and 31.3401(c)-1, relating to the FICA, the FUTA, and Federal income tax withholding, respectively.

In general, it should be noted that IRC section 3121(d)(2) requires the application of the common law rules in determining the employer-employee relationship. In determining whether an individual is an employee under common law rules, 20 factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The 20 factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual content in which services are performed, as explained in Rev. Rul. 87-41, 1987-1 C. B. 296 that sets forth the factors. The 20 factors are discussed in detail in IRM 4646 and Exhibit 4640-1. The factors are not to be applied mechanically as a scorecard. Rather they are to be used as an aid in applying the common law. See *Nationwide Mutual Insurance Co. v. Darden*, 112 S.Ct.1344, 1348 (1992).

Although a variety of factors may be used to analyze employment status for tax purposes, the regulations provide that the employer's right to control the manner in which the work is performed is the most important.

Determination of employee versus independent contractor status is relevant with respect to the following Federal tax issues:

1. Whether an individual is liable for the employee's share of the FICA tax.
2. Whether business expenses must be itemized and subject to the 2 percent floor on miscellaneous itemized deductions of IRC section 67, or are subject to the adjusted gross income additions under IRC section 62(c) and the itemized deduction limitation of IRC section 68.
3. Whether the firm's qualified pension plan must treat the individual as an employee for qualification purposes; and
4. Whether the individual has the right to continuing health care coverage after termination for purposes of COBRA (**Consolidated Omnibus Reconciliation Act of 1986, P.L. 86-292**).
5. Determining coverage under or liability for:
  - a. Workers' compensation benefits,
  - b. State and federal civil rights laws,
  - c. Fair Labor Standards Act (regulating minimum wages and overtime pay),
  - d. National Labor Relations Act (providing employees with collective bargaining rights)
  - e. Occupational Safety and Health Act (regulating safety in the work place),
  - f. Americans with Disabilities Act (requiring employers to make special accommodations for disabled employees).

Explore the extent to which the dealership is the employer of these workers under the common law standard of IRC section 3121(d)(2). This requires determining the degree to which the dealer has the right to direct and control the means and details of the services the workers perform.

Begin by establishing which of the "20 Common Law Factors" listed in Rev. Rul. 87-41, 1987-1 C.B. 296, are relevant in analyzing control. Also consider whether factors not listed in Rev. Rul. 87-41 may also be relevant. Having determined the relevant factors, consideration must be given to the relative weight of these factors in determining worker status. The auditor will then need to weigh the facts and circumstances of each case and determine worker status accordingly.

For further assistance regarding employment tax issues, contact the employment tax coordinator.

## **SECTION 530 "SAFE HAVEN"**

Section 530 of the Revenue Act of 1978 provides relief for taxpayers involved in controversies over employee/independent contractor status with the Internal Revenue Service. Section 530 is not found in the Internal Revenue Code or Treasury Regulations. It is located in Public Law 95-600 of the Revenue Act of 1978, 1978-3 C. B. 119. Consideration of employee/independent contractor status must be addressed on Form 4318, Examination Workpapers, and in the section of any unagreed report involving employee/independent contractor issues. The examiner also has the responsibility to notify the taxpayer whether or not he or she qualifies for Section 530 relief.

Section 530 should be addressed as early as practicable where the employee/independent contractor issue exists. Discuss with the taxpayer the reasons the workers in question were treated as independent contractors.

Failure to correct a taxpayer's improper treatment of workers during an examination provides the taxpayer a "safe haven." Thus, it is important to correct employee status, even if only a small number of employees is involved.

Section 530(a)(1) terminates an employer's liability for employment taxes under subtitle C, which includes FICA, FUTA, and income tax withholding, and any interest or penalties attributable to the liability for employment taxes. Section 530 provides that, for employment tax purposes, an individual will be deemed not to be an employee unless the employer had no reasonable basis for not treating the individual as an employee. The purpose of Section 530 is to shield employers who had a reasonable basis for treating workers as independent contractors from tax consequences arising from employment status reclassification by the Service.

To qualify for relief under Section 530, a taxpayer must meet three general requirements:

- Required Forms Filed
- All Federal tax returns required to be filed consistent with the taxpayer's treatment of the individuals as independent contractors must be timely filed. The returns include information returns (Form 1099). If the forms were not timely filed, the taxpayer cannot claim Section 530 relief. When the taxpayer

fails to file required returns, he or she will lose the relief, even if given relief in the past. Consistent Treatment.

