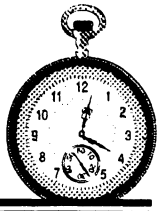
De Filipps'

DEALER TAX WATCH



A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. IRS AUDIT UPDATE ...

HOT & EMERGING TAX ISSUES. In addition to many other interesting IRS activities to report, we finally have something ***specific*** on one of our three "hottest" topics: **LIFO conformity for dealership financial statements**. As we go to press, the IRS has issued Revenue Procedure 97-44 and Revenue Ruling 97-42. **THE BOMBS HAVE FALLEN!** Rev. Proc. 97-44 is the settlement document telling dealers how to pay for their conformity violations. Rev. Rul. 97-42 defines what "conformity violations" are by reference to three (limited) "situations."

Under separate cover, *Dealer Tax Watch* subscribers will receive our complete write-up of both documents which is included in the September, 1997 issue of the *LIFO Lookout*.

Now for the second hot and emerging tax issue we have been tracking: **Demonstrator vehicles** (how far does the salesman's exemption extend and how should the income from demo use be computed?)... There is nothing new to report right now. **But**, you should expect a major, adverse development from the IRS very soon...within a month or so. There is nothing "official" to report at this time. All dealers are likely to be hurt by this development... not just those on LIFO.

Factory incentive payments (who pays the "employer's portion" of the FICA taxes?)... Nothing new to report at this time, not even a rumor.

Add one more: A very significant "new" development is brewing as the IRS continues to challenge dealer inventory practices. This one involves the valuation of parts and accessories inventories and will affect all dealers...for better or for worse.

#2. AFTER-MARKET SALES. The primary focus of this issue of the *Dealer Tax Watch* involves tax matters relating to auto dealers' after-market sales. We have included a perspective on the broader VSC market and the IRS' more recent interest in it, along with an overview of the SWIM method for dealer obligor extended warranty/vehicle service contract (VSC) sale income. Next, the article on the *Rameau Johnson* case highlights the Tax Court's holding in June against dealer obligors using escrow accounts. The VSC-PORC Conference in Dallas earlier this year is summarized on page 28. And finally, the case of *William McCurley* on page 30 realizes everybody's nightmare over dealers' "borrowing money" from their off-shore exotic PORCs.

WATCHING OUT FOR

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Dealer Tax Watch Out

#3. TAX COURT ACTION. In its on-going battle over buy-sell agreements and allocations, the IRS often challenges the former dealer's agreement not to compete with the purchaser after the deal goes through. In *Howard Pontiac-GMC, Inc.*, the IRS said the amount allocated to the non-compete agreement was too high. The taxpayer said $490,000...The IRS, $125,000. Although the Tax Court didn't fully agree with the IRS' reallocation, it did reduce the taxpayer's allocation to $300,000 in this case which involved a pre-1993 buy-out. For full coverage, see page 3.

We recently included several articles reflecting the IRS' growing interest in the activities of used car dealers, Buy-Here, Pay-Here (BHPH) operations and Related Finance Companies. Another dealership area the IRS has been overhauling is the sale of products to customers after they buy a vehicle. These products include credit life and disability insurance and contracts that extend the manufacturer's basic warranty on the mechanical performance of the vehicle. As to these vehicle service contracts, or VSCs, the Tax Court in *Rameau Johnson Et Al v. Comm.*, in June held that the dealerships were required to include in income currently the entire contract amounts deposited in escrow. All other related tax issues also were resolved against the dealerships. This case is analyzed beginning on page 15.

Also involving VSCs, but only in the Tax Court petition stage, Pinegar Chevrolet, Inc. filed a petition recently challenging the IRS' adjustments for its service warranty contracts. Pinegar contends that the VSCs it sold in 1992 under a VSC program administered by Mechanical Breakdown Protection, Inc. (MBP) were such that the obligor under the VSCs was MBP, and not Pinegar. Pinegar claims it had no risks associated with its future obligations under its VSCs. Alternatively, it claims that if it did, it managed such risks, and customers' risks, with transfers to an Escrow Account. This sounds somewhat like *Rameau Johnson* ... but, the essential difference is that in *Rameau Johnson* the dealerships were the obligors. An interpretation of the contracts under state law seems necessary in Pinegar's situation because if Pinegar is really a dealer obligor, what the Tax Court said in *Rameau Johnson* would control, unless the other facts are different.

Another case, *William L. McCurley*, discussed on page 30, involves a dealer who reinsured credit insurance policies sold by the dealerships through an off-shore producer owned reinsurance company. This dealer got into trouble with the IRS because he "touched the money." After his PORC built up enough

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cash, the dealer "borrowed" some of it from the PORC. The IRS didn't believe the dealer ever intended to repay these advances or loans. The Tax Court agreed with the IRS. This is a real problem for many dealers.

The last current Tax Court development relates to the sale of credit life insurance policies by two Michigan dealerships. The IRS has challenged the deductibility of commissions paid by *Berger Chevrolet, Inc.* to its employees for selling credit life insurance. The IRS contends that the dealerships are not in the insurance business; therefore, they cannot benefit from the payment of the commissions. More on this matter when it is finalized.

#4. MORE ON VOLUNTARY CHANGES IN ACCOUNTING METHODS. Revenue Procedure 97-27 issued in May considerably simplifies many rules, terms and conditions involved when taxpayers have to request IRS permission to change accounting methods ... including LIFO accounting methods. The requirement that the Form 3115 request must be filed within the first 180 days of the year of change has been removed, and several difficult technical definitions have been eliminated. The 90-day window for filing 3115s by taxpayers coming under IRS audit has also been eliminated. The now-familiar 6-year spread period for reporting positive Section 481(a) adjustments in income has been shortened to four (4) years.

Recently, the IRS issued Revenue Procedures 97-36, 97-37 and 97-38 which collectively deal with

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AMOUNT ALLOCATED TO NON-COMPETE COVENANT DOESN'T STAND UP *HOWARD PONTIAC-GMC, INC.*

BUY-SELL TERMS

Here is another case to add to the growing list of IRS challenges to non-compete agreements when dealerships are bought and sold: *Howard Pontiac-GMC, Inc. d/b/a Bob Howard Automall v. Comm.*, T.C. Memo 1997-313 filed July 7, 1997.

Other articles on IRS activity in the buy-sell area have appeared in the March, 1996 *Dealer Tax Watch* related to *Heritage Auto Center* (T.C. Memo 1996-21), December, 1995 related to *Beaver Bolt* (TCM 1995-549) and June, 1994 related to *East Ford* (TCM 1994-261).

In *Howard Pontiac-GMC*, the newest case, an Oklahoma City Jeep-Eagle franchise was sold for $2,500,000. The buyer and seller allocated $2,000,000 to inventories, $490,000 to the seller's non-compete agreement and $10,000 to the franchise. The IRS challenged the $490,000 allocation to the non-compete agreement, claiming it should only have been $125,000. The Tax Court valued the non-compete agreement should be valued at $300,000.

BACKGROUND FACTS

The franchise involved was a Jeep-Eagle franchise owned by Mr. John Markley. Mr. Markley had entered the auto dealership business in the mid-'60's, purchasing Ford dealerships in Yukon, Oklahoma and later in Dallas, Texas. As a suburban Oklahoma Ford dealer, he had been a competitor of Oklahoma City dealerships and was consistently ranked among the top two or three truck dealers in the Oklahoma City metro area.

In 1980-81, Mr. Markley sold his Ford dealerships. Several years later, in 1988, he reentered the auto dealership business by obtaining a Jeep-Eagle franchise in Oklahoma City, acquiring this franchise directly from Chrysler Corp. Mr. Markley became a successful Jeep-Eagle dealer in the Oklahoma City market, with vehicle sales averages exceeding his market share responsibility as determined by Chrysler. His name was well known in the area as a result of the previous 14 years of advertising he had done as a Ford dealer. At the time he sold his Jeep-Eagle franchise to Howard Pontiac-GMC, he was 49 years old, in good health, and he intended to expand an existing used car and finance company business in Oklahoma City.

The purchaser, Robert E. Howard, II, owned Howard Pontiac-GMC, Inc. and had a very impressive track record as a dealer. In early 1982, he had acquired considerable land in Oklahoma City on which he constructed an auto mall. The land needed by his existing dealerships was only about one-half the total land he owned. Accordingly, he was looking to acquire additional franchises in order to spread the overhead costs from his oversized facilities. Specifically, he was interested in finding dealerships whose assets could be acquired without having to enter into a lease or having to purchase the underlying real estate. In 1988-1989, he became very interested in the possibility of selling Chrysler products.

Mr. Howard found Mr. Markley's Jeep-Eagle franchise very attractive... especially because of the real estate aspects. They pretty much agreed to the sale of the dealership before talking to their attorneys. When they did, it was suggested that they allocate $10,000 to goodwill ... and this left $490,000 to be allocated to Mr. Markley's covenant not to compete. For the payment of $500,000 over and above the inventory amount, the buyer received the seller's agreement to terminate its Jeep-Eagle franchise and the seller's agreement to provide the buyer with all sales and service records, customer lists and other useful information.

The sale agreement was signed on November 15, 1989. Howard Pontiac-GMC, Inc. deducted $163,000, $163,500 and $163,500, respectively, in its 1990, 1991 and 1992 income tax returns as amortization of the amount paid for the covenant not to compete. The IRS disallowed each year's deduction to the extent of placing a value on the non-compete agreement of only $125,000.

VALUATION OF THE NON-COMPETE AGREEMENT

At the time of the transaction, the buyer believed that the seller was a significant competitive threat because:

1. He had very good connections with the Jeep-Eagle factory personnel,
2. His name was well-known in the Oklahoma City metropolitan area,
3. He was from Oklahoma City and was continuing in the automotive business in Oklahoma City after the sale,

see **AMOUNT ALLOCATED TO NON-COMPETE COVENANT DOESN'T QUITE STAND UP...**, page 4

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4. His demonstrated sales ability was very good,
5. His age and background made him a competitive threat,
6. He had good customer relations in the Oklahoma City metropolitan area, and
7. He had superior knowledge of Chrysler and Jeep-Eagle product lines.

The buyer was aware and fearful that Mr. Markley would be a competitive threat if he were to (1) acquire a new Jeep-Eagle franchise in a suburb of Oklahoma City (as he had done when he was a Ford dealer previously), (2) acquire an existing Jeep-Eagle dealership or (3) go to work for an existing competitor.

Accordingly, Howard Pontiac-GMC was willing to establish a non-compete agreement with the seller for a 3-year term which covered six Oklahoma counties. The agreement did not preclude the seller and/or Mr. Markley from competing with the purchaser in Kingfisher County, a county adjacent to Oklahoma County and less than 15 minutes from the Howard Auto Mall site. Other provisions in the non-compete agreement did not preclude Mr. Markley from competing by working for any dealership, including Jeep-Eagle, for compensation of less than $100,000 per year, or from competing with the purchaser by obtaining any franchise other than Jeep-Eagle.

HOW BUYER VALUED NON-COMPETE AGREEMENT

Mr. Howard indicated that he had "intuitively" calculated the value of Mr. Markley's agreeing not to compete by estimating that Mr. Markley could take 25% of his business if he competed with him. Mr. Howard projected annual gross profits less variable costs for the Jeep-Eagle dealership at approximately $1,996,000 as follows:

New vehicle sales	$	810,000
Finance and insurance income		351,000
Used vehicle sales		222,750
Parts and service		612,000
	$	1,995,750

Rounding his figures, and taking just under 25% of the total, Mr. Howard believed that a value of $490,000 (25% of $1,996,000 = $499,000) for the non-compete agreement was reasonable.

IRS REASONS FOR DISAGREEING

The IRS had challenged the value of the non-compete agreement by claiming that the buyer had overstated the magnitude of potential lost sales, citing the buyer's own strong background in auto sales and its established presence in the Oklahoma City market. The IRS also challenged the valuation for the following reasons:

1. The likelihood of competition from Mr. Markley was low, due to the "limited market entry" (i.e., the limited number of Jeep-Eagle franchises allowed by Chrysler in the Oklahoma City market area).

2. Mr. Markley showed no intention of competing and, in fact, left Oklahoma shortly after the sale to pursue a business opportunity in Houston, Texas.

3. The covenant not to compete allowed for significant competition, since it only covered the sale of new Jeep-Eagles and did not cover an adjacent county.

4. The computations used by Mr. Howard did not discount the stream of payments required under the covenant to reflect the time value of money.

5. The computations also did not factor in the effect that amortizing the covenant would have on after-tax cash flow, since these deductible payments would reduce the buyer's income tax liability.

6. Any amount paid in excess of the IRS allocation of $125,000 to the covenant was for Mr. Markley's agreement to terminate his Jeep-Eagle franchise, and the sale was contingent on Chrysler's awarding Mr. Markley's franchise to the buyer and the buyer could not obtain Mr. Markley's Jeep-Eagle franchise unless Mr. Markley informed Chrysler that he wished to terminate his franchise.

WHAT THE TAX COURT SAID

The Tax Court's discussion of the law in this case is relatively brief. It stated that the taxpayer bears the burden of proof as to the value of the non-compete agreement. A taxpayer generally may amortize intangible

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assets over their useful lives. To be amortizable, an intangible asset must have an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy. A covenant not to compete is an intangible asset that has a limited useful life and, therefore, it may be amortized over its useful life.

The Tax Court observed that it strictly scrutinizes an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack "economic reality". A covenant not to compete must have "economic reality," some independent basis in fact or some relationship with business reality so that reasonable persons might bargain for such an agreement. In its summary, the Tax Court cited numerous cases supporting each of these statements and it noted that the IRS had conceded the existence of economic reality, leaving the value of the non-compete agreement as the only issue for the Court to decide.

Neither the IRS nor the taxpayer called an expert witness. However, one individual was allowed to testify as an expert witness relating to the practice in the automobile dealership industry of using covenants not to compete. This individual stated that, based on his experience, practice and industry custom, he would estimate lost profit (i.e., lost sales) due to competition from a seller in an Oklahoma City metropolitan dealership such as this one ... in the range of twenty (20) to twenty-five (25) percent.

The Tax Court found that a part of the $490,000 allocated to the covenant not to compete was, in reality, paid to compensate Mr. Markley for terminating his franchise with Chrysler. The Court pointed out that the buyer failed to take into account the fact that the covenant was restricted to the sale of new Jeep-Eagle vehicles and that the covenant had to be reduced to reflect its present value. On the other hand, the Tax Court indicated that the IRS underestimated the probability that Mr. Markley might compete and the amount of damage that his competition might cause.

The Tax Court found that the testimony by the industry expert was "in line with industry norms in the Oklahoma City area." The industry expert who testified had no personal knowledge of the buyer's transactions and did not give an opinion on the value of the seller's covenant not to compete.

