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. LIFO conformity for dealership financial statements: In order to avoid violating the LIFO conformity requirement, be sure that all year-end dealership financial statements, including those sent to the Factory and to various Factory credit subsidiaries, reflect year-end LIFO reserve changes in the Income Statement.

IRS plans to "check up" on dealer conformity violation settlement payments. Apparently only 2,500 auto dealerships paid the 4.7% penalty tax or settlement amount during 1998 to avoid termination of their LIFO elections by taking advantage of the relief provided by Revenue Procedure 97-44. The IRS Motor Vehicle Industry Specialist, Mary Burke Baker, recently said she anticipates the IRS will do some type of "compliance checking" to follow-up and to see if maybe some dealers who didn't pay, should have. So far, no major activity has occurred. For more, see page 5.

Factory incentive payments: Good News! Informally, and without fanfare, the IRS recently announced that it was backing off from its harsh audit position that dealers should be responsible for various payroll taxes on incentive payments made to dealership employees by the Factory/manufacturers. Dealers who previously paid assessments on Factory incentive payments should now be able to file claims for refund if their "facts and circumstances" are covered by Revenue Ruling 70-337. For more on this development, see page 6.

Demonstrator vehicles: The IRS-NADA debate over the need for mileage logs is now pretty much at a stand-off. When appearing on the same tax panel at the AICPA Auto Dealership Conference, representatives of both agencies seemed pretty content in their general remarks to leave things about where they are and go on to other subjects.

WATCHING OUT FOR

NADA's views on demos. With respect to recordkeeping and substantiation required for qualified demonstration use, Jim Minnis, on behalf of NADA, said that there must be a written policy that spells out all of the key restrictions, and that any salesperson using a demo should sign that policy indicating that he or she understands and agrees to the restrictions.

As to how to substantiate business and/or personal use, NADA's view is that a log detailing each individual use of the vehicle is not required. It should be sufficient if the log allows the personal use outside

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of the salesperson's normal working hours to be distinguished from the business use of the vehicle by the salesperson...or by some other dealership employee... during normal working hours while the vehicle is at the dealership.

Mr. Minnis suggested that this could be achieved by developing a log that allows the salesperson to record the vehicle's mileage upon arrival at the dealership and to again record the mileage upon leaving work. This way, one could readily determine the total mileage and what portion of that mileage had been put on the vehicle by the salesperson when the vehicle was being used for commuting and other non-commuting personal use.

IRS views on demos. Mary Burke Baker, the IRS Motor Vehicle Industry Specialist, pointed out that the reason the recordkeeping requirements are not specific is that what is "appropriate" depends on the particular facts and circumstances of the geographical area, what the driving habits may be in that particular area, and several other factors. These need to be considered to determine what is acceptable and reasonable *de minimis* mileage.

The best guideline Ms. Baker could give was that demo users should make an honest effort to keep a reliable record of personal use. She said: "***I don't think that a log is absolutely required in the regulations***." However, she added that she did think that "***there does need to be some effort made to record what the personal mileage is. And, my personal feeling on this is that the salespeople are receiving a tremendous benefit by having these demonstrator vehicles; even if it's not for compensatory reasons, it does have a compensatory effect, and I think that the least that they can do is to keep a record of what their personal use is. It's not asking too much***." (Let's face it, folks, Ms. Baker is absolutely right on this.)

In commenting on whether or not a sales manager might qualify for some of the exclusions, and how an agent would approach that, she said she thought that...realistically...it would depend on the whole picture. For example, important considerations might be (1) how good the other records are, (2) what efforts have really been made, (3) whether or not other records are being kept on other salespeople, (4) how reliable those other records appear to be, and (5) whether or not they are contemporaneous.

She added: "***I think the regulations are clear in that there is a lot more value placed on a contemporaneous recordation of the personal use as opposed to something that's reconstructed later***."

So, what's next?

(Continued from page 1)

Changes in accounting methods: More IRS agents are raising audit issues involving changes in accounting methods, while the IRS National Office has stepped-up its rhetoric by issuing Revenue Procedures and Notices. For further evidence of the Courts' strong interest in CAM matters, see Update item #4 involving *Cordes Finance Corporation* where significant penalties increased the sting of losing to the IRS on these issues.

#2. USED CAR DEALER GETS A TAX BREAK ...BUT NO CLARIFICATION... WHEN "SELLING" NOTES TO A LOAN SERVICING COMPANY. In LTR 9840001, the IRS held that the transfers of credit-impaired customers' purchase notes by a used car dealer to a loan servicing company were sales, rather than "financings." The National Office further held that the amounts realized from the sales of the customer notes were equal to the sum of (a) the cash received for the customer note, plus (b) the fair market value of the dealer's right to receive the distribution payments created by the sale.

Apparently, this second factor–i.e., the fair market value of the right to receive subsequent distribution payments from the loan servicing company–generally would be zero. That's what most people think, and... surprise... the IRS recently informally indicated that is not always going to be the result. Just as in so many other situations, it really comes down to a question of determining the fair market value of those future payments. So...it's not as simple as it seems.

On its face, this is a favorable ruling for used car dealers and for the NIADA. But, there really hasn't been any clarification on the real issues: how to determine the fair market value of the back-end payments...and how the IRS intends to apply Section 483 to these payments.