- The treatment of an individual as an independent contractor must be consistent with the treatment by the employer or predecessor of any individual holding a substantially similar position (the whole class of workers concept.) The employer cannot change the treatment of an individual from an employee to an independent contractor if their position is substantially similar.

A substantially similar position exists when the job functions, duties, responsibilities, the party controlling the functions, and the exercise of the duties and responsibilities are substantially similar.

- Reasonable Basis
- Section 530 (a)(2) allows a reasonable basis for the taxpayer's treatment if he or she can show reasonable reliance on the following:
  - a. Judicial precedent published rulings, technical advice with respect to the taxpayer, or a ruling issued to the taxpayer. The precedent of a published ruling does not have to relate to the particular industry or business in which the taxpayer is engaged.
  - b. Reliance on a past Internal Revenue Service audits. The audit does not have to be an employment tax audit. However, the prior audit would qualify only if the audit entailed no assessment attributable to the taxpayer's treatment, for employment tax purposes, of those holding positions substantially similar to that held by the individual whose treatment is at issue.
  - c. A long-standing, recognized practice of a significant segment of the industry based on the geographical location in which the taxpayer does business. It is the taxpayer's responsibility to establish a long-standing, recognized practice of a significant segment of the industry. Examiners are advised to determine if this is in fact the case. You must properly develop this issue.

It is important that you discuss the reasons workers were treated as independent contractors with the taxpayer as early as possible in the examination process. Keep notes of the taxpayer's responses during the discussion. A taxpayer cannot have relied on recently decided cases for years prior to the taxpayer's decision. An opinion letter from an attorney written after the examination began is less persuasive than one written when the taxpayer first started using the workers and treating them as independent contractors.

## REFERENCES

IRC section 3301 imposes on every employer for each calendar year an excise tax, with respect to individuals in his or her employ, equal to 6.2 percent of the total wages paid during the calendar year.

IRC section 3101(a) imposes a tax on the income of every individual for Old Age, Survivors, and Disability Insurance.

IRC section 3101(b) imposes a tax on the income of every individual for Hospital Insurance.

IRC section 3509 provides a "statutory offset mechanism that applies in reclassification cases." If any employer fails to deduct and withhold any income or social security tax by reason of treating an employee as an independent contractor, IRC section 3509 provides different rates for determining an employer's employment tax liability. The employer pays the full amount of the employer's share of FICA and FUTA taxes. However, IRC section 3509 provides a reduced rate for the employees' FICA tax and their income tax liability.

Employment Tax Regulations sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 relate to the FICA, the FUTA, and Federal income tax withholding, respectively.

Section 31.3121(d)-2 requires the application of the common law rules in determining the employer-employee relationship.

Rev. Rul. 87-41, 1987-1 C.B. 296 provides information on the 20 Common Law Factors.

Rev. Rul. 72-74, 1972-1 C.B. 318 states that when an individual engages in the wholesale purchase and sales of used cars between licensed dealers for a company that does not have the right to control his or her business operations, he or she is not an employee of the company.

*Avis Rent A Car System, Inc. v. United States*, 503 F.2d 423 (2d Cir.1974), an auto rental company was denied a refund of FICA, FUTA, and income withholding taxes paid on behalf of shuttlers since the shuttlers were employees and not independent contractors.

Rev. Rul. 73-260, 1973-1 C.B. 412 details the method of determining wages of an agent or commissioned driver who is an employee for FICA and FUTA purposes.

*Neely v. Commissioner*, T.C. Memo 1978-18, in applying the common-law tests to determine an employer-employee relationship, the evidence established the taxpayer, a used car salesman, was an employee.

Rev. Rul. 55-144, 1955-1 C.B. 483 states that an individual employed by a used car dealer to drive cars to an auction company located in a city distant from the dealer's place of business, instructed with respect to the price at which the cars are to be sold at auction, required to protect that price, paid all expenses of the trip, and remunerated on the basis of a stated amount for each car sold, is an employee of the dealer.

