DEALERSHIP LIFO BENEFITS MAY BE LOST

During times of inflation, the last-in first-out (LIFO) method of valuing inventory generally results in a lower value of inventory than other methods. Dealers using the LIFO method are able to lower their income tax for a period of time, which is like having use of the money interest-free. It is not a permanent benefit, however, as LIFO benefits are lost when the business is sold or the entire inventory is otherwise liquidated. Eventually – but maybe not for many years – the benefit will be lost and the taxes saved must be paid back.

The Future of LIFO

The availability of the LIFO benefit may end sooner than expected. As the federal government looks for ways to reduce the budget deficit, discontinuing the LIFO method might be a potential source of tax revenue. It has even been proposed that taxpayers currently using the LIFO method be required to recapture their LIFO inventory benefits in the first taxable year beginning after Dec. 31, 2011. The increase in gross income attributable to recapturing the LIFO reserve would be spread over eight years. While the future of LIFO is uncertain, dealers should remain informed about potential legislative and regulatory changes and the impact on their businesses.

Various trade and professional organizations are lobbying to preserve the LIFO method. The LIFO Coalition is concerned that representatives in Washington are not well-informed about the LIFO method of accounting and the effect discontinuing the method would have on taxpayers, including dealers. Dealers nationwide should consider sending a letter to their U.S.

*(See **LIFO** on page 2)*

TAX CONSIDERATIONS FOR TROUBLED DEBT

The recent stimulus bill included a provision allowing taxpayers to make an irrevocable election to defer recognition of cancellation of debt ("COD") income arising in 2009 and 2010 from business indebtedness discharged upon the reacquisition of a debt instrument and to recognize it in taxable income ratably over five years beginning in 2014. The election is made for each applicable debt, must clearly identify each debt and must set forth the amount of income being deferred. However, taxpayers who elect this deferment under IRC Section 108(i), will lose the opportunity to use the non-elective COD income exclusions under IRC Section 108(a) that apply to bankruptcy, insolvency, qualified farm indebtedness, qualified real property business indebtedness, and qualified principal residence indebtedness in the year of the election or any subsequent year that the deferred 108(i) income is includable. In other words, taxpayers cannot make the election now to defer the income to a later year and then exclude the income in another year when the exclusion provisions might apply.

Taxpayers who have COD income that falls under both the new deferral rules of 108(i) and the exclusion rules under 108(a) will therefore need to examine the differences and decide whether to make the election under 108(i). The decision to elect or not will vary based upon each taxpayer's situation and projection of future events.

What Transactions Cause COD Income?

Examples of transactions that cause COD income include:

- Conveyance of property in satisfaction of recourse debt if the property's fair market value is less than the amount of the recourse debt.
- Significant debt modifications which result in the new issue price being worth less than the face amount of the old debt. These rules are discussed in Treasury Regulation 1.1001-3 (e). A significant modification could result from a change in any of the following:
    1. Yield,

*(See **Debt** on page 2)*

(*LIFO continued from page 1*)

senator to share the impact a loss of the LIFO method would have on their business.

Closing Franchises and the LIFO Effect

Dealers across the country are facing the reality of losing their LIFO benefits as franchises are terminated and inventories are eliminated. If a dealer has other franchises, he or she might be able to combine the inventories to limit the tax effect.

Another option may be to terminate using the LIFO method and spread the tax effect over four years if a dealer can manage to continue the business – for instance, via a used-car operation. The entire amount of a dealer's LIFO reserve must be reported as income for the current tax year if the dealer loses all of his or her franchises and does not remain in business. Unfortunately, franchise terminations happen quickly, leaving little time to plan for the many technical aspects of tax law that must be considered. Dealers should also consider accumulating cash now to fund the future tax liability.

Dealers should consult their tax professionals to determine the potential impact LIFO termination would have on their particular circumstances. Dealers required to begin recapturing their LIFO inventory benefits in the coming years should consider the various options available to help soften the blow.

TAX TIP

The Car Allowance Rebate System

President Obama signed into law a program that the National Highway Traffic Safety Administration (NHTSA) is calling the Car Allowance Rebate System (CARS). This is a federal program that helps you purchase a new, more fuel efficient vehicle when you trade in a less fuel efficient vehicle.

While the CARS Act makes transactions on and after July 1 potentially eligible for credits under the CARS program, interested dealers and consumers may want to wait until all of the detailed issues that must be addressed in the implementing regulations are resolved and the final rule is issued. Issuance will occur around July 24.