The Tax Court noted, however, that lost sales in the first year should reflect several business realities:

1. Lost sales in the first year would have to reflect the business reality that it would take some time to implement whatever form of competition Mr. Markley might engage in. Accordingly, using 20% at the lower end of the 20-25% range and factoring in a time lag, the potential for lost business would be closer to $300,000 the first year and $400,000 for each of the following two years.

2. The potential annual lost business would need to be reduced to reflect the probability of competition taking place during each of the three years of the covenant.

3. In evaluating the probability of competition, the covenant was restricted to the sale of new Jeep-Eagle vehicles, which required a franchise from Chrysler.

4. The value assigned to the covenant should be reduced to reflect its present value.

The Tax Court concluded that the buyer had failed to take these factors into account, and therefore, the covenant not to compete was worth less than $490,000. Based on the record as a whole, the Tax Court valued the covenant not to compete at $300,000.

CONCLUSION

In this case, the IRS had formally conceded that the covenant not to compete was amortizable and that it had "economic reality". In other cases, the IRS may first attack the economic reality of a seller's non-compete agreement ... but, in this case, the facts prevented this approach. We have discussed the IRS' "economic reality" challenges to non-compete agreements in prior *Dealer Tax Watch* articles.

The *Howard Pontiac* buy-sell agreement, of course, pre-dates the enactment of Section 197 under which amounts allocated to non-compete agreements are treated as Section 197 intangibles to be amortized over 15 years. The Court's analysis suggests a number of factors that dealer advisors should be considering in valuing non-compete agreements, regardless of the number of years over which the covenant payments will be amortized.

In a petition recently filed in the Tax Court, *John Crissman* Docket No. 23972-96, the Service is challenging the valuation of covenants not to compete in the amounts of $600,000 and $900,000 paid by some dealerships in southeastern Michigan. And the beat goes on....

VEHICLE SERVICE CONTRACTS, REV. PROC. 97-38 & THE *SWIM* METHOD FOR DEALER OBLIGORS

SWIM

OVERVIEW

This article summarizes the activity of the Internal Revenue Service relating to vehicle service contracts (VSCs) and the required tax treatment where the dealer is the obligor. Another article reports on the *Rameau Johnson* decision by the Tax Court in June, 1997. A very specialized two-day Conference was held in Dallas earlier this year on tax issues affecting VSCs and PORCs, and another article reports on this seminar and several of the more recent IRS letter rulings on VSCs.

In 1992, the IRS issued two revenue procedures addressing the tax treatment of VSCs: for the income side there was Revenue Procedure 92-98, and for the expense side there was Revenue Procedure 92-97. These only apply where the dealer is the obligor. As part of several revenue procedures issued this summer, the IRS republished ... without any real modification ... these 1992 revenue procedures.

Revenue Procedure 97-38 now describes the SWIM (Service Warranty Income Method) that may be used by auto dealers for treating part of the income payments received in the year of sale in a specialized manner. Revenue Procedure 97-37 contains the procedures for obtaining automatic IRS consent to change to the SWIM method, as well as to make a corresponding change in the treatment of deducting insurance premiums related to the multi-year service warranty contracts. If a dealer properly changed to the SWIM method ... in 1992 or a later year ... pursuant to Revenue Procedure 92-98, it is not required to do anything now to comply with the restatement Revenue Procedure 97-38, nor is it required to refile any Forms 3115 at this time.

VSCs: A UNIVERSE OF POSSIBILITIES

Vehicle service contracts may be purchased along with a new vehicle to protect the purchaser against mechanical breakdown that is not covered under the manufacturer's basic warranty.

A manufacturer's warranty usually contains a comprehensive base period warranty, and it may include a power train warranty only on other major components after the base period. Usually, there is a 3-year/36-month time limit or a 36,000 (or longer) mileage limit, with the manufacturer's warranty expiring as soon as either limit is reached. Manufacturers' warranties, and what they cover, vary greatly.

A typical VSC provides coverage beyond that provided by the manufacturer's warranty. Accordingly, a VSC "extends" the manufacturer's warranty to some longer period of time and/or mileage plateau. There is considerable variation among VSC benefits, and VSCs typically provide little benefit while the manufacturer's warranty is running. Often, VSCs will take care of mechanical breakdowns of other components not covered by the manufacturer's warranty. VSCs are not limited to new vehicles: They are often sold with used vehicles...usually with shorter time and/or mileage plateaus.

Expanding the spectrum of VSC variation even further is the fact that different parties may be contractually obligated to the purchaser to repair the vehicle. The party obligated to the purchaser of the VSC to repair the vehicle is called the ***obligor***. There are four potential parties who may be the obligors under a VSC: (1) the dealership, (2) a third-party administrator, (3) the manufacturer, and/or (4) an insurance company.

DEALER OBLIGOR. Some programs sold to customers are contractual relationships in which the dealership is the obligor, contractually liable to the purchaser to repair the vehicle. Where the dealership is the obligor, the dealership may either self-administer the plan or contract with an administrative service company (known as a third-party administrator) to handle the claims. The dealership then decides whether it will self-insure or purchase insurance to protect itself against adverse risk. Often, the third-party administrator will be affiliated with an insurer providing that insurance product. Many insurers have different programs. This, in turn, results in dealers "negotiating" different prices to customers for their VSCs.

THIRD-PARTY ADMINISTRATOR AS OBLIGOR. In some instances, the third-party administrators function as service companies that are named as the obligor, thus letting the dealership off the hook. In these instances, the third party-administrator markets a package or program through the dealership which the dealership sells to customers for prices which vary depending on the terms of the VSC and the type of vehicle being insured. In these instances, the dealer is not the obligor and is only acting as an agent. Accordingly, in these situations, a dealership that sells a VSC for $1,000 and remits $600 to the third-party administrator is entitled to fully deduct the

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$600 payment at the time of the payment. The dealership is taxed on only the net $400 it retains as a "commission" for selling the VSC.

MANUFACTURER OBLIGOR. Competing with independent third-party administrator companies are the manufacturers, each of whom have similar programs in which the administrator and the insurer are both affiliated with the manufacturer. As one might expect, each manufacturer—Ford, General Motors, Chrysler, etc.—has a variety of its own programs available.

INSURANCE COMPANY OBLIGOR. Less frequently encountered, but nevertheless a possibility, is where the obligor might actually be a property and casualty insurer for whom the dealership is selling a mechanical breakdown insurance policy as a commission insurance agent. This is a much more restrictive and structured situation requiring compliance with state insurance regulatory departments. Also, someone in the dealership will have to have an insurance license.

Rounding out the universe of options, some VSC programs may provide the dealership with the possibility of additional compensation through retroactive compensation arrangements. Some dealer obligors who opt to self-administrator and self-insure are bound by their state requirements and limitations to set aside and maintain appropriate "reserves". Finally, if a dealer obligor is involved with a producer owned reinsurance company (PORC) in connection with its credit life and disability insurance activities, that PORC (domestic or off-shore) may also have VSC business commingled with the credit life and disability business.

For a comprehensive discussion on vehicle service contracts, see Chapter 12 of *Money On the Table* by Gary Fagg and John S. Mailho, published by CreditRe Corporation, from which the above summary was prepared.

THE CUSTOMERS' PERSPECTIVE

Customers who buy new cars and simultaneously buy extended warranty contracts are simply trying to protect themselves from sudden and unexpected repair costs. When buying an extended warranty contract (or VSC), they receive the comfort and assurance—backed by contract—that the insurer will pay for the repairs or reimburse the customer for them. The dealer, as seller of the VSC, charges whatever can be negotiated for the contract. In some instances, the price is subject to state limitations.

As far as most customers are concerned, their mindset is that they are buying this insurance through an agent and they really don't care who is going to be obligated to make the repairs...as long as the repairs are made when needed and they don't have to pay for them. Some VSCs provide that the customer can take the vehicle to any "authorized" dealer for repairs, affording the customer a further element of comfort, convenience, or incentive to purchase the contract.

THE IRS' PERSPECTIVE

Most dealers in the '70's and '80's (and some even before) essentially treated any proceeds they received from the sale of VSCs as income, and this income was offset by any payments they made and deducted for insurance to cover their obligations. Accordingly, if a dealer had sold a VSC for $1,000 and remitted $600 to the manufacturer, third-party administrator or other party to cover "the repair obligation," the dealer would report $400 as its net income from that "sale" transaction. Things seemed simple enough ... and many dealers didn't know or care whether or not they were "obligors" under the contracts they sold.

In the early and mid-1980's, several things happened. First, the Tax Reform Act of 1986 placed a tremendous amount of emphasis on the timing of income recognition. For that matter, so did DEFRA in 1984. Second, the IRS was starting to spend even more time in auto dealerships as a result of auditing them in connection with their LIFO inventory elections. Third, a certain amount of publicity became focused on an extended service plan offered from 1985 through 1989 by Ford Motor Company through its affiliate, The American Road Insurance Company. As a result of these and other factors, the IRS began auditing the tax treatment of VSCs where the dealer was the obligor and the dealer was making payments for insurance only or making payments that involved some type of self-insurance arrangement.

In Letter Ruling 9218004, the IRS held that a dealership that sold a VSC and purchased insurance from a third party to cover that risk was required to include the gross amount of the customer's payment in income in the year it was received. In addition, LTR 9218004 held that the dealer must capitalize and amortize the related insurance payment over the term of the insurance contract. These holdings were contrary to the practices of most dealers at the time who, as indicated above, typically had been including the full payment received in income and—at the same time—deducting the full amount paid out to the insurer in the year payment was made.

In LTR 9218004, the IRS' position was that the dealer was the principal under the VSC and that the

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policy in question covered the dealer's risk, as obligor, under the contract.

This IRS holding...also known as the TAM (Technical Advice Memorandum 9218004) Method... created a big negative impact on cash flow. It came as a bombshell. Not surprisingly, dealers sought help from the National Automobile Dealers Association (NADA) to overturn—or soften at least—the IRS' holding which, as a Technical Advice Memo, was not supposed be used or cited as precedent. However, this treatment was being applied across the nation by the IRS to all dealers under audit. This caused many dealers to read their VSCs (for the first time) to find out whether they were principals (i.e., dealer obligors)...or agents...under their contracts.

MID-1992 FORMS 3115

Tax Notes (April 20, 1992, pg. 287) in "Auto Dealerships Careening Over TAM on Extended Service Contracts," reported that this ruling involved a Ford-Lincoln-Mercury dealer in Ohio and that although the IRS had agreed at a 1989 meeting to leave dealers alone on VSC matters, that deal with the IRS had never solidified. Meanwhile, as concern over this TAM circulated among dealers and their CPAs in the spring of 1992, the calendar was running out on the 180-day time period during which dealers could file Forms 3115 as a "voluntary" or protective measure once the IRS position in TAM/LTR 9218004 became known. Accordingly, many CPAs filed protective Forms 3115 for calendar year 1992 dealerships before June 28, 1992. Many of these Forms 3115 proposed to use the cut-off method—i.e., no Section 481(a) adjustment—in changing the treatment of premiums paid by dealer obligors to cover their VSC risks.

Tax Notes (June 29, 1992, pg. 1713) indicated in "Treasury May Provide *Fix* For Issuers of Auto Warranty Contracts," that the "fate of auto dealers ... is still the subject of intense debate between Treasury officials and industry representatives." *Tax Notes* further reported that Treasury officials "appear to have settled upon a version of a proposal known as a 'dealer proxy' approach. The tax rules would be applied, at the election of the dealer, in lieu of the rules of TAM 9218004."

Something was brewing ... but what...and when?

ANNOUNCEMENTS 92-93 & 92-127

In March of 1992, the IRS issued Revenue Procedure 92-20 which substantially overhauled the procedures governing all taxpayer requests for "voluntary" changes in accounting methods. Rev. Proc. 92-20 introduced the creation of different categories of accounting methods, and differing terms and conditions intending to reflect "a gradation of incentives to encourage prompt voluntary compliance." The Summer of 1992...as well as the Fall...saw a blizzard of Forms 3115 filed under Rev. Proc. 92-20 with the National Office for all sorts of accounting method changes: LIFO, VSCs...and a host of others!

Then, on June 17, 1992, in Announcement 92-93, the IRS said that it was planning to issue a Revenue Procedure that would allow dealers to expeditiously change their method of accounting for VSCs. However, the IRS said, when issued, the automatic accounting method change would not be available to dealers who were either under audit before June 12, 1992 or before an IRS Appeals Officer or a Federal Court on VSC issues.

Shortly thereafter, on September 2, 1992, the IRS issued Announcement 92-127 which stated that it planned to offer a settlement to dealerships under audit for VSC issues in order to resolve those cases where the dealers had currently deducted the premiums paid for the cost of the multi-year insurance policies. To resolve those cases "uniformly and expeditiously" for pre-92 years, the IRS settlement offer would involve the use of a method of accounting based on the present value of the dealer's insurance cost deduction for each year a multi-year VSC was insured by the dealer. The present value amount would be calculated based on the statutory underpayment rate as the discount rate, and the term of the VSC as the number of years over which the cost would be discounted. Simplifying assumptions (allowing the grouping of all VSCs sold during the year as if they were sold on the first day of the year) were also included to make the proposed settlement more attractive to taxpayers.

Dealers under audit who agreed to the offer were able to (1) settle VSC issues for their open tax years, and (2) change to the method of amortizing the cost of the insurance policies over the terms of the policies for ... tax years ending on or after June 12, 1992. In return for a dealer accepting the IRS offer, no adjustment would be required under Section 481(a). In order to accept the offer, dealers had to notify the IRS agents handling their cases before November 21, 1992.

THE COMPROMISE

On November 13, 1992, the IRS issued its long-awaited guidance on vehicle service contracts. Revenue Procedure 92-97 dealt with the debit/expense side of the VSC transaction. Revenue Procedure 92-98 dealt with the credit/income side.

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Rev. Proc. 92-97 held that a dealer could not fully expense in the year of purchase the multi-year service warranty insurance policy that it purchased in connection with a VSC. Instead, the dealer was required to capitalize the amount paid and deduct it by prorating or amortizing it over the life of the insurance policy. If a dealer filed a Form 3115 to reflect this change as an attachment to its Federal income tax return for its first taxable year ending on or after June 12, 1992, then an IRS agent could not change its method of deducting VSC insurance premiums for an earlier year. As indicated in the earlier Announcement, Rev. Proc. 92-97 excluded from its scope any taxpayer that was under audit prior to June 12, 1992 or at the Appeals level or in a Federal Court over this issue. This revenue procedure did not apply to any arrangement that did not constitute insurance. The IRS consent to the change was automatic and no user fee was required.