Rev. Rul. 69-349, 1969-1 C.B. 261 states that drivers are employees where the company exercises control as to the details and manner of performance of services. Exhibit 7-1 contains a list of the 20 Common Law Factors developed to aid in determining employee/- independent contractor status. The references included are

not an all-inclusive listing of references. These are only intended to be used as a starting point in making the determination of a worker's status as an employee or independent contractor. Not all factors will apply to all cases. The examiner has the responsibility to determine what applies to the facts and circumstances of each case and make a determination on those facts and circumstances.

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**TWENTY COMMON LAW FACTORS**

<b><u>FACTOR</u></b>	<b><u>REFERENCES</u></b> (NOT ALL INCLUSIVE)
1. Instructions	Rev. Rul. 68-598, 1968-2 C.B. 464. Rev. Rul. 66-381, 1966-2 C.B. 449.
2. Training	Rev. Rul. 70-630, 1970-2 C.B. 229
3. Integration	<i>United States v. Silk</i> , 331 U.S. 704 (1947), 1947-2 C.B. 167.
4. Services Rendered Personally	Rev. Rul. 55-695, 1955-2 C.B. 410.
5. Hiring, Supervising, and	Rev. Rul. 63-115, 1963-1 C.B. 178,
6. Paying Assistants	Rev. Rul. 55-593, 1955-2 C.B. 610.
7. Continuing Relationship	<i>United States v. Silk</i> , 331 U.S. 704 (1947), 1947-2 C.B. 167.
8. Set Hours of Work	Rev. Rul. 73-591, 1973-2 C.B. 337.
9. Doing Work on Employer's Premises	Rev. Rul. 56-694, 1956-2 C.B. 694.
10. Order or Set Sequence	Rev. Rul. 56-694, 1956-2 C.B. 694.
11. Oral or Written Reports	Rev. Rul. 70-309, 1970-1 C.B. 199 Rev. Rul. 68-248, 1968-1 C.B. 431
12. Payment by Hour, Week,	Rev. Rul. 74-389, 1974-2 C.B. 330.or Month
13. Payment of Business and/or Traveling Expenses	Rev. Rul. 55-144, 1955-1 C.B. 483.
14. Furnishing of Tools or Materials	Rev. Rul. 71-524, 1971-2 C.B. 346.
15. Significant Investment	Rev. Rul. 71-524, 1971-2 C.B. 346.
16. Realization of Profit/Loss	Rev. Rul. 70-309, 1970-1 C.B. 199.
17. Working for More than One Firm at a Time	Rev. Rul. 70-572, 1970-2 C.B. 221.
18. Making Service Available to General Public	Rev. Rul. 56-660, 1956-2 C.B. 693.
19. Right to Discharge	Rev. Rul. 75-41, 1975-1 C.B. 323.
20. Right to Terminate	Rev. Rul. 70-309, 1970-1 C.B. 1



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## Chapter 8

# RELATED FINANCE COMPANIES

### OVERVIEW

The use of related finance companies (RFC) is a common practice in the used car industry. Such companies serve many valid business purposes and were utilized before any tax advantage scheme was offered. However, some RFC's are being utilized by used and new car dealers to reduce or defer the reporting of income. This section of the guide is to be used as an overview of RFC's. In it will be found reasons for establishing RFC's, and issues faced in the examination of an RFC issue.

There are three issues that exist in dealing with RFC's. 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.

### ECONOMIC REASONS

There are several reasons for creating and using an RFC. The following are some of the major reasons that an RFC is created. Each of these reasons can provide a significant and valid business and economic reason for creating a separate entity to finance the dealer's receivables, even if no third party receivables are acquired. There are other equally valid and legitimate reasons for using an RFC.

1. Providing credit to enable the purchaser to buy a car.

Many if not most of the purchasers that utilize the services of an RFC do so because of an inability to get credit elsewhere. In this way the RFC serves a useful purpose in providing credit to individuals with little credit, no credit, or bad credit. A properly operating RFC also focuses the collection function outside of the dealership itself, which relieves the sales personnel from a task that is time consuming. Payment schedules are on a weekly or monthly basis.

2. Improving the collection of accounts receivable.

AN RFC can significantly enhance the collection of accounts receivable by requiring the borrower/buyer to remit payments to a third party, even though the third party is related to the dealer. It has been the industry's experience that when payment is made directly to the dealer, bad experience with the car often leads to a default on the note for the car. This, in turn, creates a collection problem, and possibly a publicity problem for the dealership.