Important Things to Know:

- The vehicle must be less than 25 years old on the trade-in date.
- Only purchase or 60 month lease of new vehicles qualify.
- Generally, trade-in vehicles must get 18 or less MPG (some very large pick-up trucks and cargo vans have different requirements).
- Trade-in vehicles must be registered and insured continuously for the full year preceding the trade-in.
- Dealers apply for a voucher; dealers will apply a credit at purchase.
- Program runs through November 1, 2009 or when the funds are exhausted, whichever comes first.
- The program requires the scrapping of your eligible trade-in vehicle, and that the dealer disclose to you an estimate of the scrap value of your trade-in. The scrap value, however minimal, will be in addition to the rebate and not in place of the rebate.

Vouchers issued under the program and payments made for the vouchers are not considered gross income for the purchaser of the vehicle for purposes of the Internal Revenue Code. However, many state jurisdictions consider this rebate as part of the consideration paid for the vehicle and will be subjecting the rebate to the local jurisdiction's sales/use tax.

You should consult with your local ATA representative when considering your local jurisdiction's sales/use tax.

(*Debt continued from page 1*)

2. Timing of payments,
3. The obligor,
4. Addition or deletion of a co-obligor,
5. Security or credit enhancement,
6. Priority of debt,
7. The nature of a debt instrument to something that is not considered debt for federal income tax purposes,
8. Recourse nature to non-recourse.

- Acquisition of debt by the obligor or a related party at a discount.
- Contribution of debt to equity if the fair market value of the equity is worth less than the debt.

Taxpayers who have COD income should determine if the Section 108(a) exclusion rules apply to them. However, before excluding any income, taxpayers must reduce their tax attributes in the following order:

1. Net operating losses,
2. General business credits,
3. Minimum tax credits,
4. Capital loss carryovers,
5. Basis of depreciable property of the taxpayer,
6. Passive activity loss and credit carryovers, and
7. Foreign tax credit carryovers.

However, taxpayers other than C corporations can elect to first reduce their basis of depreciable property under # 5 above before reducing any other tax attributes under the normal ordering rules. The basis reduction takes effect on the first day of the tax year following the tax year in which the COD takes place. Depreciable property can include property held by the taxpayer or indirectly held through partnership interests to the extent of the partner's proportionate interest in the partnership's depreciable property. Consent must be obtained from the partnership if the taxpayer elects to treat their partnership interest as depreciable property.

The attributes are reduced on a dollar-for-dollar basis, with the exception of credits, which are reduced at a one-third rate. All this becomes even more complicated if the COD income is recognized by a pass-through entity. For corporations, the determination of bankruptcy, insolvency and attribute reduction takes place at the corporate level; these same determinations are not made at the partnership level but rather at the partner level.

Section 108(i) and Electing to Defer

The irrevocable election to defer income must be made on the tax return in the year in which the reacquisition of the debt instrument occurred and is made for each applicable debt instrument reacquired. An applicable debt instrument is defined to include any debt issued by a C corporation or any other person in connection with the conduct of a trade or business by such person. It is expected that additional guidance will be provided with these definitions. The term 'reacquisition' refers to the acquisition of the debt instrument by the debtor which issued or is otherwise the obligor under the debt instrument, or a related person. Acquisition of debt will include all the situations mentioned previously in "What Transactions Cause COD Income". In the case of a pass-through entity, the election is made by the entity. An entity election would preclude the shareholders and partners from using the exclusion provisions under Section108 (a). This could create difficult decisions for many S corporation and partnership tax matters persons.

COD income must be allocated to the partners in the same manner as if the income were not deferred. In addition, the deferred income is accelerated and recognized as income in an earlier tax year if the taxpayer dies, sells substantially all of assets (or if a partner or shareholder sells their interest), ceases to do business or enters bankruptcy.

Summary

All taxpayers who plan to pay off or restructure debt instruments should generally be aware of the COD rules since successful negotiations could result in "phantom income", i.e., non-cash income that results in a tax liability. The new law under IRC Section 108(i) is clearly taxpayer friendly, but it will create some difficult decisions for many taxpayers, especially partnerships. We believe most taxpayers will conclude that the non-elective provisions under 108(a) are more advantageous, not only for bankrupt and insolvent taxpayers, but also for real estate investors who recognize COD income from qualified real property indebtedness. Each case requires careful analysis.

If you have any questions regarding these matters, please consult your local Auto Team America member today.