Revenue Procedure 92-98 contained the solution the Treasury/IRS came up with to alleviate the dealers' cash flow problem arising from the holding in LTR 9218004. The mechanics of the SWIM or Service Warranty Income Method are discussed below and are in the present context of Revenue Procedure 97-38. It is important to note that Revenue Procedure 92-98 provided that a dealer could not elect the relatively more favorable SWIM method unless the dealer uses the proper method of accounting for amounts paid or incurred for insurance costs that cover its risks under the VSC. In other words, a dealer was required to change its accounting method under Revenue Procedure 92-97 (to capitalize and recover through amortization its insurance premium expense) in order to take advantage of the more favorable SWIM method deferral treatment for its VSC income.

As indicated previously, the **expense side** of the VSC transaction for an auto dealer obligor is currently found in Revenue Procedure 97-37 (Section 5.03 of the Appendix to Revenue Procedure 97-37 which supersedes and modifies Rev. Proc. 92-97). The SWIM method treatment for the **income side** of the VSC transaction is now set forth in Revenue Procedure 97-38, which supersedes and modifies Rev. Proc. 92-98, and in Section 5.02 of the Appendix to Revenue Procedure 97-37 which permits *eligible* taxpayers to make the change using a cut-off method, thus avoiding the adverse consequence of a Section 481(a) adjustment.

Revenue Procedure 97-38, (like its predecessor) provides that a dealer is not within the scope of its terms unless that dealer already uses proper methods of accounting for its VSC income and for insurance costs deductions. This is discussed more fully in a later section of this article. Accordingly, the deferral benefits of the SWIM method are yoked to the spreading by amortization of the insurance premiums, and a dealer not properly amortizing insurance premium payments is not entitled to use the SWIM method.

HOW THE SWIM METHOD WORKS: REV. PROC. 97-38

Clearly, the general rule is that payments received by an accrual-basis taxpayer for services to be performed in the future must be included in gross income in the taxable year of receipt. The IRS recognized that this treatment created a significant cash flow problem for auto dealers who were obligors under the VSC contracts they sold. The Service wanted to provide relief, but still have a method that would "generally conform economically to the tax treatment of advance payments under current law." Accordingly, the IRS/Treasury devised a method that permits dealers "to recognize and include in gross income, generally over the period of their service warranty contracts, a series of equal payments, the present value of which equals the portion of the advance payment qualifying for deferral". This method is referred to as the "SWIM" method (**S**ervice **W**arranty **I**ncome **M**ethod) and it is available to manufacturers, wholesalers, and retailers of motor vehicles or other durable consumer goods; it is not limited to retail automobile dealers.

A dealer may elect to include a "qualified advance payment amount," increased by an imputed income amount, in gross income on a level basis over the shorter of: (1) the period beginning in the taxable year the advance payment is received and ending when the service warranty contract terminates, or (2) a six-taxable-year period beginning in the taxable year the advance payment is received.

A dealer using the SWIM method must include in income in the year received, the excess of the aggregate advance payments received over the aggregate qualified advance payment amounts for that year. The "qualified advance payment amount" is defined as the "portion of an advance payment received...(under a VSC)...that is paid by that taxpayer to an unrelated third party within sixty days after receipt for insurance costs associated with a policy insuring that taxpayer's obligations under the contract." Note the payment within sixty (60) days after receipt requirement. Also note that the payment must be to an *unrelated* third party.

The payment within sixty days after receipt must be for the entire amount of the insurance costs

see **VEHICLE SERVICE CONTRACTS & THE *SWIM* METHOD FOR DEALER OBLIGORS**, page 12

SWIM METHOD TABLE OF FACTORS

APPLICABLE INTEREST RATE	TERM OF SERVICE AGREEMENT IN YEARS					
	(1)	(2)	(3)	(4)	(5)	(6)
1.0%	1.0000	0.5025	0.3367	0.2537	0.2040	0.1708
2.0%	1.0000	0.5050	0.3400	0.2575	0.2080	0.1750
3.0%	1.0000	0.5074	0.3432	0.2612	0.2120	0.1792
4.0%	1.0000	0.5098	0.3465	0.2649	0.2160	0.1834
5.0%	1.0000	0.5122	0.3497	0.2686	0.2200	0.1876
6.0%	1.0000	0.5146	0.3529	0.2723	0.2240	0.1919
7.0%	1.0000	0.5169	0.3561	0.2759	0.2279	0.1961
8.0%	1.0000	0.5192	0.3593	0.2796	***0.2319****	0.2003
9.0%	1.0000	0.5215	0.3624	0.2832	0.2359	0.2045
10.0%	1.0000	0.5238	0.3656	0.2868	***0.2398*****	0.2087
11.0%	1.0000	0.5261	0.3687	0.2904	0.2438	0.2130
12.0%	1.0000	0.5283	0.3717	0.2940	0.2477	0.2172
13.0%	1.0000	0.5305	0.3748	0.2975	0.2516	0.2214
14.0%	1.0000	0.5327	0.3778	0.3011	0.2555	0.2256
15.0%	1.0000	0.5349	0.3808	0.3046	0.2594	0.2298

NOTES

1. This Table ***must*** be used as the reference source for the factor(s) needed to determine the amount of the gross income (attributable to a qualified advance payment amount) that must be reported annually under the service warranty income method (SWIM).

2. To use the Table for a particular contract, first use the Column headed by the "Term of Service Agreement in Years." Determine which Column to use by ascertaining the length (the number of years) of the service warranty contracts (limited to six years) without regard to whether there is a period for which there are no obligations under the contract. For example, if a service warranty contract begins in the third year after payment is received and ends in the fifth year after payment, use the column headed "5."

Then find the factor in the Row headed by "The Applicable Interest Rate" which is defined in Section 5.04 of the Revenue Procedure. If the applicable interest rate were 8 percent, the resulting factor would be .2319*. This factor is multiplied by the qualified advance payment amount to determine the "annual equal payment amount" included in gross income each year for the number of years at the top of the Column.

3. Taxpayers may calculate the aggregate amount to be included in gross income each year by aggregating the qualified advance payment amounts with respect to contracts of the same class (i.e., 2-year contracts, 3-year contracts, 4-year contracts, etc.).

4. This Table is the Appendix to Revenue Procedure 97-38 (1997-33 IRB 43).

5. The factor corresponding to the Example on page 11 (based on a 10% rate and a 5-year term) is .2398.**

SERVICE WARRANTY INCOME METHOD
SWIM EXAMPLE FROM REVENUE PROCEDURE 97-38

A is a calendar year accrual basis taxpayer. A elects to use the Service Warranty Income Method of accounting (SWIM) for its qualified advance payment amounts on service warranty contracts. A sold 5 service warranty contracts on January 1, 1997 for $800 each. A also sold 5 service warranty contracts on December 31, 1997 for $800 each. All the service warranty contracts sold by A in 1997 carry a term of 5 years and run concurrently with the manufacturer's warranties.

Within 60 days of the receipt of each advance payment, A pays $600 per contract to an unrelated third party to insure (in an arrangement that constitutes insurance) its obligations under the service warranty contracts. The applicable interest rate is 10 percent, determined in accordance with Section 5.04 of Revenue Procedure 97-38.

A aggregates all its qualified advance payment amounts on its 5-year service warranty contracts, thus determining that $6,000 ($600 per contract (x) 10 contracts) of qualified advance payment amounts were received in 1997 with respect to the class of 5-year service warranty contracts. Applying the "10% and 5-year" factor of .2398 found in the Table in the APPENDIX of Revenue Procedure 97-38, A determines that it must report gross income of $1,439 ($6,000 x .2398) in each of the 5 years from 1997 through 2001 under the SWIM method.

In addition, A must include in gross income in 1997 the $2,000 payment received for services that is not deferred under the SWIM method ($800 - $600 = $200 per contract (x) 10 contracts = $2,000).

Gross income is reported by A as follows:

Description of Item	1997	1998	1999	2000	2001
Non-deferred Income	$ 2,000	-	-	-	-
Deferred Income	1,439	$ 1,439	$ 1,439	$ 1,439	$ 1,439
Gross Income	$ 3,439	$ 1,439	$ 1,439	$ 1,439	$ 1,439

S CORPORATION STOCK BASIS ADJUSTMENT

Assuming that A is an S corporation with a single shareholder and that A reported no income other than that arising from the above service warranty transactions, the shareholder would report the following adjustments to stock basis under Section 1367:

Description of Item	1997	1998	1999	2000	2001
Non-deferred Income	$ 2,000	-	-	-	-
Deferred Income	1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200
Gross Income	$ 3,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200

The stock basis adjustment for the deferred advance payment amount is determined by ratably spreading the stock basis adjustment over the term of the service warranty contract. Since the service warranty contract is treated as sold at the beginning of the taxable year, the stock basis adjustment each year would be $1,200 ($6,000/divided by 5 years). The aggregate imputed income of $1,195 ($239 x 5) on the $6,000 of aggregate qualified advance payment amounts for 1997 is not taken into account at any time by the shareholder in determining its basis in the stock of A, an S corporation.

 (Continued from page 9)

associated with the policy. Section 4 of Revenue Procedure 97-38 contains several other requirements that must be consulted to be sure the dealer falls within its provisions. Section 5 also contains other special rules which must be studied carefully. Special treatment is provided when a dealer ceases activities, for short taxable years, for basis adjustments and in other circumstances.

If a customer cancels a contract during the taxable year of sale and the amount received by the dealer is refunded in that year to the customer, then that amount is not included in the dealer's income for the year of sale. If a customer cancels a VSC after the year when the contract was purchased, then the dealer must continue to include the annual equal payment amount in income for the original length of the canceled contract. Any amount refunded to the customer reduces income in the year paid. If a customer's contract is terminated because of a mileage or usage limitation during or after the year in which the contract was sold, the dealer must continue to include the annual equal payment amount in gross income for the original length of the terminated contract.

The Revenue Procedure includes a "simplifying" Table that the dealer must use to determine the amount of gross income to be reported under the SWIM method. The "Term of Service Agreement in Years" (i.e., the length of the VSC contract) used in connection with the Table is determined without regard to whether there is a period for which there are no obligations under the contract. For example, if a (two year) VSC begins in the third year after payment is received (because the manufacturer's warranty covers the first three years) and ends in the fifth year, the "Term of Service Agreement in Years" is considered to be five years.

Another "simplifying" feature of the SWIM method allows the dealer to calculate the aggregate amount to be included in gross income each year by aggregating the qualified advance payment amounts received each year with respect to contracts in the same class (i.e., two-year contracts, three-year contracts, etc.).

An example of the SWIM method is included on page 11. Based on the "Term of Service Agreement in Years" and the "Applicable Interest Rate," the simplifying Table provides a factor which is to be multiplied by the qualified advance payment amount to determine the "annual equal payment amount" that is to be included in gross income each year for the number of years at the top of the column (i.e., the "Term of Service Agreement in Years").

The "Applicable Interest Rate" to be used under the SWIM method for a particular year is the applicable Federal rate in effect for purposes of Section 1274(d) (compounded annually) for the month with or within which the taxable year ends. The applicable federal rate is rounded to the nearest full percent (or if a multiple of ½ of 1 percent, it is increased to the next highest full percent).

Two reminders: First, the typical dealer who sells VSC plans with different years of coverage will have more than one factor for each year...because the Table has a different column/factor for each different "Term of Service Agreement in Years." Second, there is likely to be a different "Applicable Interest Rate" factor for each year...because interest rates usually change from year to year. So if you are reviewing a dealers' calculations over a period of years, if the applicable interest rate being used for every year is the same, there could be something (significantly) wrong with the calculations.

MAKING THE SWIM ELECTION

The SWIM method can be elected—if the dealer is eligible—in any taxable year ending on or after August 18, 1997. The election is made by attaching a statement to the timely filed original federal income tax return (including extensions) for the year of adoption. The statement should be identified at the top as: "Election of the Service Warranty Income Method under Rev. Proc. 97-38". The statement must include the following:

1. A paragraph stating that the dealer is electing the service warranty income method (SWIM) for all advance payments (as defined in Rev. Proc. 97-38) received in the current taxable year and to be received in subsequent taxable years;

2. A paragraph stating that the dealer agrees to all the terms and conditions of Rev. Proc. 97-38, and **specifically stating that** the dealer agrees to include in gross income all imputed income amounts necessary at the applicable interest rate...so that the net present value of gross income inclusions in taxable years to which qualified advance payment amounts are being deferred equals the amount of qualified advance payment amounts received in earlier taxable years;

3. A description of the service warranty contracts sold during the taxable year the SWIM method is elected;

4. The aggregate amount of the qualified advance payment amounts received for each class (three-year contracts, four-year contracts, etc.) of service warranty contracts sold during the taxable year of election;

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5. The future value factors that are to be applied to the aggregate qualified advance payment amounts for each class of service warranty contracts sold during the election year; and

6. A signature by or behalf of the taxpayer making the election by an individual with the authority to bind the taxpayer in such matters.

NOTE: This statement was required for SWIM elections under Rev. Proc. 92-98. ***QUERY:*** What is the consequence if this statement is not attached or it is carelessly or sloppily filled out?

ANNUAL REPORTING REQUIREMENT

For each taxable year after the election of the SWIM method, the taxpayer must attach a statement to its tax return setting forth:

1. A description of the service warranty contracts sold during the taxable year;

2. The aggregate amount of the qualified advance payment amounts received for each class of service warranty contracts sold during the taxable year; and

3. The future value factors that are to be applied to the aggregate qualified advance payment amounts for each class of service warranty contracts sold during the taxable year.

NOTE: This statement was required for SWIM elections under Rev. Proc. 92-98. ***QUERY:*** What is the consequence if this statement is not attached or it is carelessly or sloppily filled out?

IS THE DEALER *ELIGIBLE* TO ELECT THE SWIM METHOD?

In order to elect the SWIM method, the dealer must be *eligible*. This means the dealer must be "within the scope of" Revenue Procedure 97-38. Section 4.03 and 4.04 contain these eligibility requirements. Under Section 4.03, a taxpayer is not eligible to use the SWIM method unless the taxpayer either (1) has never previously received advance payments under service warranty contracts prior to the year of an adoption under the revenue procedure, or (2) uses the proper method of accounting for advance payments under its service warranty contracts (see *Schlude v. Commissioner,* 372 U.S. 128 (1963), 1963-1C.B. 99).

The first prong of this test means that the dealership never before received payments under a VSC as a dealer obligor (i.e., the dealership has just started selling VSC contracts under which it is now the dealer obligor). The second prong means that the dealer already must be following an IRS approved method for including the entire amount of the advance payments in income in the year of receipt. This is consistent with the *Schlude* case, and if a dealer is not already doing this, it is ineligible to elect the SWIM method.