Apparently, the holdings in LTR 9840001 will be the positions of the IRS in generally dealing with these cases, even though technical advice memoranda are not to be used or cited as precedent. But everybody knows that to get the IRS to express its position in a formal document, like a Revenue Ruling or a Revenue Procedure, takes an inordinate amount of time and effort. Furthermore, the final result is usually less than complete in dealing with variations on possible fact patterns found in the real world. (Revenue Procedure 97-44 clearly exemplifies this.) Therefore, all the parties seem to be better served by having Letter Ruling 9840001 "out there," even though in its present form the IRS can walk away from it any time it wants, or say the words don't really mean what they appear to mean, because letter rulings lack precedential value.

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In this ruling, the IRS also held that the one-time, non-refundable enrollment fee paid by the dealer to sign up with the loan servicing company was a capital expenditure, amortizable over 15 years. For more discussion of LTR 9840001, see page 10.

#3. USED CAR LIFO COMPUTATIONS TAKE A HIT. In LTR 9853003, the IRS disagreed with an auto dealer's method of computing inflation indexes for its used vehicle inventory on LIFO. The Service held that it would be necessary to use an official used car guide covering the day 52 weeks prior to the date that the dealer acquired the used vehicle as the basis for computing an annual inflation index. The Service further expressed its position that in order to "clearly reflect income," the dealer must take into consideration a vehicle of similar make, model, age, condition, mileage and options.

Here we go again. Many CPAs do not make exact one year matches to the date of acquisition in their used vehicle LIFO computations. This LTR should provide the basis for many interesting discussions in the future.

#4. IRS CHANGE IN DEALER'S ACCOUNTING FOR INTEREST INCOME AND A $300,000 PENALTY UPHELD BY TENTH CIRCUIT. In the June 1997 *Dealer Tax Watch*, we reported the Tax Court Memo Decision in *Cordes Finance Corporation*. The decision of the Tax Court upholding the IRS in all respects was recently affirmed.

Interestingly enough, the U.S. Court of Appeals for the Tenth Circuit stated that the adjustment in dispute was really a one-time adjustment to include as income the discrepancy between the deferred interest amounts shown on the detail ledger cards and interest shown on the balance sheet. The Appeals Court said that the adjustment by the IRS was **not**, *per se*, a change in accounting method. On the basis of that reasoning, the Appeals Court reaffirmed that the Commissioner did not abuse her discretion, and that the dealer had failed to carry its burden of proof in all respects.

Related to this issue, the Tax Court had sustained, and the Appeals Court upheld, a $303,000 accuracy-related penalty under Section 6662(a) for the substantial understatement of income tax. The dealer's alleged long-standing relationship with its CPA firm...over 30 years...was not, by itself, sufficient to help the dealer avoid the penalty.

Another $33,000 penalty, for fraud, was assessed because the dealer had instructed the bookkeeper to credit a balance sheet account–instead of an income account–for receipts that should have been reported as income. For the details, see page 23.

(Continued)

#5. DEALERSHIP SOFTWARE PROGRAMS MUST SAVE ALL THE DETAIL REQUIRED BY REVENUE PROCEDURE 98-25. Often examining agents will bring in another IRS computer audit specialist (CAS) to help them get into the software programs that the dealerships are using, and to use that information in a format that assists the agent in conducting the examination. Typically, a CAS will go into a file to extract certain information, to prepare a comparative analysis between years, or to choose a month's activity or a particular line item to sample. There are many different ways that a CAS may take information and reformat it.

Apparently, many agents have found that some software programs used in dealerships delete all of the details for a particular month once that current month's information has been input, rolled over into the next month, and summarized. Mary Burke Baker pointed out that this does not comply with the provisions of Revenue Procedure 98-25. If electronic forms of recordkeeping are used by the dealership, then the IRS has the right to have that same information available to it when it comes in to audit the dealer.

CPAs should review the software used in dealerships to see whether the audit trail produced by that software is appropriate. It is not sufficient to have only the summary information retained in case there is an IRS audit. The dealership must be able to rerun that month's activity and produce the same summary after the fact for the IRS to examine. The Service has the right to be able to come in and look at the same electronic records that were used in the actual preparation of the tax return.

Revenue Procedure 98-25 updates the basic requirements to be satisfied by taxpayers who maintain their records on computers, effective for tax years beginning after December 31, 1997. A taxpayer with assets of $10 million or more must comply with this revenue procedure and with the record retention requirements set out in Revenue Ruling 71-20. Incidentally, for purposes of Rev. Proc. 98-25, a controlled group of corporations–as defined in Section 1563–is considered to be one corporation, and all assets of all members of the group are aggregated.

It may come as a surprise to some to find out that Section 8 of Rev. Proc. 98-25 contains a requirement that a taxpayer must promptly notify its District Director if any machine-sensible records are lost, stolen, destroyed, damaged, or otherwise no longer capable of being processed, or are found to be incomplete or materially inaccurate. The taxpayer's notice to the District Director must identify the affected records and include a plan that describes how, and in what

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timeframe, the taxpayer proposes to replace or restore the affected records in a way that assures that they will be capable of being processed.

Furthermore, the taxpayer's reconstruction plan must demonstrate that all of the requirements of Rev. Proc. 98-25 will continue to be met with respect to the affected records. Among other consequences, failure to comply with this revenue procedure may result in the imposition of various penalties, including the Section 6662(a) accuracy-civil penalty and the Section 7203 willful failure criminal penalty.

#6. IRS Y2K READINESS UPDATE. Continuing our musings over whether or not–or to what extent–the IRS may have significant Y2K problems of its own, it has been reported that the IRS's self-reported data shows that Y2K work on all of the Treasury's 323 mission-critical systems, including those at the IRS, will be completed by late 1999. Apparently, other agencies, including the State Department, are in far worse shape, with some mission-critical systems not scheduled for completion until 20 years after the start of the millennium.

