

## Dealers Experiencing Franchise Terminations – Must Read!

### LIFO Income Deferral Where Franchise is Lost

With the recent termination of Chrysler and General Motors franchises, many affected dealerships are facing LIFO recapture. That is, the LIFO reserves associated with new vehicle inventories held by these dealerships will now become subject to income tax as there are no longer inventories to support the reserves.

In a Chief Counsel Advice (CCA) released 8/28/09, IRS provides some good news for dealers that remain in business following the loss of a franchise. Where the appropriate accounting method change is filed to terminate LIFO, a four-year spread of the LIFO recapture income may be obtained even if the dealership no longer holds any new vehicle inventory.

Ordinarily a dealership may terminate the use of the LIFO method and adopt another permissible inventory method by filing an Application for Change in Accounting Method with IRS. Under the rules for accounting changes, the accumulated LIFO reserve would generally be taken into taxable income over a four year spread period starting with the year of change. If there is a cessation of the business the spread period terminates and all remaining income accelerates and becomes subject to tax. For example, if a dealership elected to terminate LIFO in 2008, 1/4<sup>th</sup> of the LIFO reserves would be taken into income in 2008 under the four year spread rule. If in 2009 the dealership ceases all business activity, the entire remaining 3/4<sup>th</sup> of the LIFO reserves must be taken into income in 2009 under the acceleration rule.

### Lost Franchises – Impact on the Four Year Spread Period

**Situation #1 – Five different franchises and the dealership maintained separate LIFO calculations or pools for each of the five franchises and continued business with the remaining franchises.**

The CCA addressed three situations regarding lost franchises and what the impact would be on the four year spread period. The first situation involved a dealership with five different franchises including Pontiac, Ford, Chevy, Toyota, and Honda. The dealership maintained separate LIFO calculations or pools for each of the five franchises. During 2009, the dealership lost the Pontiac franchise and by year-end at December 31, 2009 had no remaining Pontiac vehicles in inventory. Operations continued with the remaining four franchises. In March of 2010 in connection with the preparation of 2009 income tax return the dealership elected to terminate the LIFO method with respect to new Pontiac inventory for 2009 under the automatic accounting change provisions. The LIFO method was retained for all other franchises.

The question posed was, is it appropriate to only include 1/4<sup>th</sup> of the Pontiac LIFO reserve in 2009 or must the entire amount be accelerated in 2009 as there is no remaining inventory as of year-end. The CCA confirmed that the dealership taxpayer could terminate the LIFO election for Pontiac by filing for a Change in Accounting Method and would be allowed to spread the Pontiac LIFO reserve over the normal four year spread period. There was no acceleration of the spread period due to the fact that there are no Pontiac vehicles in inventory at year-end.

### **Situation #2 – One franchise and the dealership continued business as a used vehicle retail outlet.**

The second situation addressed in the CCA is similar to the first. In this case we only have the Pontiac franchise for which a LIFO election is in place. Again, the Pontiac franchise is lost in 2009 and there were no Pontiac vehicles left on-hand at the end of 2009. The dealership would however continue to sell used vehicles, parts, and service. In connection with the preparation of 2009 income tax return in March 2010 the dealership elected to terminate the LIFO method with respect to new vehicle inventory for 2009 under automatic accounting change provisions. The CCA again confirmed that a four year spread is available on the new vehicle LIFO reserve starting in 2009 and no acceleration of the spread is caused by the absence of Pontiac inventory at year end. It is important to note that without the continuance of business (e.g., used car sales) by the dealership the four year spread would not be possible.

### **Situation #3 – Five different franchises and the dealership included all five in a single LIFO calculation.**

The final situation addressed by the CCA involved the same facts as in the first situation except all five franchises were included in a single LIFO calculation (i.e., single pooling under the vehicle pool method is utilized). As there is no provision to terminate a portion of a single LIFO calculation or pool under the rules for accounting method changes, a four year spread is not available for the elimination of just the Pontiac inventory. In this case the magnitude of the inventory reduction caused by the elimination of Pontiac inventory will dictate the amount of LIFO recapture income in the current year. The CCA points out that the dealer may alternatively terminate the LIFO method for the entire new vehicle inventory or may change to a method of pooling based on vehicles of each franchise and then terminate LIFO on the vehicles of the lost franchise only. Generally, these options may not be desirable depending upon the recapture amount under various scenarios. Also, the creation of additional pools for the remaining franchises is disadvantageous for future LIFO computations in general.

### **In Summary**

This CCA confirms a unique planning opportunity that allows dealers a four year spread of LIFO recapture income resulting from lost franchises. Dealerships that continue in business as a used vehicle dealer for example, can defer this income by filing the appropriate and timely accounting method change. This can offer a much needed tax deferral in trying times.

If you have any questions relating to your LIFO calculations or need any additional information, please contact your Dealer CPA or contact the author of this advisory, Jorg Kaltwasser, CPA directly at (901) 684-5642 or via email at [jkaltwasser@dixon-hughes.com](mailto:jkaltwasser@dixon-hughes.com).

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