Under Section 4.04, a taxpayer also is not within the scope of Revenue Procedure 97-38 unless the taxpayer already uses the proper method of accounting for amounts paid or incurred for insurance costs that cover the taxpayer's risks under service warranty contracts. The proper method is defined in Appendix A of Rev. Proc. 97-37 as follows: If a multi-year service warranty insurance policy (in connection with its sale of multi-year service warranty contracts to customers) is purchased by paying a lump-sum premium in advance, the taxpayer must capitalize the amount paid or incurred and may only obtain deductions for that amount by prorating (or amortizing) it over the life of the insurance policy. In other words, in order to be eligible to elect the SWIM method, the dealership already must be capitalizing insurance premiums paid and amortizing that expense over the life of the contract.

These "eligibility requirements" may have been overlooked in some cases. They really require a dealership to have "clean hands" before it can elect the SWIM method. A dealership can't just go from any (unauthorized) method right over to the SWIM deferral method. It must first change its improper methods (for recognizing income and/or expense)—via a more formal filing of Form 3115 and incurring a Section 481(a) adjustment—to proper methods. Then it will be eligible (i.e., "within the scope of Rev. Proc. 97-38") to change from the proper full recognition method to the SWIM deferral method. Stated yet another way, a dealership can't go from an improper method directly to the SWIM method without first incurring a Section 481(a) adjustment.

Warning: These same eligibility conditions were also a part of Rev. Proc. 92-98 when it was issued in 1992. Consequently, dealer advisors should be especially alert for situations where an "election" was made to use (i.e., to change to) the SWIM method, but the dealership at the time was not eligible to do so because it was outside the scope of Rev. Proc. 92-98 for any one of the reasons discussed above.

WHAT ONE MIGHT FIND "SWIMMING" AROUND OUT THERE

From all of the foregoing, it is apparent that CPAs need to be alert to what might be shark-infested waters their dealer obligors could be swimming in. Here are some scenarios for dealer obligor situations:

1. The SWIM method has not been elected. One reason: the SWIM method was never heard of,

see **VEHICLE SERVICE CONTRACTS & THE *SWIM* METHOD FOR DEALER OBLIGORS**, page 12

 (Continued from page 13)

nor considered, even though the dealership is the obligor on the VSCs. Another reason: the dealership is "not within the scope" of Rev. Proc. 97-38 and is ineligible to make the SWIM election because it is using improper methods for reporting VSC income and deducting premium payments. Still another reason: Computations were made comparing the after-tax results (1) using the SWIM method and (2) not using the SWIM method, and the decision was consciously made not to elect the SWIM method even though the dealership was eligible to make the election.

2. The dealership filed a Form 3115 in mid-1992 electing to use the TAM method (i.e., that prescribed in LTR 9218004)...and it has not changed to the SWIM method. Note: this may be deliberate and in the dealer's best interest. Calculations need to be made to make such a determination.

3. The dealership changed accounting methods, filed Forms 3115 under Rev. Proc. 92-97 and 92-98, but either did not properly make the changes or (possibly) only elected under Rev. Proc. 92-98 for the income side of the VSC transaction, and failed to do anything under Rev. Proc. 92-97.

4. The dealership may have changed VSC plans, programs, etc., over the years and currently has a "mixed bag" of VSCs, on some of which the dealer is obligor...and these require immediate attention.

5. The dealership filed Form 3115 (in 1992 or later) to elect the SWIM method ... but the dealership was not eligible to use the SWIM method at the time the election was made... A real problem!

6. The dealership changed in 1992 to the methods provided under Revenue Procedure 92-97 (to amortize insurance premiums paid) and to reflect and defer income under the SWIM method in Revenue Procedure 92-98...and the Forms 3115 were properly filed, with all necessary attachments. This dealership is on the SWIM method and doesn't need to refile anything under Rev. Proc. 97-38.

Cautionary steps for CPAs advising dealer obligors include those listed below.

CONCLUSION

Revenue Procedure 97-38 contains a restatement of the SWIM deferral method that dealer obligors may elect for reporting their VSC income.

Dealers pay a price for swimming! The SWIM method entails an additional cost each year for the privilege of deferring a portion of the VSC income beyond the first year. In the example on page 11, the cost of this deferral is the tax on the imputed income amount of $239 ($1,439 - $1,200 = $239) for each year. For some taxpayers, the additional tax cost of this deferral benefit may not be justified, and they should not make the SWIM election. This conclusion will vary depending on the calculations, facts and circumstances of each case.

Rev. Proc. 97-38 eliminated the cumbersome transition rules that were originally included when the SWIM method became available in 1992. Dealerships who were eligible and properly elected the SWIM method at that time need not take any further action now. CPAs who were not always the advisors to the dealership may be surprised to find that some made the election to use the SWIM method...even though they were ineligible to do so. The status of the dealership as being "within the scope" of the SWIM Revenue Procedure when the election is/was made should be confirmed and documented for obvious reasons.

CAUTIONARY STEPS & SUGGESTIONS FOR DEALER OBLIGOR VSCs

Cautionary steps for CPAs advising dealer obligors include those listed below:

1. Review the tax return filed for 1992 (or later) to confirm that the dealership did voluntarily change methods under Rev. Procs. 92-97 and 92-98.
2. Determine that the dealership really was eligible to elect the SWIM method and that it was not "outside the scope" of the Revenue Procedure when the election was made.
3. Look at the returns for each subsequent year to be sure that the dealership has complied with the **annual reporting requirement**. Be especially careful with respect to the changing interest factors from year to year and to the different "classes" of VSCs (...3yr-4yr-5yr...) requiring different factors.
4. Confirm that the dealership is making payment on all VSC contracts **within sixty (60) days** after customer payment **to an unrelated party**.
5. If the dealer obligor is eligible to elect the SWIM method, but hasn't, compute the after-tax comparison of SWIM and non-SWIM methods to support a decision made to elect or not to elect the SWIM method.
6. Review all existing VSC contracts and programs (with counsel) to determine that appropriate reporting and elections have been made for all VSCs for which the dealer is the dealer obligor. Some newer plans may have replaced older ones, and the dealership's status as obligor may have changed.
7. Be especially careful of the GAAP requirements for reporting VSC income.

DEALERS USING ESCROW FUND FOR VSC SALES CAN'T AVOID FULL TAX ON PROCEEDS IN YEAR OF SALE

The cases of several dealerships selling vehicle service contracts (VSCs) in Missouri from 1989 to 1992 were recently consolidated and tried in the Tax Court in the case of *Rameau Johnson Et Al. v. Comm.* (108 T.C. No. 22) June 16, 1997. These dealerships were dealer obligors using escrow funds under a program administered by Automotive Professionals, Inc. (API). The Tax Court upheld the IRS in requiring the dealerships to currently include in gross income the entire amount of VSC sales proceeds received, even though a substantial portion of the proceeds received was immediately deposited in escrow accounts.

After thoroughly analyzing the contracts involved, the Court concluded that the dealers could not justify excluding portions of the VSC sales under the theories that the amounts were either "customer deposits" or held in a "trust fund" for the benefit of the VSC purchasers.

FACTS

Several dealerships in Missouri under common ownership offered VSC programs as part of their after-market sales activities. Under the contracts, the dealerships agreed, for a fixed price, to make repairs or replace any of the listed parts or components of the VSC purchaser's vehicle or to reimburse the VSC holder if the repairs or replacements were made by an authorized repair facility. Under the VSCs sold by the dealerships, the dealer was the obligor. The VSC purchaser could select the term of coverage desired from a range of options defined by reference to a specific number of months or mileage limitation, whichever was reached first. Almost 75% of the VSCs sold by the dealerships provided coverage for at least 5 years or 60,000 miles. The aggregate limit of the dealer's liability was fixed in some contracts as the value of the vehicle at the time of purchase; in other VSCs, it was fixed as the lesser of the value of the vehicle at the time of purchase or $10,000.

The VSCs provided that a specific amount of the Contract purchase price shall be held in escrow in accordance with API's Administrative Agreement. That amount was paid into the escrow account established by the Administrator and Brokerage Professionals, Inc. (BPI), the Escrow Trustees. All amounts placed in escrow, together with the accrued investment income, were to constitute a Primary Loss Reserve Fund or PLRF (the "reserves") for payment of claims covered by the VSCs. The dealerships further agreed to provide an insurance policy with the Travelers Indemnity Company to cover claims in excess of the reserves and to continue to maintain those policies in force during the term of the contracts.

The purchaser of a VSC was entitled to cancel the contract at any time upon payment of a nominal service charge. If the purchaser canceled the VSC, the entire contract purchase price would be refunded by the dealer if the notice of cancellation was given during the first sixty (60) days, provided a claim had not been filed thereunder. If a claim had been authorized during the first sixty days, or if a cancellation were requested after the first sixty days, then there would be a refund of the pro-rata unearned contract purchase price by the dealer based on the greater of the days in force or the miles driven.

The Administrator Agreement provided for the handling of the VSC purchase price: The dealership retained a portion as its profit. Out of the remainder, specified amounts were payable to the Primary Loss Reserve Fund (PLRF) as reserves, to the Travelers Insurance Company as a premium for excess loss insurance over the full term of the VSC, to various entities as fees for administrative services, and to other entities that had marketed the VSC program on behalf of the Administrator. Thus, payments were made into an escrow account to cover:

ESCROW

- Reserves for estimated liability under the contracts,
- Insurance premiums for excess loss coverage,
- Fees for administrative services, and
- Commissions.

The right of a VSC purchaser against other entities participating in the program were limited. The Administrator was not liable to the VSC purchaser. Each dealership entered into an Administrator Agreement and separate accounts were established in the name of trustees for each dealership. The Administrator Agreement provided that "all reserves in the Escrow Accounts shall be held for the primary benefit of the Contract holders to secure Dealer's performance under the Contracts and to pay for valid claims arising under the Contracts. Dealer shall have no beneficial interest or other property interest in the Reserves or investment income in the Escrow Accounts; nor can Dealer assign, pledge or transfer such reserves."

see **DEALERS USING ESCROW FUND FOR VSC SALES...**, page 16

Dealers Using Escrow Fund for VSC Sales...

(Continued from page 15)

Each dealership was required to remit these amounts to the Administrator no later than the 15th day of the following month, along with a Remittance Report summarizing VSC sales during that month. After verification and processing of the Remittance Report, the payment made by the dealership was distributed to the various recipients.

The Administrator Agreement provided for the refund of these payments in the event that the VSC was canceled. The "unearned" portions of (1) reserves attributable to the canceled contract, excluding any investment income, (2) fees, (3) the insurance premium, and (4) the commissions would be refunded to the dealer who would then forward the total amount of these refunds, plus the "unearned" portion of its profit on the sale, to the purchaser.

The dealer's access to the reserves held in escrow was strictly controlled. Reserves were released to a dealer only when:

1. The dealer had performed repairs for a contract holder and it was then entitled to be compensated at standard rates for parts and labor,
2. The VSC was canceled by the purchaser, or
3. A VSC expired or terminated... at which time the dealer was entitled to the release of unconsumed reserves attributable to that contract, subject to certain limitations.

Generally, it was Travelers' policy to approve release of unconsumed reserves to the dealer only to the extent that the particular dealer's loss to earned reserve ratio did not exceed 70%.

The dealerships were also subject to audit by the Administrator to verify that (dealer) requests for disbursements from the Primary Loss Reserve Fund accounts were proper. The Agreement also required the Escrow Trustees to report the status of the PLRF accounts on a monthly basis. Inasmuch as the VSC purchasers were not parties to the Agreement, the Escrow Trustees were not required to report to them. Under "Excess Insurance" policies issued by Travelers, each of the dealerships was entitled to indemnification for covered losses exceeding the aggregate amount of the reserves deposited by the dealership in the escrow account plus the accumulated investment income. The excess loss insurance policies were renewed on an annual basis.

The dealerships started selling VSCs in 1987 under the foregoing program. Before 1987, they had sold similar VSCs under a program administered by North American Dealer Services, Inc. NADS had gone bankrupt, causing the dealerships heavy losses when they were called upon to honor their contractual obligations. The VSC program the dealerships started using in 1987 had been designed to offer them greater security than the NADS program. In fact, in marketing the program to the dealerships, salesmen had stressed the security provided by the escrow arrangement and by Travelers' reputation as a major insurance company. These factors were of considerable significance to the dealerships when they decided to start selling the program administered by API.

In the dealerships' tax returns for 1989 through 1992, they had reported as income from the sale of the VSCs only that portion of the contract price that they retained as profit. The amounts paid to the Administrator on the VSCs sold were not reflected in the returns. The PLRF Escrow Accounts were not reflected in the dealerships' tax returns for these years, and the income earned by investment of these reserves was not currently included in their gross income either. The dealerships included reserves in income only when, and to the extent that, portions were paid to them from the PLRF accounts. For calendar year 1992 and subsequent years, the Escrow Trustees filed Forms 1041, U.S. Fiduciary Income Tax Returns, with respect to each of the PLRF accounts. These Fiduciary trust returns treated the investment income as if the PLRF accounts were complex trusts. This treatment was in accordance with the Escrow Trustees understanding that the final regulations under Section 468B issued in December, 1992 required this treatment.

IRS POSITION

The IRS argued that the dealerships' method of accounting for VSCs did not clearly reflect income because it resulted in the omission of items of income and the premature deduction of expense items. The Service adjusted the dealerships' income to include the full VSC purchase price in the year of sale and to defer deductions for related expenses until later years. The IRS further required the dealerships to include in income their respective shares of investment income earned by the PLRF/Escrow Accounts as it accrued.