One of the more generic year-end "cut your taxes" articles contained a comment likely to grate on some folks at the IRS. It was captioned: ***"Withhold less this year,"*** and it said, "The IRS swears it won't suffer from any year 2000 glitches. But do you really want to take the chance that your big, fat refund check might be caught in the agency's computers next year? Take the money in each paycheck this year and you won't have to give it a second thought. Trim your withholding by filing a new W-4 form with your employer. You'll see the benefit long before you prepare next year's tax return."

#7. WHERE'D NADA EVER GET THAT IDEA? In its "Management Series Bulletin" entitled *The Able Accountant: Choosing and Working with Your CPA,* (BM 21), NADA tossed off an arbitrary guideline to dealers that, in the long run, may be a disservice instead of solid advice. The guideline (unfortunately) occurs very early in the article under the heading "Is your CPA Qualified?" NADA advises dealers that: "Your CPA should serve ***at least 50 dealerships*** to be considered an industry specialist."

The real troubling issue here is whether serving some arbitrary number of dealership clients makes a qualified specialist out of a CPA or makes a CPA firm into qualified specialists in the industry. Many smaller firm CPAs and practitioners are seeking to become ***niche*** specialists in the automobile dealership industry by participating in high-level CPA resource groups, obtaining specialized education in the area, and networking nationally with other experienced firm CPAs.

The obvious problem with NADA's advice as written is that the quick "50+ rule" automatically eliminates these smaller firms from consideration as "qualified industry specialists." It seems to be telling dealers to not even bother to consider these more independent practitioners who are practicing in smaller firm environments.

Wouldn't it...and doesn't it...still boil down to the credentials, experience and judgment of the individual who walks through the door to sit down with the dealer and the controller to do the job? Also, doesn't it boil down to their accessibility and willingness to use all resources available to them, either from within their own firm or from cooperative, allied sources?

A much more accurate measure of what qualifies a CPA or CPA firm to be an industry specialist is the combination of (1) years of professional experience in the industry, (2) the percentage of the CPA firm's time, effort and business that is completely devoted to industry-related work, (3) the range, depth and variety of the experiences accumulated over that time, and (4) the resources available to the CPA to assist him or her where their experience may currently be more limited.

We think NADA is wrong on this.

Is bigger always better? What do you think? We'd be pleased to receive your responses to NADA's assertion and print them for others to consider.

That leads right into our next item.

#8. UPCOMING CONFERENCE OF INTEREST. *Spring, '99 CPA-Auto Dealership Niche Conference,* May 3-5, at the Flamingo Hilton in Las Vegas.

Topics include: Industry outlook, dealer consolidation in public markets, Factory Project 2000 downsizing, new financial products, dealership valuations, financial statement analysis and benchmarks, computers: negotiation and utilization, used car LIFO calculations, related finance companies, and much more.

For more information, call 847-577-3977 or visit the Conference web site at http://www.defilipps.com.

IRS MOTOR VEHICLE INDUSTRY SPECIALIST COMMENTS ON CONFORMITY & USED VEHICLE LIFO

At the AICPA National Auto Dealership Conference in San Diego on October 22, 1998, several LIFO issues came up for discussion during the Tax Panel presentation. Panel members were (1) Mary Burke Baker, IRS Motor Vehicle Industry Specialist, Grand Rapids, MI; (2) James Minnis, Esq., Legal & Regulatory Affairs Department, National Automobile Dealers Association, McLean VA; and (3) William Morris, Esq., Moore & Bruce LLP, Washington, D.C. During the question & answer period, Ms. Baker provided several interesting responses.

USED VEHICLE LIFO METHODOLOGY

Several IRS audits focusing on used vehicle LIFO mechanics are said to be bottled up (somewhere) in the IRS. See "Update" item #3 referencing LTR 9853003. One question posed was: ***When will there be an alternative method for used vehicles similar to the Alternative LIFO Method for new vehicles?***

Ms. Baker's response was: "We do have questions in the National Office on LIFO for used vehicles, and there are a lot more questions at this point than there are answers. I think that our ultimate goal is to come up with a Revenue Procedure that is similar to Alternative LIFO for new vehicles to provide some sort of guidance and simplicity for dealers to compute their LIFO for used cars."

IRS POLICING OF SETTLEMENT PAYMENTS

Bill Morris reported that about 2,500 dealerships had paid the 4.7% settlement amount/penalty tax that was due by May 31, 1998. One question raised was: ***What is the IRS planning to do as a follow-up to the LIFO conformity issue settlement, self-audit, and the 4.7% payment required in case of violation?***

In response, Ms. Baker said: "We do anticipate that we will be doing some sort of a compliance check on this. We don't really have a process in place as to precisely how we're going do this compliance check, but we do anticipate that there will be one. And, if that is the case, and it's determined that there were conformity violations, then that taxpayer can expect to be taken off LIFO."

As a follow-up, she was asked, ***Do you expect the compliance tests or checks to be conducted on a sample basis, an overall basis, a 100% basis, etc.?*** Her reply was that the Service just doesn't have the "manpower" to audit to all of the dealers who might be involved. Therefore, she expected that any follow-up by the IRS "would probably be on a statistical basis of some sort." Whether further IRS follow-up would be based on a statistically valid sample, a certain dollar criteria, or dealership size...she was not sure.