On the other hand, if an RFC is involved, experience shows that the customer is less likely to default on the payment. Given the general creditworthiness of the customers, this is a significant advantage. Some dealers, through effective management and controls, have RFC discount rates lower than what they can obtain from third parties and still make a profit on their RFC financing operations.

3. Avoiding licensing and other regulatory requirements on the dealer entity.

Many states have licensing requirements for finance companies. Establishing an RFC permits the dealer to isolate liability for violation of any requirements in a separate entity, without jeopardizing the status of the dealership. In addition, some states have capital requirements for finance companies that may interfere with the normal operations of a dealership.

4. Preventing adverse publicity on repossessions and other collection actions from affecting the dealership.

Repossession and collection problems are a daily fact of life for buy here/pay here dealers. Creation of an RFC permits a new entity to undertake these actions, thereby insulating the dealer from any adverse publicity. Even in states where disclosure of the relationship is required, the resulting publicity is usually less adverse when an RFC is used.

5. Insulating the dealership from the financial risk of default on the notes.

The industry deals with a customer base that generally has poor or non-existent credit. The default rate on buy here/pay here notes is substantially higher than on general bank loans. This economic fact is recognized in both the interest rates charged by the dealer or finance company and the reserves that independent finance companies generally maintain. A separate RFC removes the financial risk from the dealership entity.

6. Diversification of ownership.

Since the financing of used cars is not inherently a part of a dealership, an RFC permits the dealer to provide ownership in that specific business by both family and non-family members without diluting ownership in the dealership. This allows the dealer to separate the two businesses and reward certain employees or other individuals with an ownership interest in a segment of the business. It also provides a more accurate accounting of the financing activities when dealers report to banks and other financing entities.

A final advantage is that an RFC can be expanded, depending upon the dealer's desire, to finance unrelated receivables as well as those of a particular dealership. It should be pointed out that although this is possible, it rarely happens.

## VALIDITY OR FORM OF RFC

The second issue that should be considered is how a valid RFC is structured and operated. Since the purpose of the RFC is to isolate liability or segregate transactions in a separate entity, the RFC should meet several criteria to be treated as a separate, valid business. These criteria are:

1. The RFC should be a separate, legal entity.
2. The RFC should meet all licensing requirements of the jurisdictions in which it operates.
3. A major factor is that the RFC should be adequately capitalized in order to pay for the contracts.
4. The RFC should have its own employees and compensate them directly. However, the fact that the RFC and the dealership or other related entities may elect to use a common paymaster does not indicate, that the RFC does not have its own employees.
5. The RFC should obtain and maintain all appropriate local business and similar licenses.
6. The RFC should have a separate telephone number.
7. The RFC should have a separate business address, which may be a post office box. Even if a separate business address is maintained, it is common for the RFC to have an office at the dealership.
8. The RFC should maintain a separate set of books and records.
9. The RFC should comply with all title, lien, and recordation rules in the jurisdictions in which it operates.
10. The RFC should notify customers of the purchase of their notes.
11. The RFC and the dealership should have a purchase contract for the receivables that both complies with the appropriate state law and provides evidence of how the FMV of the receivables was determined.
12. The RFC should pay the dealer for the receivables at the time of purchase. The RFC can generate the cash to make the payment from any combination of capitalization of the RFC, bank or third party borrowings, or borrowings from related entities or shareholders. Borrowings from related entities or shareholders can diminish the validity of this factor.
13. The RFC should be operated in a business-like manner.

**While all of these attributes need not be present, to the extent that they are absent, a question as to the substance of the RFC exists.**

## ECONOMIC SUBSTANCE

The third and most important issue that should be addressed is the sale of discounted receivables at fair market value (FMV). Sales of receivables must have economic substance to qualify for tax purposes; valid business reasons alone will not suffice.

The FMV of a receivable or group of receivables will depend on a number of factors, Purchasing receivables is not an exact science, and many subjective factors enter into the determination of value. The industry's position is that a deep discount is warranted in nearly all transfers of receivables. The factors that directly influence the amount of discount include:

- Absence of or poor credit history.
- History of payments on the note.
- Amount of time left on the note.
- The age of the vehicle.

Reviews of some third-party finance company documents indicates that these companies can offer to acquire the receivables from dealers at up to a 50 percent up-front discount. These discounts apply whether or not the finance company buys in bulk or "cherry picks" the best accounts.