The position of the IRS was that Section 451(a) required this treatment. Under the accrual method of accounting, income is includible for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Generally, all the events that fix the right to receive income have occurred when it is (1) actually or constructively received, (2) due or (3) earned by performance... whichever comes first.

see **DEALERS USING ESCROW FUND FOR VSC SALES...**, page 18

DEALER OBLIGOR VEHICLE SERVICE CONTRACT SALES

RAMEAU JOHNSON ET AL. (108 T.C. No. 22) June, 1997

ISSUES	HOLDINGS
1. Whether accrual basis auto dealerships may exclude from gross income for the year of sale of a vehicle service contract (VSC) that portion of the contract price that they are required to deposit in escrow accounts to secure their obligations under the VSC contracts.	1. At the time the dealerships sold the vehicle service contracts (VSCs), they acquired a **fixed right** to receive the portion of the contract price deposited in escrow. Accordingly, the dealerships must currently include in gross income the entire amount of the VSC sales proceeds. The reasoning in *Comm. v. Hansen* controls. The amounts received from the sales of VSCs did not constitute purchaser deposits. The holding in *Comm. v. Indianapolis Power & Light Co.* is distinguishable. The amounts received on the sale of VSCs and deposited in the escrow accounts did not constitute "trust funds" for the benefit of the VSC purchasers. *Angelus Funeral Home v. Comm.* and *Miele v. Comm.* are distinguishable.
2. Whether the dealerships may exclude from gross income the investment income earned by the funds held in escrow accounts.	2. The dealerships are treated as **owners** of the amounts placed in escrow accounts. Therefore, they must currently include the investment income of the escrow account in gross income. Section 468B(g) is distinguishable.
3. Whether the dealerships may exclude or deduct from gross income for the year of the sale of vehicle service contracts those portions of the contract price that they remitted to third parties as prepayments of: • Service fees for administration of the VSC program, and • Insurance premiums for the indemnification of their losses under the VSC program.	3. Premiums paid for insurance policies to protect the dealerships against excess losses arising under the VSCs are capital expenditures that must be recovered through amortization. Fees paid to the program administrator are deductible in accordance with a formula that reasonably measures the administrator's performance of services over the life of the VSCs. (The Tax Court allowed the provisions that govern how fees are earned <u>for refund purposes</u> to be used as a reasonable estimate of the liability accrued.) The dealerships may neither (1) currently deduct these payments to offset income they are required to recognize with respect to the corresponding portions of the contract price, nor (2) defer recognition of income until the offsetting deductions are allowable.
4. Whether an additional adjustment under Section 481(a) is required for one of the dealerships.	4. An adjustment under Section 481(a) is required. The Courts have repeatedly held that a change in method of accounting under Section 481 results where a taxpayer is required to cease a practice of improperly reducing gross receipts by amounts allocable to a reserve for estimated losses or contingent liabilities. Since excluding an amount from income is essentially equivalent to recognizing income and offsetting it by a current deduction, the change in method of accounting would effectively result in the duplication of deductions ... and Section 481(a) applies.

(Continued from page 16)

According to the Service, the dealerships acquired a fixed right to receive the full purchase price of the VSC at the time of the sale, even though the dealerships were required by contract to immediately deposit a portion of the VSC proceeds into an escrow account. The IRS cited *Comm. v. Hansen* as the controlling precedent.

TAX COURT OPINION & ANALYSIS

The Tax Court agreed with the IRS that the tax treatment of the dealerships' VSCs was controlled by the *Hansen* line of cases. The Court's opinion in *Rameau Johnson* thoroughly discusses the taxation of VSCs and includes a rebuttal of the arguments the dealerships raised in support of their positions that the amounts received on the sale of VSC contracts were "customer deposits" and/or that the amounts received were really held in trust for the VSC purchasers under a "trust fund" theory. For the Court's rationale upholding the *Hansen* line of cases, see: "Taxation of Dealer Obligor Vehicle Service Contracts—What The Tax Court Said" on page 23.

PAYMENTS TO ESCROW WERE NOT "CUSTOMER DEPOSITS"

The taxpayers argued that the VSC proceeds were, in part, reserves they held as customer deposits which could be excluded from income under the "complete dominion" test laid down by the Supreme Court in *Comm. v. Indianapolis Power & Light Co.* (493 U.S. 203 (1990)). Following a lengthy analysis and numerous case citations, the Court rejected the taxpayer's "customer deposit" theory with the following:

"... What distinguished the nontaxable deposits in the *Indianapolis Power & Light* line of cases from taxable income was not their refundability per se; ultimately the classification of these amounts as nontaxable deposits turned on the fact that the taxpayer's right to retain them was contingent upon the customer's future decisions to purchase services and have the deposits applied to the bill. (*Comm. v. Indianapolis Power & Light*, ... *Oak Indus., Inc. v. Comm.*, *Buchner v. Comm.*). The payments at issue in the cases at hand do not share this characteristic.

"To see why this is true, assume that a dealership sells 500 VSCs, all contract holders elect to receive coverage until their contracts expire, and they file claims with the dealership for covered repairs that fully consume the reserves in the dealership's PLRF account. On these facts, all amounts deposited into the account will be recovered by the dealership. Now assume that the facts are the same except that no claims are filed. Upon expiration of the contracts, all amounts deposited into the account become available for release to the dealership. Thus, in both scenarios the dealership recovers all the reserve deposits, yet only in the first were any amounts applied to payment for repair services. Finally, assume that in the first week of coverage due to expire after 5 years or 60,000 miles, one contract holder files a claim for covered repairs that consumes the entire amount of the reserves attributable to his contract. Then, at the end of the first year when he has driven 30,000 miles, he cancels. The contract holder is entitled to a refund of one-half of the purchase price of the VSC, even though the entire amount of the reserves attributable to his contract has already been applied to his claim for repair services. As these examples demonstrate, the dealership's right to recover amounts deposited in the reserve is not contingent upon the contract holders' actual future claims for repair services. Rather, it is contingent upon time elapsed and mileage driven while the contract remains in force, variables that are entirely independent of the amounts applied to repair services.

"The absence of any relationship between the amounts of the reserves actually applied to the provision of repairs under the VSC and the determination of how the reserves are earned for refund purposes highlights the central error in (the taxpayers') theory. This absence indicates that the contract price is in fact paid for a service that is measured in terms of time and mileage, not parts and labor.

"In short, the contract price is consideration for the present sale of a warranty, not a deposit to be held pending future agreements to provide repairs.

"There is a straightforward explanation for the refundability of the contract holder's payment that does not require us to obliterate the well-settled distinction between deposits and sales income and to extend the holding of *Indianapolis Power & Light* beyond all recognition: the price of the VSC is subject to pro rata refund upon cancellation because it is similar to a premium paid under a standard insurance policy. Since the VSC serves the function of insuring the vehicle purchaser against loss, it is not surprising that it is sold on terms similar to other types of insurance."

PAYMENTS TO ESCROW NOT HELD "IN TRUST" FOR VSC PURCHASERS

In an equally thorough discussion, the Tax Court rejected the taxpayers' theory that funds placed in the escrow should be excludable from the dealerships' income under a "trust fund" theory. The two cases primarily cited by the taxpayers were *Angelus Funeral Home v. Comm.* (47 T.C. 391 (1967)) and *Miele*

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v. Comm. (72 T.C. 284 (1979)). These cases were found by the Tax Court to be inapplicable.

In its analysis, the Court stated that it was satisfied that the PLRF Escrow Accounts would qualify as trusts under general principles of law, as well as state law. However, the Court observed "the language that contracting parties used to describe the effect of their agreements may accurately reflect their intentions, but it may also inadvertently or deliberately misrepresent them. In determining whether the operative agreements create rights and obligations characteristic of a trust, we do not regard the language quoted above as controlling."

After pointing out some of the inconsistencies in the taxpayers' own position regarding its "trust fund" theory, the Court said that ... "By contrast, the VSC creates no rights for the purchaser that are defined by reference to the portion of the contract price deposited in the PLRF. The amount of this deposit is determined by reference to the cost that the dealership expects to incur in satisfying its warranty obligations to the purchaser. But plainly the purchaser is not entitled to have the dealership incur this cost in all events. Nor does the VSC or any other operative agreement require the dealership to maintain a separate account for each contract holder to preserve a fixed portion of the reserves for his exclusive benefit. The amount of any contract holder's claims that may be satisfied from the reserves is at all times indefinite. The deposit attributable to each contract holder makes possible the payment not only of his own claims, but also those of other contract holders. Conversely, the amount of reserves available for use on behalf of each contract holder is as large or small as the pool, up to the specified coverage ceiling. The pooled aggregate of all deposits plus accumulated income is the only identifiable trust *res* and no individual contract holder is capable of transferring title to the pool."

The Tax Court also found compelling economic reasons for structuring the dealerships' VSC arrangements differently from the pre-need funeral arrangement found in the *Angelus* case and the attorneys' fees in the *Miele* case. The Court found that the VSC purchasers had no beneficial interest in the PLRF/Escrow Accounts since those escrow accounts really existed for the benefit of the dealerships and for the protection of Travelers Insurance Company. The Court observed that the Administrators Agreements and other operative agreements did not grant VSC purchasers any rights that the status of a beneficiary would imply. Furthermore, there was no reporting obligation to the VSC purchasers concerning the status of the PLRF/Escrow Accounts. The Court said that it was "unable to see any functional rationale for (taxpayers') theory of beneficial ownership" and concluded its rebuttal to the taxpayers' "trust fund" theory as follows:

"The contract holder would have been largely indifferent to the status of the trust fund. Under the VSC, the contract holder was entitled to have his losses covered up to the maximum amount specified in the contract from the PLRF, the dealership's own funds, or Travelers. If the dealership failed to satisfy a covered claim or refund the unearned portion of the contract price upon cancellation, the contract holder had recourse against Travelers. With 'one of the six largest property and casualty insurance companies in the United States' providing ultimate assurance to the contract holder that his interests would be protected, a beneficial interest in the PLRF would have been essentially superfluous to him.

"If the dealerships had understood the VSC program to protect the contract holders by granting them a beneficial interest in the trust fund, one would expect them to have called attention to this aspect of the program when they recommended it to their customers. It generally appears that the dealerships did not mention the PLRF in their sales presentations to prospective VSC purchasers. The protection that the dealerships did emphasize was the major insurance company that was underwriting the program, symbolized by the red Travelers umbrella that the manager of one of the dealerships testified that he kept on hand for this purpose.

"We conclude that VSC purchasers held no beneficial interest in the PLRF. Recognition of the PLRF as a trust for Federal income tax purposes provides no basis for the exclusion of reserve deposits from the dealerships' gross income."

ESCROW ACCOUNT INVESTMENT INCOME IS TAXABLE TO DEALERSHIPS CURRENTLY

As indicated previously, the investment income earned by the Escrow Account/Primary Loss Reserve Fund was not reported on any tax return for years prior to 1992. The taxpayers attempted to justify their position based upon the enactment of Section 468B. However, the scope of that section was defined by final regulations in December, 1992 to be limited to certain types of litigation settlement funds. Funds that satisfy obligations "to repair or replace products regularly sold in the course of the transferor's trade or business" are specifically excluded from Section 468B coverage.

The Tax Court did not agree that the investment income earned by the Escrow Account was "homeless income" whose taxation must be deferred until

see **DEALERS USING ESCROW FUND FOR VSC SALES...**, page 20

its ultimate disposition was determined. In concluding its rebuttal of the taxpayers' "trust fund" theory in support of excluding Escrow Account income, the Court said: ... "Pursuant to the Administrator Agreement, the PLRF (Escrow Account) was established to fund the dealerships' obligations under the VSCs. All income earned by the PLRF was available for use to discharge the dealerships' obligations either currently or in the future, as needed. It follows that the dealerships are treated as owners of the entire trust, provided that the application of trust income for the dealerships' benefit in this manner did not depend upon the approval or consent of an adverse party.

"... The Administrator has no power to withhold consent to a payment from the PLRF for a dealership's benefit in order to appropriate those funds for its own benefit. The authorization requirement must therefore be intended only to ensure orderly administration of the trust.

"To the extent that the Administrator Agreement does confer discretionary authority upon the Administrator, it is not authority to determine the use of trust assets but an authority limited to procedural matters incidental to the use of trust assets to satisfy the dealerships' obligations.

"In spite of having an interest adverse to the use of trust income for the dealerships' benefit, the Administrator is not an adverse party. ... Accordingly, pursuant to Sections 671 and 677(a), the dealerships are each treated as owning an allocable portion of the PLRF and must include the income attributable to their respective portions as if earned by them directly. ...

"Section 468B(g) does not warrant a different result. The statute and regulations issued thereunder do not prescribe rules for identifying the person currently taxable on the income earned by the PLRF. However, the statute plainly requires that this income be taxed currently and does not purport to override any existing rules that may apply to tax the income of the PLRF currently. Nor does the statute purport to suspend the application of such rules pending issuance of implementing regulations.

"The TAMRA Committee Reports contemplate that if an escrow arrangement creates a trust relationship, the rules of Subchapter J will control. Taxation of the PLRF as a grantor trust is therefore consistent with the statutory mandate and the intention of Congress."

(Continued from page 19)

DEDUCTIBILITY OF INSURANCE PREMIUMS PAID FOR EXCESS LOSS COVERAGE

Under the accrual method of accounting, a liability is incurred and generally taken into account for the taxable year in which:

1. All events have occurred that establish the fact of the liability,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance has occurred with respect to the liability.

The time when economic performance occurs is determined in accordance with Section 461(h) and the regulations thereunder. These rules provide generally that:

1. Where the liability requires the taxpayer to provide services or property, economic performance occurs as the taxpayer incurs costs in connection with satisfaction of the liability,
2. Where the liability arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided by that person, and
3. Where the liability arises out of the provision of insurance to the taxpayer, economic performance occurs when payment is made to the insurer.

Reg. Sec. 1.461-1(a)(2) clarifies that a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year in which the liability is incurred is taken into account through capitalization and may affect the computation of taxable income in later years through appropriate cost recovery deductions. Lump-sum payments for multi-year insurance coverage generally are capital expenditures that may be recovered only through amortization over the period of coverage *(Comm. v. Boylston Market Association, Higginbotham-Bailey-Logan Co. v. Comm.,* Reg. Sec. 1.461-4(g)(8), Example (6), and Reg. Sec. 1.167(a)-3).

The VSCs required the dealerships to obtain excess loss insurance coverage for periods of 1 to 7 years. The dealerships incurred the liability for this insurance in the year the premium was paid. However, to the extent that part of any premium was allocable to coverage for subsequent years, that part of the premium must be capitalized and amortized by deductions in those years.

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DEDUCTIBILITY OF FEES

The Administrator's fees were subject to a different treatment. The VSC required the dealerships to establish the PLRF to fund their repair obligations. Economic performance with respect to this liability occurred as the dealerships incurred costs in connection with the establishment and administration of the PLRF. The dealerships incurred these costs as the Administrator actually rendered services to them (Reg. Sec. 1.461-4(d)(2), and Reg. Sec. 1.461-4(d)(7), Examples 1, 2 ,4 & 5).

Since no portion of the fees is incurred for a taxable year preceding the year in which the corresponding service benefits are provided, the fees do not constitute capital expenditures like the insurance premiums that are to be recovered through amortization. This result under Section 461(h) marks a departure from the law in effect prior to the Deficit Reduction Act of 1984.

While the rule is clear for identifying when prepaid service expenses are incurred, its application to these VSC cases presents some problems. If it were known at the inception of the contract that, for example, X % of the services would be provided in the first year and the remaining (100-X) % in the final year, then the rule would be applied by recognizing proportional amounts of the expense for the first and final years. If it were not known at the inception of the contract when the services would be performed, but they could only be performed within the same year, then the rule would be applied by recognizing the entire cost for the year in which services were performed.