"SECOND THOUGHTS" ON CONFORMITY SETTLEMENT PAYMENTS

Apparently, some dealers and/or their CPAs are having "second thoughts" about payments made under Rev. Proc. 97-44 to the IRS. Maybe they over-reacted or should have done more homework. In this regard, someone asked: ***What if you've entered into the settlement, and you've had "second thoughts" about it and decided maybe you didn't need to make the payment after all. Can you ask for your money back?***

According to Ms. Baker: "If your calculator was broken that day and you couldn't multiply 4.7% times your LIFO reserve and you made a mistake, you can ask for an adjustment to the amount that you made." Ms. Baker commented that if the multiplication error resulted in the taxpayer owing more money to the IRS, she was sure that the taxpayer would ante up that additional payment, too. After all, math is math.

However, if the taxpayer was just having *second thoughts* or *remitter's remorse*, then her comments were: "No. We're not going to honor those [requests for refunds of payments]. The idea is that this was a settlement agreement that could be entered into. It was a relief provision. The Revenue Procedure clearly says that the payments are not refundable, and they're not creditable; and that by making the first payment or entering into this agreement, you are complying and agreeing with all the terms of the Revenue Procedure. So, therefore, you are liable, even if you've made one payment, you're liable for all three payments, and we are not planning on refunding any amounts otherwise."

CONFORMITY CLARIFICATION

When asked whether there are any TAMs or Private Letter Rulings forthcoming on currently unanswered conformity issues, Ms. Baker answered that she was not aware of any and referred further questions to IRS Chief Counsel attorney Jeff Mitchell at (202) 622-4970.

On the subject of clarification, when asked what constitutes a "reasonable estimate," Bill Morris answered that this is a question you really don't want to get an answer from the IRS on!

FACTORY INCENTIVE PAYMENTS... IRS BACKS OFF OF HARSH TREATMENT FOR DEALERS

Revenue Ruling 70-337...now almost 30 years old...holds that bonuses paid by a manufacturing company to salespersons employed by dealers engaged in selling the company's products are not wages for purposes of FICA, FUTA and income tax withholding.

Without much publicity, the IRS recently announced that it will honor the conclusions in this Revenue Ruling in disposing of audit issues involving this question for payments to employees of automobile dealerships. This about-face negates to some extent Letter Ruling 9525003 which involved Factory incentive payments to a dealership employee. It also paves the way for dealers to file refund claims if they paid payroll taxes on these payments in settling recent audits.

BACKGROUND

In 1995, the IRS issued Letter Ruling 9525003 in which it held that incentive payments made by an automobile manufacturer to an salesman who was employed by an automobile dealership were subject to FICA tax. This letter ruling did not address FUTA tax or income tax withholding. The letter ruling held that the incentive payments were received by the salesperson for services performed as an employee of the dealership and that the salesperson was not required to perform additional services for the manufacturer in order to receive the incentive awards. In addition–and critical to the IRS conclusion–was the finding that the award payments constituted an integral part of the dealer-employer's overall wage structure. Consequently, the awards were paid with respect to the salesman's employment, and the salesman was liable for the FICA taxes on those award payments.

The taxpayer directly involved in LTR 9525003 was an individual salesman who received Factory incentives and was reporting them in his individual tax return. It is clear that the ultimate responsibility for the salesman's (employee) portion of the FICA tax lies with the salesman-employee-taxpayer. Nevertheless, the IRS often seeks to collect employment taxes from the employer (i.e., the dealerships employing the individuals), since employers are much easier targets to go after and usually have deeper pockets.

Consistent with LTR 9525003's notion that Factory incentive payments constituted an integral part of a dealership-employer's overall wage structure, many IRS agents gathered strength and began assessing FICA, FUTA and income tax withholding judgments against auto dealers. These agents levied assessments against dealerships in connection with amounts received by both existing and by former employees under various Factory/manufacturer incentive programs. Dealers did not know what to do...who was right (i.e., the IRS or NADA, to whom they had looked for help)...and many dealers ended up paying the amounts assessed against them to simply get the IRS agents off their backs.

Later, in 1996, the IRS issued Letter Ruling 9647003. That letter ruling held that a manufacturer of cosmetic products was required to pay Federal employment taxes on the commissions it paid directly to salespersons who were the employees of a department store in which its products were sold. Although the facts in LTR 9647003 were distinguishable from LTR 9525003 (the Factory/automobile dealer situation), LTR 9647003 went even further and held the manufacturer to be accountable and responsible for "***all Federal employment tax purposes with respect to such payments***."

These rulings involving incentive payments by manufacturers are discussed further in the summaries on pages 8 and 9.

Throughout 1996, 1997 and 1998, there was further debate, discussion and disagreement between the National Automobile Dealers Association (NADA) and the IRS over these issues. During this period, NADA kept insisting that the IRS position was simply unrealistic.

From the dealer's standpoint, the determination of incentive payments is entirely at the discretion of the Factory. The criteria for having incentive payments, who will be eligible, how much the payments will be...these are all determinations the Factory makes. The Factory decides which models will be the subject of incentive payments. The Factory determines whether the program will be a Factory-only program, whether there will be dealer participation or contribution in the incentive payments, whether the incentives will be trips, merchandise or cash.

Also, the Factory controls the payments. It determines whether the checks will be sent directly to the salespeople at their residences, or whether the checks will be sent to the dealership for the dealer to distribute to the salespeople.

Participation in incentive programs is not voluntary for dealers. It really is mandatory. If an incentive program is adopted by a particular manufacturer, the →

dealer has relatively little choice in the matter...if he wants to retain his salespeople, he has to make those incentive payments available to them.