It is also important to note that these same third-party finance company documents refer to back-end reserves. These back-end reserves can be released to the dealer at the time the loan is paid off. The back-end reserves can restore the dealers profit on the sale to 100 percent, less any transaction costs. RFC purchases at a deep discount should be inspected for these back-end reserves.

A dealer can use an RFC to discount its receivables and have it accepted for tax purposes. To summarize the above discussion, the following three factors need to be addressed:

The discounting transactions must have economic substance. All of the relevant facts and circumstances must be considered. Remember that the primary reasons for selling receivables are to obtain cash (improve cash flow) or to shift risk. If both of these are missing, it is a good indication that the sales transaction lacks economic substance.

- The form of the transactions and the form of the RFC must be perfected.
- The receivables must be sold for fair market value. The seller and purchaser must base the discount on some reasonable factors, not on an arbitrary determination of the discount rate.

## ISSUES

Related finance company transactions such as the example above may raise several issues. Among the issues that may arise are the following:

1. Whether there has been a change in method of accounting where a related refinance company is used to defer income.
2. Whether a loss incurred by a car dealer from the purported sale of notes receivable to a related finance company should be disallowed because the related finance company existed only in form and the transaction between the dealer and related finance company lacks economic substance.

3. Whether IRC section 482 applies to the loss claimed by a dealer from the sale of notes receivable to a related finance company because the notes receivable were sold at less than the fair market value.
4. Whether Internal Revenue Code section 267 disallows a loss from the sale of notes receivable by a car dealer to a related finance company.
5. Whether a dealer and related finance company are members of a controlled group for the purposes of IRC section 267 and thereby eligible for the special loss recognition rules of Treas. Reg. section 1.267(f)-1(f).

## ISSUE DEVELOPMENT

**Issue development is the key to any substance versus form argument.** This is especially true when related companies are involved. Depending on the facts and circumstances of each dealership, the RFC could be a valid business and should be respected as a separate entity. Your issue will be resolved based on the particular facts and circumstances of your taxpayer. Accordingly, **the importance of fully developing your RFC issue cannot be overstated.**

This section is only an overview of RFC's, and has been included to make the examiner aware of the issues involved if he or she encounters one on the examination of a used auto dealer. Contact your Area ISP for further guidance and updates on the topic.

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## Chapter 9

### Sub-Prime

#### ISSUE

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

#### WHAT IS A NON-PRIME OR SUB-PRIME FINANCE CONTRACT?

Because of poor credit, many potential vehicle purchasers cannot obtain financing directly from banks, credit unions or manufacturers' finance companies. These individuals are referred to as "non-prime" or "sub-prime" consumers, depending on their credit rating (non-prime having a higher credit rating than sub-prime). To tap into this large market, many vehicle dealerships (particularly used car dealerships) have established relationships with lenders who have dealers execute their own retail installment agreements to these customers. These contracts are known in the industry as "non-prime" or "sub-prime" financing.

#### HOW A NON-PRIME OR SUB-PRIME PLAN WORKS

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



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

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

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

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

To rectify this some finance companies offer pool capping. Under this arrangement, the dealership may pay an additional fee to cap off one pool (or group) of contracts and to create a new pool for additional contracts. Pool capping speeds up the time in which the dealer is eligible to receive back-end distributions because it segregates a group of contracts, and collections received on those particular contracts are applied exclusively to those contracts. The collections on those contracts are not used to repay advances on contracts in another pool. Once the advances on the contracts in that specific pool are repaid and the 20 percent collection fee and any out-of-pocket costs are covered, the dealership will begin to receive back-end distributions on those contracts. The same process applies to all pools of the dealer that have been capped. The terms of pool capping arrangements must be carefully analyzed, however, since cross collateralization of pools may occur (payments made on contracts in one pool may be applied to another pool), diminishing the benefits of capping.

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

## **WHAT ARE THE ISSUES?**

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

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

- Is the transfer of the contract from the dealership to the finance company a sale of the contract or merely a pledge of the contract to collateralize a loan made to the dealership by the finance company?
- How should the cash advance be reported?
- How should the payment of the fixed percentage collection fee be reported?
- Are back-end distributions contingent payments?
- When should the back-end distributions be reported?
- How should the back-end distributions be valued?
- How should interest be computed and reported?
- How should enrollment fees and capping fees be reported?
- Are adjustments to this issue changes in method of accounting?