However, in these VSC cases, the services consist to a substantial extent of the processing of breakdown claims and contract cancellations, and hence are contingent in both timing and amount. As a result, the amount of the liability properly allocable to any of the years under the contract cannot be accurately determined until the contract expires. Neither the statute nor the regulations provide specific guidance for handling these uncertainties.

The responsibility for developing fair and administrable standards for implementing statutory requirements lies with the Commissioner. Where the timing and amount of services to be provided to the taxpayer cannot be determined before expiration of the service contract, but the taxpayer can demonstrate "a reasonable manner in which to estimate the amount and timing of the services that will be required," the IRS may permit the taxpayer to accrue its liability over the term of the contract in accordance with the taxpayer's estimates.

One index for measuring the Administrator's performance of services may be found in the provisions of the operative agreements that govern how the fees are earned for refund purposes. Under the refund formula, the fees attributable to a contract are earned in proportion to the greater of (1) time elapsed or (2) mileage driven under the contract. This formula reflects two important aspects of the Administrator's performance. First, the Administrator was obligated to incur substantial costs simply in making certain resources available at all times for processing claims and cancellations, whether or not a claim or cancellation notice was actually filed. Second, the Administrator provided record keeping and reporting services regularly throughout the term of the VSC.

The Tax Court considered the refund formula to represent "a reasonable manner in which to estimate the amount and timing of the [Administrator's] services" for purposes of section 461(h). Neither the taxpayer nor the IRS had established the validity of any other estimation approach. The formula implies that, for any taxable year while a VSC is in effect, the cumulative amount of fees incurred up to and including that year must bear the same relation to the total fees attributable to the contract as the greater of (1) time elapsed or (2) mileage driven bears to the applicable limit specified in the contract.

In general, while a VSC remained in effect the issuing dealership would have known only the amount of time elapsed; it would have had no means of ascertaining the amount of mileage driven, unless the contract holder brought the covered vehicle in for repairs. In the absence of mileage information, the Administrators fees would have been incurred, and may be recognized, in equal annual increments over the maximum time period provided for in the contract to which they relate. If for any taxable year the dealership had mileage information establishing a higher cumulative amount of fees incurred than the amount implied by time elapsed, then a compensating adjustment would be made for that year.

OTHER MATTERS

The dealerships also had argued that the proper matching of income and expense under the accrual method required deferred income recognition of the portion of the VSC purchase price allocable to the insurance premiums paid and Administrator fees until the corresponding deductions were allowed. The Tax Court distinguished the dealerships' VSC situation from that found in *Artnell Co. v. Comm.,* the case relied upon the dealerships in support of this argument.

see **DEALERS USING ESCROW FUND FOR VSC SALES...**, page 22

Dealers Using Escrow Fund for VSC Sales...

(Continued from page 21)

Finally, the IRS proposed an adjustment under Section 481 to reflect (i.e., tax) the aggregate of the unreported income realized from the sale of VSCs in prior taxable years plus accumulated investment income, reduced by allowable deductions for refunds, payments to other repair facilities, commissions and an amortization allowance for excess loss insurance premiums. The Court upheld the Section 481(a) adjustment proposed by the IRS. See the "Issues and Holdings" box on page 17 for more on this.

CONCLUSION

The *Johnson* case provides a thorough analysis of the tax issues underlying dealer obligor VSCs where a third party administrator program involves escrow accounts. The dealerships in *Johnson* seem to be representative of many others that have been hit by the IRS' stepped up attack on extended warranty contract activities.

The SWIM (Service Warranty Income Method) method for recognizing income under Revenue Procedure 97-38 is available to dealer obligors who might want an alternative to the harsh result in *Johnson*. Therefore, dealers in fact patterns similar to *Johnson* might want to consider voluntarily changing accounting methods for their VSCs under the new rules for filing Forms 3115 in order to get a 4-year spread period for their Section 481(a) adjustment amount ... and then consider changing to the SWIM method to defer some of the tax on future VSC sales.

Dealer Tax Watch Out

(Continued from page 2)

accounting method changes where taxpayers will be granted automatic consent by the Commissioner to make their changes. Relevant changes in these revenue procedures include (1) the termination of LIFO elections, (2) the republication of the Alternative LIFO Method for Automobile Dealers, (3) the republication of the Service Warranty Income Method (SWIM) for dealer obligors in connection with their extended warranty or VSC contract sales, and (4) certain application matters relating to used vehicle LIFO. **There is still no IRS approved LIFO method for used vehicles**...there is one for new vehicles.

The republication of the Alternative LIFO Method in Revenue Procedure 97-36 and the republication of the SWIM method in Revenue Procedure 97-38 share common elements. First, each method is repeated essentially word-for-word, with no real modification or further illumination from the original. Second, the revenue procedures they replaced (Rev. Proc. 92-79 and 92-98, respectively) contained cumbersome transition rules which the 1997 documents were able to delete. The final common element between them is that if an auto dealer previously "volunteered" to make these accounting method changes under the predecessor documents, then no action by the dealer is required at this time.

#5. STATUTE OF LIMITATIONS ON (DEALER) DISCOUNTS FOR GIFTS OF DEALERSHIP STOCK.

One of the changes in the 1997 Tax Act clarifies a question that had been troubling taxpayers for a long time. In the June, 1997 issue of the *Dealer Tax Watch*, we analyzed Letter Ruling 9718004 in which the IRS held that a taxpayer, by timely filing an amended return or claim for refund, could go back and adjust (i.e., lower) the value of prior gifts where (sufficient) discounts had not been claimed in connection with valuing property given away to family members.

This Letter Ruling involved Section 2504(c) which permits such revaluations in connection with subsequent **gifting** activity. The 1997 Tax Act now provides that if the IRS has not challenged, by audit, the valuations in prior gift tax returns, the valuations used in those gift tax returns will be allowed to stand in connection with the computation of subsequent **estate** tax liability for the donor. This applies only to gifts made after the date of enactment and only if proper disclosures were made in or with the gift tax return originally filed.

#6. TAX COMPLEXITY ACT OF 1997. Other changes in the Act of interest to auto dealers and their advisors obviously include the overall reductions in the income tax rates on long-term capital gains ... By the way, has anybody thought about how capital ***losses*** fit into the picture? Just wait till you see the capital gain Schedule D for 1997!

Also of note are the increases for the dollar amounts of the annual exclusion and the unified credit to be phased in over several years. Finally, the special estate tax exclusion available for "family-owned businesses" seems like a big joke. Worse yet, if one manages to qualify, the effect of the phased in increase in the unified credit and the phased in decrease in the amount of the "family-owned business exclusion" actually end up producing more estate tax, rather than less. Just read the fine print!

#7. RECORD RETENTION: HOW LONG IS LONG ENOUGH?

In Revenue Procedure 97-22, the IRS issued guidance for taxpayers using electronic storage systems to maintain

see **DEALER TAX WATCH OUT**, page 32

THE TAXATION OF DEALER OBLIGOR VEHICLE SERVICE CONTRACTS

WHAT THE TAX COURT SAID

IN *RAMEAU JOHNSON ET AL.* (108 T.C. No. 22) JUNE, 1997

A line of cases beginning with *Comm. v. Hansen* (360 U.S. 446 (1959)), establishes the conditions under which a taxpayer's right to receive income becomes fixed even though payment to the taxpayer is withheld or deposited in a reserve account. The taxpayers in *Hansen* were accrual basis retail dealers who sold automobiles and house trailers on credit and then assigned the consumer installment paper to a finance company, guaranteeing the consumer's payment. The finance company paid the dealer cash equal to the face amount of the installment paper less a specified percentage that the finance company credited to a reserve account and withheld as collateral to secure the dealer's guaranty and other obligations to the finance company. Periodically the finance company released to the dealer amounts in the reserve exceeding a stated percentage of the unpaid balances on installment paper purchased from the dealer.

On their tax returns the dealers currently included in income only the amounts paid to them by the finance company. The dealers contended:

1. That they had no right to receive amounts that they could not currently compel the finance company to pay them.

2. Their right to receive reserves did not become fixed so long as the amount that they would ultimately recover was subject to their contingent liabilities to the finance company.

Accordingly, the dealers argued, there was no basis for accrual of the reserves as income for the year in which the reserves were withheld and credited to the dealer's account.

In *Hansen*, the Supreme Court rejected the dealers' first argument, stating that, under the accrual method, it was the time of acquisition of the fixed right to receive the reserves - not the time of their actual receipt - that controlled when the reserves must be reported as income.

In reply to the dealers' second argument, the Court observed in *Hansen* that only one of two things could happen to the reserves: Either they would be paid to the dealer or applied in satisfaction of the dealer's obligations to the finance company. As the dealer would thus effectively receive the entire amount of the reserves in all events, the right to receive the reserves was not conditional but absolute at the time they were withheld and credited to the dealer's account, and the dealer accordingly realized income at that time.

The line of cases following *Hansen* includes *General Gas Corp. v. Comm.*, *Resale Mobile Homes, Inc. v. Comm.*, *Shapiro v. Comm.*, *Federated Dept. Stores, Inc. v. Comm.* and *Klimate Master, Inc. v. Comm.* The principles in the dealer reserve cases have been affirmed in other multiparty transactions in which payments to the taxpayer are withheld or deposited in reserve as security for the taxpayer's executory obligations (*Stendig v. United States* and *Bolling v. Comm.).*

The taxpayers' position (in *Rameau Johnson Et Al.)* was that amounts deposited by a dealership in the Primary Loss Reserve Fund (PLRF) were not includable in its gross income unless or until actually released to the dealership as payment for covered repairs or, upon expiration of the VSC, as unconsumed reserves. They reasoned as follows: the VSCs are executory contracts. The issuing dealerships earned the amounts required to be paid under their terms through performance. At the time the VSCs were entered into, the issuing dealerships had not earned and were not entitled to be paid any portion of the funds required to be held in escrow. The first time the issuing dealership had any right to this portion of the contract holder's payment was when (or if) it made repairs covered by the terms of the VSC. If no such repairs were made, the money remained in escrow until the VSC expired, and even then it would not be paid to the issuing dealership unless all of the conditions for a release of unconsumed reserves were met.

The Tax Court analyzed and refuted each of the taxpayer's arguments. There are a number of problems with (the taxpayers') argument. First, it confuses the right to receive with both (1) earning through performance and (2) the right to present payment. Each of these rights is independently sufficient to require accrual under the all events test (*Schlude v. Comm.* and *Automobile Club of New York, Inc. v. Comm.).* That the dealerships could not compel the Escrow Trustees to pay reserves from the escrow accounts does not control the determination of whether the dealerships had a fixed right to receive them (*Comm. v. Hansen*), nor is it dispositive that the dealerships had not performed any repair services under the VSCs at the time they collected the purchase price and deposited it in escrow.

... The Taxpayers' confusion on this point causes them to misread the relevant case authorities. Thus, they argue that the fact that the cases at hand concern executory service contracts distinguishes them materially from the *Hansen* line of cases:

> "*Hansen* and *Resale Mobile Homes* both involve the sale of retail installment contracts. In the context of a sale of property, these cases held that the taxpayers had to currently recognize the agreed purchase price for the installment contracts as income at the time of sale since the transfer of the property by them to their respective purchasers established their right to be paid. Here, in contrast, we are dealing with executory service contracts which can be terminated at will by the contract holder. At the time the VSC is entered into, the dealerships have only a conditional right to receive a portion of agreed purchase price, and no right to receive the amount required to be held in Escrow. This fundamental difference undoes all of (... the IRS') argument based on *Hansen* and *Resale Mobile Homes.*"

The distinction that (the taxpayers) draw between executory service contracts and completed sales of property misrepresents the issue in the dealer reserve cases and their holdings. If the transactions at issue in those cases had simply been closed and completed sales of property, then no portion of the purchase price would have been withheld in reserve. The dealer reserves were established precisely for the purpose of securing executory obligations of the taxpayer as guarantor of future payments on the installment paper. The cases held that the taxpayer acquired a fixed right to receive the reserves notwithstanding the possibility that, as guarantor of the consumer's performance, the taxpayer would forfeit some or all of the reserves to the finance company in the event that the consumer defaulted or paid off the balance of the loan prematurely, terminating the installment contract before the scheduled interest was earned.

Another problem with (the taxpayers') argument is that it assumes that the proper method of reporting income from the sale of VSCs is the same as the method the dealerships are entitled to use to report income from repairs that they perform on a fee-for-service basis. In making this assumption they fail to appreciate that the economic position of the dealership (as well as that of the customer) is materially different in the two situations. When the dealership sells a motor vehicle without a VSC, the income it may earn from servicing the vehicle is contingent in both time and amount; the dealership would properly report income in the future as earned by performance of services. It would be impracticable to accrue this contingent service income in the year the vehicle is sold, and the conditions for inclusion in gross income under the all events test would not be satisfied. By contrast, when the dealership sells a vehicle together with a VSC, it assumes the obligation to perform or finance all covered repairs that may be required over a defined term in exchange for a fixed price. The sale of the contract effects a transfer to the dealership of the risk that the actual cost of servicing the vehicle over this term will be greater or less than the fixed price. Thus, the VSC is not a contract for the sale of specific future services, as (the taxpayers) characterize it, but a service warranty. ***The purchase price of the contract likewise corresponds not to the cost of any particular repair jobs that the dealership may be called upon to perform in the future, but to the cost of assuming a defined risk.***

It is undisputed that the full contract price was due and collected at the time the VSC was sold. The timing of the purchaser's performance is consistent with the distinctive economics of the VSC arrangement. The purchaser agrees to part with his money in advance of any repair services because the benefit for which he is paying is the transfer of risk effective upon execution of the contract. ***The dealership demands the full contract price in advance of repair services because it has begun to perform when it accepts this risk.***

The economic consequences to the dealership of selling a service warranty under the VSC arrangement are not the same as the economic consequences of selling repair services on a fee-for-service basis. The sale converts contingent future payments into a fixed cash deposit immediately available for satisfaction of the dealership's liabilities to all its contract holders. The deposit is invested and earns income that is accumulated on the dealership's behalf. If the actual cost of repairs under the dealership's contracts turns out to exceed the deposits plus accumulated investment income in its account, and the dealership has failed to insure itself or to comply with the terms of the insurance policy, the dealership will bear the loss. On the other hand, if the actual cost of repairs turns out to be less than the reserves, some or all of the unconsumed reserves revert to the dealership.