Often there are very different...even conflicting ...interests on the part of dealers and manufacturers as to which vehicles they would really like salespeople to concentrate on selling, leasing and/or financing. Often, it may not be in the dealer's best interest to concentrate attention on vehicles that are hard to sell, just because they are part of the manufacturer's overall inventory or production problems. Similarly, a dealer might rather have his people focus their efforts on selling more popular vehicles which can be sold more quickly or with less effort and on which the dealer may have higher margins. Often, these vehicles are not included as part of the manufacturer's incentive program.

As to control over the payments, related withholding obligations, and tax reporting requirements, those obligations should be imposed on the payor of the funds (i.e., the manufacturer), who is actually providing the compensation for services...rather than on the dealer, who may be merely a transmittal agent in the process.

NADA suggested to the Service that in order to sustain its adverse position on dealerships, the Service would have to disregard LTR 9647003, in which it had held that payments from a manufacturer of cosmetics to individuals who were employed in a retail facility were subject to withholding at the manufacturer level. Also, to sustain its position in the context of the auto industry, the Service would have to disregard–or more convincingly distinguish–Revenue Ruling 70-337 as well as other precedents.

ABOUT-FACE BY THE IRS ...WITH QUALIFICATIONS

During this protracted period of discussion, there was no real clarification or other precedent...until an announcement in October, 1998 by the Motor Vehicle Specialist, Mary Burke Baker, that the IRS had decided to honor the position set forth long ago in Revenue Ruling 70-337.

This announcement came at the National Auto Dealership Conference during the Tax Panel discussion. Mary Baker announced that the National Office had determined that it would honor the holding in Revenue Ruling 70-337 that "payments that are made by manufacturers to salespeople are not wages...they are not wages that are paid by the dealers...they are not wages paid by the manufacturers." However, the IRS will be bound by the holding in Revenue Ruling 70-337 ***only if*** an auto dealer's facts and circumstances are similar to those in the Revenue Ruling.

If a dealer's facts and circumstances are not similar to, or differ substantially from, those in Revenue Ruling 70-337, then IRS agents may still raise the issues of (1) whether or not such payments are wages and (2) who should be liable for withholding and the various related employment taxes. The IRS position seems to be that Revenue Ruling 70-337 will not apply in ***any*** of the following circumstances:

- The bonuses paid are an *integral* part (i.e., as opposed to being an *incidental* part?) of the wage structure of the dealer-employer (see Rev. Rul. 64-40),
- The dealer-employer is liable for payment of commissions to sales personnel even if the manufacturer does not remit the amounts to the dealer, or
- The dealer-employer indicates to the employee that the compensation will be received by the employee as a result of services the employee performs for the employer.

INDIVIDUALS OWE NO SELF-EMPLOYMENT TAX ...AMENDED RETURN POSSIBILITIES

There is no question that the payments received by the individual salespersons are subject to income tax and should be reported in the recipient's Form 1040. Ms. Baker confirmed this, and she said that the appropriate place to report such payments is as "other income" on page 1.

However, these payments will not be subject to self-employment tax. To quote Ms. Baker, they "essentially escape any type of Social Security tax, whatever." She cautioned that many salespeople have reported Factory incentive payments in their income tax returns in Schedule C, and that often they have offset expenses that may be more accurately categorized as "employee business expenses" against this income.

Under the current position of the IRS, since the Factory incentive payments are determined not to be income from self-employment, expenses an individual previously deducted in Schedule C (which may be more accurately categorized as "employee business expenses") will not be allowed in Schedule C. Instead, those expenses will have to be shifted out of Schedule C and should be reported as itemized deductions in Schedule A. This change in treatment obviously will not be helpful in situations where the recipient was not itemizing deductions in Schedule A or because of the 2% of AGI cutback.

Accordingly, any salesperson who previously reported Factory incentive payments in his or her Form 1040, Schedule C, and who considers filing a claim for refund of previously paid self-employment taxes in light of the recently announced IRS change in policy,

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REVENUE RULING 70-337: MANUFACTURER INCENTIVE PAYMENTS

The question presented in this ruling is whether amounts paid by a company under the circumstances described below are "wages" for purposes of the Federal Insurance Contribution Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages.

The company, a manufacturer, agreed with various dealers engaged in selling its products to pay a "bonus" to each of the dealers' salesmen whose sales reach a certain volume. No other remuneration is paid by the manufacturer company to the salesmen of the dealers, nor does it have the right to exercise any control over them. The salesmen are hired and paid by the dealers, are entirely under their control, and are, therefore, employees of the dealers under the usual common law rules applicable in determining the employer-employee relationship. The company sometimes sends "bonus" checks directly to the individual salesmen, and at other times it authorizes the dealers to pay the "bonuses" to the salesmen who qualify and the Company later reimburses the dealers for the amounts so paid.

In order for remuneration to be "wages" for purposes of the Federal Insurance Contribution Act and the Federal Unemployment Tax Act, it must be remuneration for services in employment, performed by an employee for the person employing him. In order for remuneration to be "wages" for income tax withholding proposes, it must be for services performed by an employee for his employer (other than an employer as defined in Section 3401(d)(1)).

Section 3401(d)(1) provides in part, that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for the purpose of the definition of "wages") means the person having control of the payment of such wages.