## **INCOME TAX TREATMENT**

Since inventory is a material income-producing factor, vehicle dealerships are required to use the accrual method of accounting. Often, however, dealers use the cash method to report the transfer of installment contracts to the finance company. They report only the customer down payment and the advance received from the finance company as current income. Back-end distributions are often reported in a later tax period, when received. The primary reasons these transactions are reported in this manner are because

1. they follow the actual cash flow, or economic reality, of the transactions, and
2. It is difficult to assign a value to money which the dealership does not know if, when or how much will be received.

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

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

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

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

## **SALE, ASSIGNMENT, LOAN or PLEDGE TO COLLATERALIZE A LOAN**

Whether the transfer of an installment contract is a sale or a pledge to collateralize a loan made to the dealership by the finance company depends on the facts and circumstances. Many of the servicing agreements or other arrangements between the dealerships and finance companies are worded in form as if the finance company is loaning money to the dealership. However, a close review of the provisions of these agreements often reveal that in substance they are sales.

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

1. The terms of the transfer are nonrecourse; that is, the dealership is not responsible for payment of any defaulted notes or payments (often after 90 days).
2. The transfer gives the finance company unilateral power to dispose of the note
3. The dealership's security interest in the financed vehicle was transferred to the finance company.
4. The finance company receives all files and paperwork related to the customer note
5. The finance company handles all collections and other administrative actions on the customer note.
6. The finance company is entitled to endorse the dealership's name on any payments made to the dealership and any other instruments concerning the installment contract and the financed automobile.
7. The finance company determines whether the note is in default

8. The finance company can waive any late payment, charge or any other fee it is entitled to collect.
9. The finance company can repossess and sell or otherwise liquidate the financed vehicle if default occurs.
10. The dealership's customers are notified the note will be assigned to the finance company.
11. The finance company may or does pledge the customer notes as security for its own indebtedness.
12. The finance company bears the credit risk on the customer notes.
13. The dealership is not required to provide financial statements to the finance company in a manner normally associated with a line of credit or other loan arrangement.
14. There is no stated interest rate, maturity date, or other specific details normally associated with a line of credit or other loan arrangement.

### **Treatment of a Pledge of Collateral (i.e. Loan, an Assignment)**

If the transfer of the installment contract to the finance company from the dealership is determined to be a pledge to collateralize a loan from the finance company there is no income to the dealership upon receipt of the cash advance and no gain or loss is recognized at the time of the transfer of the contract. The cash advance is considered a loan. Collections by the finance company are treated in a dual manner since they must be applied to both the original installment contract between the purchaser and the dealership (which the dealership still owns), and the outstanding cash advance loan between the dealership and the finance company.

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

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

It is anticipated that few, if any, of these transactions are likely to be true loans.

### **Treatment of a Sale**

If the transfer of the installment contract to the finance company is deemed to be a sale by the dealership, the amount realized on the sale is compared to the dealer's basis in the contract to determine the dealer's gain or loss. Per Internal Revenue

Code section 1001(b) the amount realized from the sale is the cash plus the fair market value of any other property received. This formula appears simple, but is actually difficult to apply. It is made more complex by the impact of Internal Revenue Code section 483, which requires deferred payments to be recharacterized in part as a payment of unstated interest.

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

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

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

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

The amount of back-end distribution recharacterized as unstated interest may also be difficult to determine. The regulation requires this amount to be determined by discounting the back-end distribution at the applicable federal rate from the time the applicable installment contract was sold until the back-end distribution is made. The regulations do not explain how to apply this rule when the back-end distributions are made on a pool of installment contracts. Similarly, the portion of a back-end distribution that is not unstated interest is a recovery of basis received from the sale of the installment contract and, if all basis has been recovered, is treated as gain from the sale. When the back-end distributions are made on a pool of installment contracts, it is not clear to which installment contract the recovered basis should be attributed.

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

1. Has the dealer received any back-end distribution payments?
2. What is the amount of back-end distribution payments received?
3. How long has the dealer been involved in the program with the finance company?
4. Has the dealer capped any pools of contracts?
5. Are the pools cross-collateralized?
6. Has the dealer's involvement in the program with the finance company been terminated?
7. Has the finance company changed the dealer's collection rating since joining the program?
8. What is the historical rate of default for the dealer's customer base?
9. Has the current customer base changed?
10. How does the taxpayer value the right to back-end distribution payments?
11. Have the terms of the servicing agreement between the dealer and the finance company changed?