The credit that the dealership receives for each contract sold counts toward satisfaction of the minimum sales quota that must be achieved for the year in order to qualify for release of unconsumed reserves attributable to any contracts sold during the same year. It also contributes toward the minimum account balance required in order to receive unconsumed reserves attributable to currently expiring contracts. In brief, the many distinctive benefits and risks of the VSC arrangement for the dealership are attributable to the form of a present sale in which it is cast: "It is the sale itself which makes a difference." *General Gas Corp. v. Comm.* ***Therefore, it is entirely appropriate to treat the arrangement as a present sale for Federal income tax purposes, with consideration received up front in the form of cash and reserve credits.***

Like the taxpayers in the *Hansen* line of cases, (the taxpayers) argue that the inability of the dealership to predict at the time it sold a VSC how much of the reserve it would ultimately recover, either through performance of repairs or upon expiration of the contract, precludes satisfaction of the necessary conditions for accrual under the all events test. They attempt to distinguish *Hansen* on the ground that in that case the funds in the dealer reserve account would in all events either be paid to the taxpayer or be applied in satisfaction of his obligations, whereas in the cases at hand the reserves might have been disposed of in a manner that did not constitute "receipt" by the dealership. Specifically, there were two additional possible scenarios: The reserves might be: (1) paid to another repair facility, or (2) refunded to the purchaser upon cancellation of the contract.

The VSC imposes an obligation upon the issuing dealership either to perform covered repairs itself or to pay for covered repairs by another authorized facility. The use of the reserves to pay another authorized repair facility would discharge the dealership's obligation and thereby constitute "receipt" within the meaning of *Hansen*. The dealership would also "receive" the reserves in the second scenario. Under the VSC, like a standard contract of insurance which it closely resembles, upon notification of the purchaser's election to cancel the contract, the dealership immediately becomes personally indebted to the purchaser for the amount of the unearned portion of the contract price (citing *Williston on Contracts*). When the dealership secures release of reserves and uses them to discharge its personal indebtedness, it has plainly "received" them for purposes of the all events test.

This result is consistent with the case law on the taxation of dealer reserve accounts. As noted above, it is well established that a taxpayer that sells a consumer installment contract for a price that includes interest payable over the term of the contract acquires a fixed right to receive the amount of the purchase price attributable to the interest at the time it is credited to the taxpayer's reserve account, even though the reserve account will be charged to the extent of any interest that is abated before it is earned as a result of the consumer's decision to prepay the balance and terminate the contract prematurely (*Resale Mobile Homes, Inc. v. Comm.*, *Shapiro v. Comm.*, *General Gas Corp. v. Comm.* and *Federated Dept. Stores, Inc. v. Comm.)* We do not perceive any difference in substance between forfeiture under those conditions and forfeiture through the cancellation refund provisions of the VSC. In both situations the forfeiture constitutes an application of the funds to discharge the taxpayer's obligations, which unquestionably inures to the taxpayer's benefit; in neither situation does the existence of the contingent liability prevent the taxpayer from acquiring a fixed right to receive the amounts subject to forfeiture when they are credited to the taxpayer's reserve account.

So long as a dealership (including any successor in interest) remains in existence until all of its VSCs have expired, all proceeds from the sale of those contracts that it deposits in the Primary Loss Reserve Fund (PLRF) (i.e., the Escrow Account) will, as in *Hansen*, either be paid to the dealership directly or be applied in satisfaction of its various liabilities under the operative agreements. The problem of prediction suggested by (the taxpayers) does not arise.

VSC—PORC CONFERENCE REPORT

VSCs PORCs

The Fourth Annual *Conference on Tax Issues Affecting Producer-Owned Reinsurance Companies and Vehicle Service Contracts* was held (July 31 - August 1) at the Dallas-Ft. Worth Lakes Hilton Conference Center near Dallas, Texas. This was the second year I attended. The 1996 Conference was excellent, and the 1997 Conference reinforced the presenters' well-earned reputations for excellence in this area.

Mark Anderson and Regina Rose from KPMG Peat Marwick and Gary Fagg from CreditRe Corporation, thoroughly covered all aspects of the VSC-PORC areas, and updated them for 1996-1997 developments. The Conference was attended primarily by individuals working in the industry and a few dealership controllers, CPAs and attorneys. There was significant interaction between the speakers and the attendees who also freely shared their insights and experiences. This year's Conference did not include a presentation by Robert Zwiers, the IRS Vehicle Industry Specialist, who had last year presented VSC and PORC issues from the IRS point of view.

VEHICLE SERVICE CONTRACT ISSUES. This session traced the general historical background from both the financial accounting and taxation perspectives up through the more recent 1997 developments: Letter Rulings 9727014 and 9729002 and the Tax Court's decision in *Rameau Johnson*. Interestingly enough, there is no definition of the term "insurance" anywhere in the Internal Revenue Code, but the case of *Le Gierse* has provided the benchmark in terms of the two elements which must be present in order for there to be an insurance contract: (1) risk shifting and (2) risk distribution.

A thorough background was provided including a discussion of the statutory "all events test" under Section 461(h)(4), the economic performance regulations under Section 461, and a review of the leading tax cases including *Automobile Club of Michigan*, *American Automobile Association*, *Mark E. Schlude*, *Indianapolis Power and Light Company*, *RCA Corporation* and *Diversified Auto Services Inc.*

After discussing the distinctions between dealer-obligor VSCs and manufacturer-obligor VSCs, Mark Anderson presented a summary of Letter Rulings 8349028, 9218004, 9225003, 9251007, 9601001 and Revenue Procedures 92-97 and 92-98 relative to the service warranty income method before discussing the new 1997 developments. (Note: the restatement of Rev. Proc. 92-97 and 92-98 in Rev. Proc. 97-37 and 97-38 did not occur until after the Conference.)

DEALER OBLIGOR VSCs. When a dealer sells a vehicle service contract and the dealership assumes the ultimate responsibility for repair of the vehicle or to pay for the repairs pursuant to the terms of the VSC, a "dealer obligor" situation exists. Generally, the dealer will turn around and either (1) obtain insurance to provide coverage for the potential loss under the vehicle service contract, or (2) enter into an administration agreement with a third party to process claims which remain the liability of the dealer.

NON-DEALER OBLIGOR VSCs. A manufacturer obligor situation arises when the dealer, acting as an agent for the manufacturer, sells the manufacturer's own extended service contract. In this situation, the dealer receives a commission and remits the net proceeds of the customer's payment minus his commission to the manufacturer who has the ultimate responsibility to repair the vehicle or pay for the repairs in accordance with the terms of the VSC. In other situations, someone other than the dealer is the obligor ... and that other party may not always be the manufacturer ... but, in any event, it is <u>not</u> the dealer. State law determines whether vehicle service contracts are either dealer obligor or non-dealer obligor contracts.

The general rules of taxation applicable to warranties and prepaid service contracts are likewise applicable to VSCs. When taxpayers get creative and come up with various unique programs and modify contractual arrangements, the certainty of the tax results becomes clouded. Generally speaking, where the dealer is the principal and not the agent under a VSC, the dealer must include the gross amount received in income and is limited to amortizing the amounts paid to cover its risks over the life of the contract. Revenue Procedures 92-97 and 92-98 provided dealers with an opportunity to expeditiously change the methods of accounting for vehicle service contracts and provided an alternative method, the SWIM method, under which advanced payment plus an imputed income amount is recognized over the period of the contract.

RECENT DEVELOPMENTS IN 1997 RE: VSCs. In Letter Ruling 9727014, warranty supplements were sold to cover the cost of repairing a product after the manufacturer's warranty expired. These warranty supplements or extended warranty arrangements were deemed to be insurance contracts. Furthermore, the affiliate handling the extended service contracts (warranty supplements) was deemed to be an insurance company. This holding →

that the affiliate was an insurance company was very important because this enabled the affiliate to claim a deduction for the premiums paid to a second affiliate for policies protecting against losses, regardless of the indemnification agreement.

In Letter Ruling 9729002, the IRS concluded that an auto dealer could not deduct payments for VSCs made to a reinsurer that was reinsured by a reinsurer owned by the same person as the auto dealer. Here, the IRS was relying on Revenue Ruling 88-72 to hold that since the reinsurance company reinsured a percentage of the dealership's risk on the service contracts, the payments were not deductible as insurance premiums.

Mr. Anderson commented that this was not a particularly surprising holding by the IRS since, under the fact pattern, the individual dealer not only owned the dealership, but he also owned the PORC to which the third party insurer had reinsured back some of the risk. However, to the extent that there is a dilution of ownership (possibly 50%, excluding children), some dealers might have been able to secure a favorable ruling under similar circumstances, with other ownership. Interestingly enough, Letter Ruling 9729002 does not discuss the arguments that the taxpayers were successful in advancing in the *Crawford Fittings* case and in the *Humana* cases. Also LTR 9729002 seems to take for granted that the arrangement involving the dealer, the dealership and the related PORC are all within the same economic family in considering the related party risk aspects.

One can't be sure whether the taxpayer's representatives really raised all of the possible defense arguments (and the IRS simply did not address them in the ruling), or whether other pro-taxpayer decisions were considered at all. In any event, LTR 9729002 is now "out there" for IRS agents to use.

RAMEAU JOHNSON. In this recent 1997 Tax Court case, the Court upheld the IRS in requiring the dealerships to be currently taxed on the full amount received from customers for VSCs. The dealerships were not allowed to report only the net-of-commission-retained amounts as income in the year payments were received. In addition, the dealerships were currently taxed on the investment income that accrued on funds placed in the escrow accounts and the dealerships were required to capitalize and amortize the insurance (excess loss) premiums over the life of the policy. The *Johnson* case is more fully discussed beginning on page 15.

USE OF PORCs IN CONNECTION WITH VSCs. One other aspect discussed was the possibility of commingling credit life and disability insurance contracts with VSCs in a PORC so as to introduce third party risk into the PORC. If this is done successfully, the taxpayer may fall under the favorable line of cases involving *Sears*, *Harper* and *Americo* if at least 30% of the premium is based on credit life and accident and health policies.

As a side note, Letter Ruling 9601001 issued in August, 1995 seemed to be favorable to taxpayers (i.e., insurance companies) because in it, the IRS held that the contracts (administrator obligor) satisfied the three conditions for insurance to exist: (1) an insurance risk ... as opposed to an investment or speculative risk ... was present, (2) the arrangement shifted and distributed risk, and (3) the arrangement was insurance in its commonly accepted sense. The IRS distinguished the contracts involved from "prepaid service contracts," in that the taxpayer, for a fixed price, was obligated to indemnify a contract holder for the economic loss arising from the failure of any covered system or part during the contract period ... and it was not required to provide any repair services, per se. Accordingly, the VSCs had the earmarkings of "insurance" as has commonly been conceived in proper understanding and usage. Accordingly, the taxpayer was held to be an insurance company ... and this was important because as an insurance company, it could deduct the premiums it paid for this reinsurance.

PORCs—IN GENERAL. PORCs have been part of the broader planning for many auto dealerships for a long time now. A producer-owned reinsurer is a reinsurance company owned or controlled by the party that is selling the insurance contracts (i.e., producing that business). A reinsurer owned by an auto dealer which assumes the credit insurance business produced (i.e., sold) by that dealership is referred to as a producer-owned reinsurer.

Typically, a PORC is set up so that the owner(s) of the dealership can participate in the underwriting profits of the business generated by the dealership in selling credit life and credit disability insurance to auto purchasers. The purchasers of the insurance sold by the dealership pay premiums to the dealership. The dealership, in turn, pays the premiums over to the direct writer of the insurance. This direct writer is an unrelated insurance company which, in turn, pays "reinsurance premiums" back to the PORC or reinsurance company owned by the same individual(s) who also own the automobile dealership. As the PORC or reinsurance company grows economically, it accumulates funds, some of which may be available to its shareholders after it has met minimum statutory requirements.

Terminology is important: PORCs are not "captive" insurance companies ... although many IRS agents (and personnel) typically lump all situations together under the same general term: "captives." PORCs are not

see **VSC—PORC CONFERENCE REPORT**, page 28

 (Continued from page 27)

involved in insuring related party risk; captive insurance companies are. There are at least three different types of PORCs: (1) credit life PORCs, (2) VSC only PORCs and (3) mixed PORCs where there is a commingling of the credit life, accident and disability insurance business with the VSC business.

PORCs are typically selected for audit by the IRS in one of three ways. Most common: the PORC is usually selected for audit as a result of an examination of the automobile dealership to which it is related. Here, the auto dealership is the producer of the business that is being reinsured by the PORC, and the PORC is often covered under a broad IRS document request made by the examining agent at the start of the agent's examination.

A second way for a PORC to be selected for audit is as a result of an examination being made of all companies domiciled in Arizona. A third way for a PORC to be selected for examination occurs when the direct writer (i.e., the insurance company that is ceding business (to the PORC)) is examined, and as part of that examination, the IRS discovers that the direct writing company manages PORCs, and it then audits these PORCs.

One of the IRS Industry Specialization Program significant issues is whether income transferred by auto dealers to their wholly-owned offshore or domestic reinsurance companies through licensed insurance companies should be allocated back to the dealership's income if income is earned by the dealership. As noted previously, referring to a PORC as a "captive" insurance company is technically incorrect because a PORC is not insuring related party risk. However, that distinction seems to have bypassed many IRS agents.

In 1996, Robert Zwiers, the IRS Motor Vehicle Industry Specialist, had pointed out several PORC issues:

PORC ISSUES

1. Has the PORC actually been formed?
2. Are commissions reduced after the PORC has been formed?

   This is a major red flag, as it gives the IRS the impression of the shifting of income to someone else, with the possibility that income may never come back to the dealership.
3. Oversubmits.
4. Loans lacking proper documentation and/or performance.
5. "Dealers touching the money," ... don't touch that money!
6. Investment of PORC funds in personal use assets such as condos, boats, hobby-like activities, etc.
7. Excise tax issues ... there may be some lurking in the background.
8. Insurance issues including (a) related party insurance income, (b) policy acquisition costs and (c) reserves and deferred income.

Most—if not all—of these issues are still around to be reckoned with. Probably the most immediate objection the IRS takes to a PORC is that it is a sham corporation and has no reason for existing other than to shelter income. This is often made with stronger force where the PORC has no place of business, no employees, does not pay claims directly and does not conduct any other business in the traditional sense.

Some arguments a taxpayer may raise against a "sham entity" allegation are that the PORC:

SHAM DEFENSES

1. Participates in a reinsurance program that has economic substance,
2. Has conducted its affairs and operated as an insurance company,
3. Has entered into commercially & enforceable contracts with third party direct writing carriers,
4. Is required by reinsurance treaties to maintain reserves in minimally prescribed amounts,
5. Has limited its activities to the reinsurance of risks, and
6. Has hired a management company to review ceding statements and to maintain its records and CPAs to prepare financial statements and tax returns.

The PORC should attempt to establish that it has a valid business purpose and involved bona fide business transactions, all carried out at arm's-length standards. In this regard (i.e., where the issue is sham corporations), the case most favored by the IRS to raise against taxpayers is *William Wright*. However, in most instances, if the taxpayers have not been overly aggressive, the facts in *Wright* can or should be distinguishable.