Holdings: The manufacturer company is not the employer of the salesmen within the meaning of Section 3401 (d)(1). The "bonuses" paid to the salesmen by the company, whether directly or through an agent (the dealer), are not remuneration for services performed for the dealer who employs the salesmen, but are remuneration for services rendered to the company. Under the facts presented, the salesmen are not employees of the company under the usual common law rule. ***Therefore, the "bonuses" paid by it to the salesmen employed by the dealers are not wages for purposes of (1) the Federal Insurance Contributions Act, (2) the Federal Unemployment Tax Act, and (3) the Collection of Income Tax at Source on Wages.***

LTR 9647003: MANUFACTURER INCENTIVE PAYMENTS

In Letter Ruling 9647003, the Service held that a cosmetics products manufacturer was obligated to pay Federal employment taxes on the commissions it paid directly to salespersons who were the employees of a department store in which its products were sold. In order to encourage a store to carry the manufacturer's product lines, the manufacturer agreed to pay sales volume-based commissions to the store. No contractual obligations exist on the part of the manufacturer to any party other than the store, regarding payment of these commissions. The amount of the commissions to be paid was negotiated by the manufacturer and the store and usually the manufacturer made payments to the store for the aggregate commissions that were payable and the store then paid the commissions to the salespersons according to their respective shares of the sales conducted.

In LTR 9647003, the manufacturer represented that the store conceivably could choose to retain the entire commission that the manufacturer had agreed to pay. The salespersons were normally told that their compensation would be a combination of salary and commission income and the commission portion would be determined based on each salesperson's sales volume. The manufacturer stated that the commissions were for services the salespersons provided for the department stores...and not for the manufacturer. In most cases, the commissions were paid in the aggregate to the department store which subsequently distributed the amounts to the salespersons. However, in some instances the manufacturer paid the commissions directly to the individual salespersons because the store requested or required such method of payment. The manufacturer issued a Form 1099-MISC to each salesperson that it had paid directly. The payments made by the manufacturer directly to individual salespersons were the payments at issue in this ruling.

The Service concluded that with respect to the commissions paid by the manufacturer directly to the salespersons, such commissions were remuneration for services performed for the employer department stores and, thus, were wages for employment tax purposes.

Accordingly, the manufacturer was held accountable "for all federal employment tax purposes with respect to such payments."

LTR 9525003 ... FACTORY INCENTIVE PAYMENTS & AUTO DEALERSHIPS

In Letter Ruling 9525003, the IRS held that Factory incentive payments received by a salesperson were received for services performed as an employee of the dealership. According to the IRS, the salesperson was not required to perform additional services for the manufacturer in order to receive the incentive payments. Finally, the award payments were held to be an integral part of the dealer-employer's overall wage structure. Consequently, the Service held that the awards were paid with respect to employment, and the salesman was liable for the FICA taxes with respect to the award payments. LTR 9525003 made no mention of the dealer-employer's liabilities or obligations with respect to these payments.

The taxpayer in LTR 9525003 was a salesman employed by an automobile dealership. There was no disagreement over the status of the salesperson as an employee of the dealership under common law rules. The salesman was treated as an employee by the dealer and was paid wages for his services on which appropriate employment taxes were paid and/or withheld. The manufacturer offered financial incentives to dealer's salespeople in the form of cash and discounts on products and services, and the manufacturer reported the incentive payments on Forms 1099-MISC.

Apparently, the salesman had several years' income tax returns in question. The manufacturer represented that it did not employ the salesman and that the awards were compensation for services performed by the salesman ***for the dealer***. The dealer, in turn, represented that it provided the manufacturer with all the information necessary for it to compute the amount of the awards to be reported on Forms 1099 issued by the manufacturer.

Although the compensation plan for employees of the dealership did not specifically refer to manufacturer awards, manufacturers promotions were ongoing at all times throughout the year and were payable only when a particular type of vehicle was sold through an authorized dealer.

Revenue Ruling 70-337 held that bonuses paid by manufacturers to salespeople employed by dealers were <u>not</u> wages for Federal employment tax purposes. The critical factor was that the payments ***were for services performed for the manufacturer - rather than for the dealer***.

In LTR 9525003, the National Office said that Revenue Ruling 70-337 was not applicable in situations where the third party payment was compensation for services performed for the common law employer if ***any*** of the following were present:

- The bonuses paid were an integral part of the wage structure of the dealer-employer,
- The dealer-employer was liable for payment of commissions to sales personnel even if the manufacturer did not remit the amounts to the dealer, or
- The dealer-employer indicated to the employee that the additional compensation would be received by the employee as a result of services the employee performed for the employer (in other words, the dealer encouraged employees to anticipate or "count on" the receipt of additional bonus monies as a result of their sales of products or services subject to Factory incentives).

In concluding that the Factory incentive payments were an integral part of the dealer's wage structure, the National Office considered four factors:

- Salespeople must sell vehicles through an authorized dealer in order to qualify for an award.
- Although the award programs are not specifically referenced in the dealer's compensation plan, the dealer is an active participant in the award process through its role in verifying that the requirements (for payment) have been met.
- Incentive programs in one form or another are in effect at virtually all times throughout the year.
- The manufacturer repeats many of the programs year after year, thus creating the expectation among dealers and salespeople that additional sources of compensation will be available.

The IRS pointed out that the bonus payments in question were not compensation for services performed <u>for the manufacturer</u>. The payments were generated automatically when the dealer verified that the salesman had met the manufacturer's conditions and requirements which were satisfied solely through the salesman's performance of services for the dealer as an employee of the dealer. The National Office accepted without reservation the manufacturer's statements that its awards were compensation for services performed <u>for the dealer</u>, and that salespeople performed no services directly for it.