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

## **AUDIT TECHNIQUES**

### **Initial Interview**

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

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

### **Records**

Ask the dealer to provide the vehicle jackets. These jackets are usually an envelope (or sometimes a file folder) for each vehicle, which includes all of the dealer's documentation related to that vehicle such as the sales invoice, purchase invoice, copy of the title, and repair receipts. The outside of the jacket often also lists

detailed information about the vehicle's purchase and sale, including the dates, amounts, and individuals or companies involved. These jackets also may contain the dealer's records pertaining to the transfer of the installment contract to the finance company.

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

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

1. Servicing Agreement (also referred to as the dealer agreement) – The Servicing Agreement defines the responsibilities of the dealer and the finance company. It provides definitions, explains the advances and how the collections will be applied, and shows how the agreement can be terminated. In addition, if the finance company changes the advance computation or other provisions of the agreement, an addendum or other notification of the changes may be provided to the dealer by the finance company.
2. Dealer Manual & Other Literature – The dealer Manual may contain various items of information, including a sample of customer paperwork with detailed advance computations. The finance company may also send the dealer literature on new programs or new features such as pool capping.
3. Account Statements – The finance company sends statements (usually monthly) to the dealer summarizing advances, collections, fees, and other pertinent information. The summary may also show detail by customer of the last payment date, amount of payment, and if the account was written off as a bad debt.

## **Example of Accounting Entries**

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

**FACTS:**

Sales Price	\$5,000	Sale Price by Dealer to Purchaser
Cash (Down Payment)	1,000	Down Payment from Purchaser to Dealer
Accounts Receivable	4,000	Installment Contract Recorded on Dealer's Books
Cash (advance)	2,000	Advance to Dealer from Finance Company
Cost of Goods	2,500	Dealer's Cost of Vehicle Sold
Monthly Payments	250	Monthly Payment per Contract
Interest Rate	10%	Rate of Interest Charged to Purchaser and by Finance Company to Dealer
FMV of BE Distribution	450	Potential Max Back-End Distribution of \$1200. Fair market value of contingent contractual right To such payment estimated to be \$450.

***Report as a Loan or an Assignment...***  
***(WHAT YOU MAY FIND ON THE DEALERSHIP BOOKS)***

I. Note	\$4,000		
Cash (down payment)	1,000		
Sale		\$5,000	

SALES	\$5,000
COS	2,500
NET PROFIT	2,500

To record the sale of the vehicle

II. Cost of Goods Sold	2,500	
Inventory		2,500

To record the cost of the vehicle sold

III. Cash	2,000	
Advance Payable to Finance Company		2,000

To record advance received from the finance company

IV. Advance Payable to Finance Company	250	
Notes Receivable		250

To record collections received and applied by the finance company to offset the advance

V. Cash		100
Accounts Receivable		90
Interest Income		10

To record back-end distribution payment from finance company.  
 Amounts and interest rate estimated.



VI. Service Fee	20	
Accounts Receivable		20

To record collections received by finance company applied to the service fee.

***Report as a Loan or an Assignment...***  
**(HOW IT SHOULD BE REPORTED)**

I. Accounts Receivable	\$4,000	
Cash (down payment)	1,000	
Sale		\$5,000
		To record the sale of the vehicle

II. Cost of Goods Sold	2,500	
Inventory		2,500

To record the cost of the vehicle sold

III. Cash	2,000	
Advance Payable to Finance Company		2,000

To record advance received from the finance company

IV. Advance Payable to Finance Company	183	
(250-(17+50))		
Notes Receivable (250-33)		217
Interest Expense (Dealer to Fin.Co.)	17	
(2000*(10%/12))		
Collection Fee Expense	50	
(250*20%)		
Interest Income (Dealer held note)		33
(4000*(10%/12))		

To record collection of first \$250 payment

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

**Reported As A Sale...**

(WHAT YOU MAY FIND ON THE DEALERSHIP BOOKS)

I. Note Receivable	\$4,000		
Cash (down payment)	1,000	GAIN ON SALE OF	2,500
Sale		\$5,000	VEHICLE(5000-2500)
			LOSS OF SALE OF (2,000)
			CONTRACT (4000-2000)
			NET PROFIT <u>500</u>
To record the sale of the vehicle			