IRS "ALLOCATION OF INCOME" ATTACKS

Another attack the IRS can use against PORCs is its ability to reallocate income among related parties under either Sections 482 ... involving a reallocation to "clearly reflect income" ... or Section 269 ... where an allocation is necessary if the original allocation by the taxpayer was made to evade or avoid income taxes. Also, there is →

a special code section, Section 845, available for the more limited purpose of reallocating income between insurance companies. Section 845 is not intended to be used for reallocating between auto dealerships and PORCs because the auto dealership is not an insurance company and Section 845 involves only the reallocation between insurance companies.

The Conference Manual provides excellent material that PORCs can use if they are challenged by the IRS—extensive discussions on business reasons for setting up PORCs, comparisons of the activities of PORCs and use of other alternative arrangements to the "typical" PORC. It also discusses the typical tax structure of PORCs and the special Code provisions which should be considered in effectively planning for their use:

1. Life insurance companies and the small life insurance company deduction (Section 806),
2. Insurance companies other than life insurance companies including the alternative tax on certain small companies (Section 831(b)),
3. The possibility of creating a Section 501(c)(15) tax exempt insurance company.

The *Malone & Hyde* decision relates to the ability of the taxpayer to deduct premiums paid to the captive insurance company where the captives involved are brother-sister to the insurer and the intention is to be able to take a deduction for premiums paid to the insurer. Accordingly, *Malone & Hyde* falls into the "structure" group of cases involving the corporate structure of the groups involved. These "structure" cases should be distinguished from the "third party risk" cases such as *Sears/Allstate*, *Harper*, *Americo* and *Odeco*.

In this area, Revenue Ruling 77-316 defines the so-called "economic family" and situations where no deductions would be allowed for the payment of premiums to the insurance company. Rather, the deductions would only be allowed when claims are paid by the insurance company.

"EXOTIC" PORCs & "ALTERNATIVE ARRANGEMENTS"

Another part of the Conference was devoted to discussing multi-class stock PORCs and comparing a PORC program with a non-CFC (controlled foreign corporation) program. For overview purposes, it should be recognized that some dealers may be participating in "exotic" PORCs which technically are situations where the dealer is one of eleven unrelated dealers in a bigger PORC ("pig pen"). The reason for having eleven unrelated dealers is to avoid the controlled foreign corporation provisions of the Internal Revenue Code which are incredibly complex and are usually not provisions a dealer wants his or her PORC to become involved with.

So long as a controlled foreign corporation (CFC) is not controlled by a 10% or more ownership shareholder, then it is able to stay outside of the reach of the CFC provisions. Probably the greatest considerations dealers face in deciding whether to become involved with exotics or to simply stay with domestic PORCs relates to their willingness to pool their risks with others so as to achieve a real sharing of risk sufficient to fend off any IRS attack or argument. Typically, in these exotics or multi-class stock PORC arrangements, each participating dealer receives shares of preferred stock.

As one conference participant observed, dealers should not be going into exotic or alternative arrangement PORCs (or regular PORCs for that matter) if they simply want to try to get their hands on accumulated funds at the earliest possible opportunity. That is simply risking IRS challenge and accepting the downside position of risk associated with setting up these types of arrangements. In this regard, see the *McCurley* case (on the next page) where the dealer was taxed upon the receipt of "interest-free" advances from his Cayman Islands PORC.

The Conference Manual contains thorough comparisons of PORC programs versus non-CFC programs and other material useful to CPAs who are asked by their dealers for advice in evaluating these alternatives.

NEW INSURANCE PRODUCT: INVOLUNTARY UNEMPLOYMENT INSURANCE

A major new insurance product was discussed at the Conference: Involuntary Unemployment Insurance (IUI). This tends to come under the "property and casualty" insurance category, as distinguished from the "credit life and credit disability" category. This is a natural development in the marketplace and it is being well received in dealerships and elsewhere. IUI pays a monthly benefit if the insured becomes involuntarily unemployed for such reasons as lay-off, strike, lock-out or business closing. Currently, this product is not regulated as to rate and, as a result, it is very attractive to those companies that wish to offer it. The loss ratios, so far, are extremely low.

CONCLUSION

All of the speakers were very generous in sharing their expertise and experience and in answering questions. In every respect, the 1997 Conference was excellent. I look forward to next year's.

"ADVANCES" FROM OFFSHORE PORC TO DEALER ARE TAXABLE DIVIDENDS

WILLIAM McCURLEY ET AL.

PORC "DON'T TOUCH THAT MONEY"

In the halcyon days of radio, one program began with: "Uh...uh...uh...Don't touch that dial...It's time for...Fibber McGee and Molly..." In the present days of dealer producer-owned reinsurance corporations, commonly called PORCs, sometimes even "exotic" PORCs, a comparable tag-line might be: "...Uh...uh...uh...Don't touch that money...Or it's time for the IRS to tax it as a dividend."

That's what happened to one dealer who "borrowed" money from his PORC. *William L. McCurley Et Al. v. Commissioner* (T.C. Memo 97-371, filed August 14, 1997) bears out all the previous warnings to dealers about potentially adverse tax results when they "borrow" money from their own entities. The entity involved was a Cayman Islands corporation formed to reinsure credit insurance policies issued through Chevrolet and Pontiac dealerships owned by Mr. McCurley and a Mr. Hall. These individuals owned several dealerships which offered credit life and/or credit health insurance policies to customers buying cars when they were financing their vehicles through the dealerships. The dealerships retained a portion of the premiums paid as compensation for selling the policies. The policies provided that the insurer would make payments on the customer car loans in the event that the insured became disabled or the insurer would repay the balance outstanding on the loan if the insured died.

Many other dealerships sold credit life and/or credit health insurance policies similar to those sold by Mr. McCurley's and by Mr. Hall's dealerships. Southwestern Dealers Insurance Co. (SDI) was formed by a group of such automobile dealers. In 1982, Mr. McCurley became an SDI shareholder and in 1984 Mr. Hall became an SDI shareholder. Prior to becoming shareholders, they had reviewed letters provided by the CPA firm of Peat, Marwick, Mitchell & Co. outlining some of the issues related to the formation of SDI and the availability to its shareholders of interest-free loans. These letters cautioned that adverse tax consequences would result if these loans were not bona fide loans.

SDI reinsured credit insurance policies that were sold by the dealerships owned by SDI shareholders. Reinsurance profits from the policies attributable to a specific shareholder's dealership were then allocated to that dealer shareholder's account. Seventy-five percent (75%) of the allocated profits was accessible to a dealer shareholder through interest-free loans. Over the years, SDI had between sixteen and twenty-four shareholders; each shareholder held 1 ordinary share (entitled to one vote per share) and 340 preferred shares (which carried no voting rights).

SDI maintained a redemption account for each dealer shareholder. This redemption account (1) represented the price at which SDI would redeem that shareholder's preferred shares, (2) formed a basis for allocating dividends to that shareholder and (3) served as a point of reference for determining the maximum amount of funds that the SDI shareholder could receive as an advance.

Preferred shares could be redeemed for an amount equal to (1) the shareholder's capital contributions and share of SDI profits (i.e., the profits attributable to policies sold/issued by that shareholder's dealerships) and investment income, less his share of SDI's losses and dividends paid with respect to the shares.

The Articles of Association authorized SDI's directors to approve an advance to a shareholder if such advance (and all previous advances) for that shareholder did not exceed 75% of that shareholder's redemption account. If a shareholder's redemption account declined in value such that total advances made previously to the shareholder exceeded 75% of his redemption account balance, then the SDI Board of Directors would demand repayment to the extent of the excess. SDI's Board of Directors had demanded repayment in only two of the more than seventy advances to shareholders during the years in question. In those cases, repayment was demanded because advances to the shareholders exceeded seventy-five percent of the account balance due to later declines in the value of the shareholder's redemption account. After becoming an SDI shareholder in 1982, Mr. McCurley served as Chairman of SDI's Board of Directors from that year forward.

On the financial statements of SDI, all advances to shareholders were classified as loans receivable. In order to obtain an advance, the shareholder was required to fill out an application which generally stated the amount of the advance requested and that no interest would accrue on the advances. SDI advanced $275,600 to Mr. McCurley over a five year period and $138,600 to Mr. Hall over a three year period. Both had issued non-interest bearing, demand notes for the funds received. SDI did not demand repayment of these advances, and Mr.

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McCurley and Mr. Hall did not repay any of the advances. In their individual tax returns, which were prepared by CPAs, these advances from SDI were not reported as income by either Mr. McCurley or Mr. Hall.

IRS CONTENTIONS

The IRS' primary position was that Mr. McCurley and Mr. Hall each received taxable income equal to the amounts that SDI had advanced to them. In the alternative, the IRS argued that 75% of the annual increases in their respective redemption accounts should be taxable to them as income constructively received. Mr. McCurley had received advances in each of the years 1988 through 1991. In 1992, he had not received any advance, but the position of the IRS was that the build-up in his redemption account in that year was constructively received. The IRS conceded that if the Tax Court were to hold that the taxpayers received income when advances were made to them, then the constructive receipt argument relative to 1992 would be dropped.

The IRS also assessed penalties and additions to tax for their negligence and for substantial understatement. Note that both Mr. McCurley and Mr. Hall were audited by the IRS and appealed in the Tax Court. Their cases were consolidated so that only Mr. McCurley's name appears. Mr. Hall is the "Et Al".

ADVANCES WERE CONSTRUCTIVE DIVIDENDS

The Tax Court held that the advances to Mr. McCurley and to Mr. Hall from their SDI accounts were taxable as constructive dividends. The Tax Court observed that a dividend does not have to be formally declared, but may be constructive. Whether a distribution from a corporation to a shareholder constitutes a dividend or a loan depends on whether the corporation has conferred a benefit on a shareholder without the expectation of repayment. A purported loan from a corporation to a shareholder will not be characterized as a loan unless, at the time the funds were transferred, the transferee had an unconditional obligation to repay the funds, and the transferor had an unconditional intention to secure repayment. This determination is to be made on the basis of all of the facts and circumstances of the case, and the burden of proving the advances were bona fide loans was on the taxpayer. This is about all the Tax Court said in laying out the law.

The Court cited six factors supporting its conclusion that the advances were taxable dividends:

SIX FACTORS

1. SDI never paid formal dividends to its shareholders.
2. The taxpayers did not establish that SDI demanded, nor that they volunteered, repayment of the advances. In this regard, the Court noted that the failure to repay a steadily increasing loan balance is indicative of constructive dividends.
3. The advances did not bear interest.
4. The amount of the advances to Mr. McCurley and to Mr. Hall were expressly made with reference to their redemption accounts...i.e., their respective shares of SDI's profits generated by their own respective dealerships' credit life and/or credit health insurance policy sales.
5. The advances were not repayable at a fixed maturity date, instead they were repayable upon demand.
6. Out of more than seventy advances to shareholders over the years, SDI had demanded repayment of only two, and those demands occurred solely because those advances had exceeded 75% of the borrowers' redemption account balances.

The Court stated that, "In essence, SDI was designed and intended to capture each shareholder's insurance-related profits and to provide the shareholder with tax-free and interest-free access to profits attributable to policies issued through the shareholder's dealership." The Court observed that Mr. McCurley and Mr. Hall would not repay their advances unless it was in their own economic interests to do so, and the taxpayers had not persuaded the Court that it would ever be in their economic interests to repay these advances. All of the parties (i.e., Mr. McCurley, Mr. Hall *and SDI*) viewed the advances as permanent distributions with the understanding that there was only a remote possibility that SDI would demand repayment.

The Tax Court also sustained the IRS' assessment of penalties for negligence and for substantial understatement. It found that the taxpayers did not have substantial authority for characterizing the advances as loans. Although the taxpayers cited several cases in support of their position, the Court said that none of those cases "explicitly or implicitly provides that where a taxpayer does not intend to repay an advance, he is never-the-less justified in reporting it as a loan." Accordingly, the Tax Court held that the Commissioner's failure to waive the understatement penalty was not an abuse of discretion.

see **ADVANCES FROM OFFSHORE PORC TO DEALER ARE TAXABLE DIVIDENDS**, page 32

Advances from Offshore PORC to Dealer are Taxable Dividends (Continued from page 31)

CONCLUSION

It is reasonable to expect that the *McCurley* decision will now be added to *William Wright* in Revenue Agent's Reports where the IRS is attacking either the validity of a PORC or dealer's loans from them.

CPAs should review the potential impact of the *McCurley* decision on their dealer clients who are involved with PORCs using "redemption accounts" for making loans to their shareholders. Dealers specifically involved with Southwestern Dealers Insurance Co. (SDI), the entity in this case, will want to make special note of this decision. In this regard, be especially careful because if a really big "loan" was made in a recent year...and it turns out to be a taxable dividend...the amount of the loan or advance omitted from income may be big enough to extend the normal statute of limitations on the dealer's personal tax return(s) from the usual three (3) years to six (6).

Dealer Tax Watch Out (Continued from page 22)

their books and records. This includes various electronic retention alternatives to microfiche. An electronic storage system is one used to prepare, record, transfer, index, store, preserve, retrieve, and reproduce books and records by either (1) electronically imaging hardcopy documents to an electronic storage media, or (2) transferring computerized books and records to an electronic storage media using a technique that allows them to be viewed or reproduced without using the original program. If records in an electronic storage system comply with Rev. Proc. 97-22, they will be treated as being in compliance with the recordkeeping requirements of Section 6001.

An IRS District Director may periodically test a taxpayer's electronic storage system, but such "test" will not constitute an "examination," "investigation," or "inspection" of the books and records. See the Rev. Proc. for more particulars.

#8. ARE USED CAR DEALERS ALSO SECURITIES DEALERS? In the June, 1997 issue of the *Dealer Tax* Watch, we analyzed Letter Ruling 9723004 in which the IRS held that the real business of a used car buy-here, pay-here operation was that of being an automobile dealer ... and not a securities dealer. One of the dealership's arguments was that it was just breaking even selling used cars as a loss leader for its real business which was financing customers' paper. In our article, on page 20, we inquired whether the mark-to-market rules of Section 475 applied to certain BHPH operations. We also referred to the IRS-Treasury hearings on proposed regulations under Section 475. We recently obtained a transcript of these hearings and it might be of interest to those CPAs involved with used car dealers who conduct their operations in a consolidated return environment. If you're interested in this application finesse, call us for more information.

#9. UPCOMING CONFERENCE OF INTEREST. AICPA's Fourth National Auto Dealership Conference. This conference is scheduled for Orlando on October 27-28. We'll be there...and hope to see you there also!

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