The IRS concluded that, without any doubt, the dealer was able to offer its salespeople less base compensation than it otherwise would have offered them had the manufacturer's award programs not been in existence.

TRANSFERS OF SUB-PRIME CUSTOMERS' NOTES BY USED CAR DEALERSHIP TO UNRELATED LOAN SERVICING COMPANY ARE "SALES"

LETTER RULING 9840001

"Qualify the buyer...always qualify the buyer first...be sure the buyer is right for the car, and we can get the customer financed." Yeah, yeah, yeah. In recent years, more and more dealers have turned their attention to the lucrative market "right under their noses" made up of people whom they never would have thought of before as being "qualified" buyers.

These customers collectively are referred to as "non-prime" consumers...used vehicle buyers with limited access to traditional sources of credit. Traditional sources (i.e., commercial banks, savings and loans, credit unions, and other manufacturer-affiliated finance companies) won't have anything to do with them. These are high-risk, credit-impaired, credit-challenged, non-prime customers. The reasons for their circumstances may include: low income, recent marital conflicts, divorce or separation, past credit problems and/or limited credit histories.

Suddenly, circa 1994-1995, everybody was jumping on the bandwagon to address (make that "sell to") the newly discovered sub-prime market. Independent used car dealers as well as the used car departments of franchised automobile dealerships were getting into the act. Buy-here, pay-here became popular and some dealers sold their customer notes right away, while others saw the potential in holding the paper themselves in order to collect sky-high interest.

Loan service companies saw that they could carve out a niche in the sub-prime market by providing dealers with immediate financing and cash-flow relief. Names like Jayhawk, Mercury, Eagle, CAC, and CPS were everywhere. These, and other companies, provided funding, receivables management, collection, sales training and related products and services. Many of them set up related companies to sell credit life and accident insurance policies to the non-prime used-vehicle purchasers, not to mention short-term, limited extended service contracts. (After all, if these consumers were "credit-challenged," why not challenge them some more?)

These new loan servicing companies derived revenues from four principal sources: (1) service fees earned as a result of servicing and collecting contracts either sold or assigned to them by the dealers, (2) fees charged to dealers at the time when they signed up or enrolled in the company's program, (3) interest and other income earned in connection with loans made directly to dealers for floor plan financing and secured working capital purposes, and (4) premiums and fees earned by selling the company's "enhancements" or "ancillary" products such as insurance and warranty contracts.

In working with the dealers, the companies generally would pay a dealer an upfront amount...typically 50% of the face amount of a customer's contract...as an advance. The company would service and collect the customers' receivables and typically retain 20% of any amount collected. Once the advance to the dealer had been recovered, the dealer's 80% share of any subsequent collections would also be distributed. Typically, monthly payments received on contracts sold or assigned would be applied in the following order: to monthly collection costs, to the 20% service fee, to repay the dealer advances, and the balance thereafter is paid to the dealer.

From an income tax standpoint, what was critical to the dealer selling used vehicles was whether the transfer of contracts to the loan servicing company would be treated as an assignment...or as a sale...of the contracts.

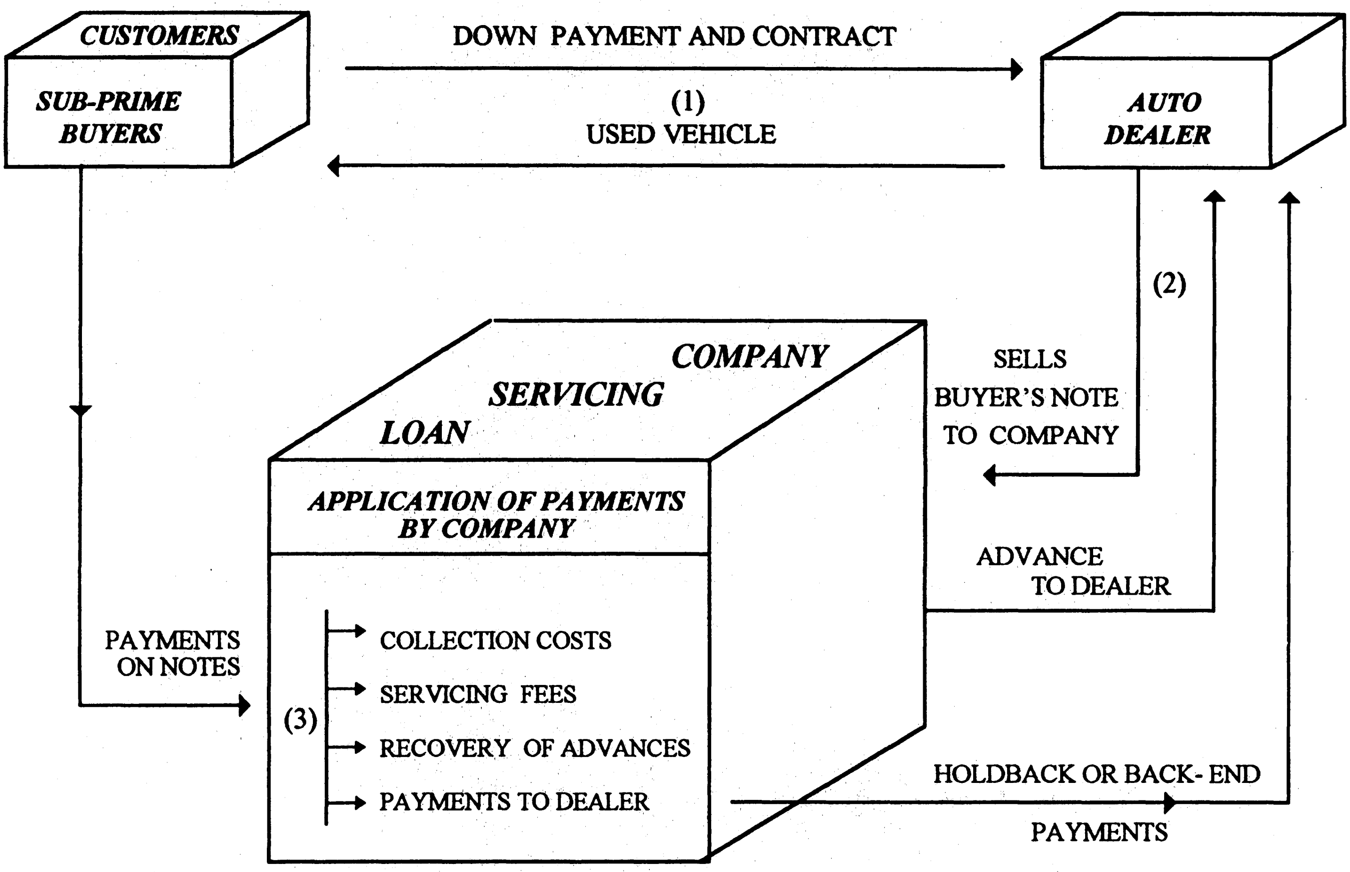
Most of the loan servicing companies obtained tax opinion letters from their legal counsel or CPA firms opining on the tax treatment. Usually these opinions trailed off into a discussion of whether the facts and circumstances supported either the position that the transfers were sales, or that they were assignments. And each company had its own program or preferred way of structuring its relationship with the dealer and the dealer's receivables. Out of a variety of possible fact patterns, one recently became the subject of a Technical Advice Memo issued by the IRS National Office.