II. Cost of Goods Sold	2,500		
Inventory		2,500	

To record the cost of the vehicle sold

III. Bad Debt Expense	2,000		
Cash (advance)	2,000		
Note Receivable		4,000	

To record the sale of the finance contract

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

**Reported As A Sale...**

(HOW IT SHOULD BE REPORTED)

I. Note Receivable	\$4,000			<b>CASH FLOW ANALYSIS</b>
Cash (down payment)	1,000			TAX ON
Sale		\$5,000		PROFIT
				(SALE OF CAR)
				(2500*30%) <u>750</u>
				TAX ON LOSS
				(SALE OF
II. Cost of Goods Sold	2,500			CONTRACT)
Inventory		2,500		(1550*30%) <u>(465)</u>

To record the cost of the vehicle sold

III. Cash	2,000		
Back-end Distributions Receivable	450		
Loss on Sale of Installment Contract	1550		
Note Receivable		4,000	

To record the sale of the finance contract

IV. Cash	600	
Back-end Distributions Receivable		600

**Reported properly, the correct loss is \$1550, not \$2000. Note that back-end distributions that are paid will include unstated interest calculated under the principals of Regulation section 1.483-4.**

## OTHER ISSUES

1. Enrollment Fee – The dealership may pay a nonrefundable fee to the finance company to join the finance company’s program. This fee is an IRC section 263 capital expenditure and may not be currently deducted under section 162. The Servicing Agreement between the dealer and the finance company meets the definition of a supplier based intangible under section 197(b) of the Code and has a 15 year life beginning with the month in which the contract was executed. Since the agreement does not have a fixed duration of less than 15 years, the exception from inclusion under section 197(e)(4)(D) of the Code does not apply.
2. Pool Capping Fee – The dealership may pay a nonrefundable fee to the finance company to cap the pools. The same reasoning used for the enrollment fee can be applied to the pool-capping fee. The fee covers a period of time, which is probably not specified in years because it is based on the number of contracts involved. This fee would also fall under section 197 of the Code because it is supplier based intangible with a value resulting from future acquisition of services pursuant to a relationship in the ordinary course of business with a supplier of services to be used by the taxpayer. The fee would be amortized ratably over a 15-year period beginning with the month in which the fee was paid.
3. Servicing Fee – The Servicing Agreement between the finance company and the dealer will specify the fee charged by the finance company to the dealer to collect the receivables (servicing fee). The servicing fee is usually a percentage of the finance contract. The deductibility of the servicing fee is not an issue if the transfer of the finance contract is deemed to be a sale because it is factored into the amount realized on the sale. If the transfer is deemed to be a loan or an assignment, the servicing fee is not currently deductible when the finance contracts are transferred to the finance company, rather it is deductible based on economic performance. The fee should be deducted as the services are provided by the finance company.

4. Mark to Market – Section 475 of the Code opened a small window of opportunity for auto dealers to elect section 475 to mark receivables to market value. For section 475 to apply, the dealer must have held (owned) the receivable at THE END OF THE APPLICABLE TAX YEAR. If the transfer of the installment contract to the finance company is determined to be a sale, section 475 does not apply since the dealer no longer owns the receivable. The IRS Restructuring and Reform Act of 1998 amends IRC section 475 effective for the tax years ending after 7/22/98. The mark-to-market accounting rules were not intended to be used by dealers in non-financial goods and services to obtain a loss deduction that otherwise would not be available. Mark-to-market no longer can be used for a receivable that is produced from the sale of non-financial goods or services by a taxpayer whose principal activity is the selling or providing non-financial goods and services.
5. Change in Accounting Method – Depending on how the dealer has reported the transactions, audit adjustments may require a change in method of accounting. If so, a section 481(a) adjustment will be made at the beginning of the year of change, usually the first open year under examination. The current year adjustment will be made pursuant to IRC section 446. The facts and circumstances of each situation must be considered to determine if a change in method has occurred.

## **OTHER SOURCES OF INFORMATION**

IRC sections 446, 475, 483 and 1001

*Hansen v. Commissioner* 360 U.S. 446 (1959)

*Resale Mobile Homes v. Commissioner* 965 F.2<sup>nd</sup> 818 (10<sup>th</sup> Cir. 1992)

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Insert Ten Core Ethical Principles