In LTR 9840001, the IRS issued what should be a very favorable ruling for dealers adopting a buy-here, pay-here type of operation, selling used vehicles primarily to purchasers who have marginal credit standing or ability, and who then "sell" their receivables to an unrelated, rather than to a related, finance or loan servicing company. This LTR/Technical Advice Memorandum represents a significant and positive achievement by the National Independent Automobile Dealers Association (NIADA), under the able leadership of R.B. Grisham.

LTR 9840001 appears to represent the position the IRS will take in comparable situations. However, a LTR/TAM may not be used or cited as precedent

see **TRANSFER OF SUB-PRIME...**, page 12

LOAN SERVICING PROGRAM ARRANGEMENTS



(1) The dealer sells a used vehicle to a *sub-prime* customer. The dealer receives a cash down payment and a contract note from the buyer. The buyer's note represents the balance of the vehicle purchase price, related interest and the cost of additional products (credit, life, accident insurance and/or extended service warranty), if any.

(2) The dealer sells the buyer's contract/note to a loan servicing company and receives a cash advance, which, when combined with the buyer's down payment, is designed to provide the dealer with an initial positive cash flow.

(3) As the buyer makes payments on the note to the company, the payments are remitted to the dealer only after:

(a) the Company has been reimbursed for any out-of-pocket collection costs,

(b) the Company has received its loan servicing fee (usually 20%) attributable to such payments, and

(c) the Company has recovered all of the advance previously made to the dealer.

NOTE: Customers' notes are usually sold to loan servicing companies in batches of either a given number of contracts or aggregate dollars of face amounts.

(Continued from page 10)

under Section 6110(j)(3) of the Code. Apparently, there is some understanding to this effect between the IRS and NIADA, with both parties realizing that such an understanding is probably better than trying to work to obtain a revenue ruling or revenue procedure addressing these issues that would constitute definite precedent.

The IRS has previously issued letter rulings on the transfer of receivables generated out of buy-here, pay-here type operations where the sale-transfers were made to related or commonly controlled entities. LTR 9534023 was favorable to the taxpayer and was discussed in the September, 1995 *Dealer Tax Watch*. LTR 9704002, not favorable to the taxpayer, was discussed in the March, 1997 *Dealer Tax Watch*, and illustrates a "how-not-to-do-things" fact pattern.

OVERVIEW

During the year, the used car dealer in LTR 9840001 sold used vehicles to purchasers who were substantially credit-impaired in exchange for cash and their customer purchase notes. The dealer then sold these customer notes to an unrelated loan servicing company [Company] for cash plus the right to receive subsequent distribution payments.

On the sale of a vehicle, the amount the dealer realized was the cash received plus the issue price of any customer note received, which (assuming adequate stated interest) was the face amount of the customer note.

On the sale of the customers' notes, the amount realized by the dealer was the cash received from the Company (the advance payment) plus the fair market value of dealer's right to receive subsequent distribution payments. At the time of sale, the dealer realized a loss on the sale of a customer note equal to the difference between the dealer's adjusted basis in the customer's note and the amount realized.

The dealer in LTR 9840001 had treated the transfer of the customers' notes as sales. For Federal income tax purposes, the dealer treated only the advance payment received from the loan servicing company as the amount it realized from the sale of the customer's note. The dealer's adjusted basis in a customer's note equaled the outstanding principal balance of a customer's note. Accordingly, the dealer calculated its loss from the sale of a customer's note as the difference between the advance payment and its adjusted basis in the customer's note.

The loan servicing company had recommended this tax treatment which had been spelled out in two memorandums which the Company sent out to all dealers participating in its program.

HOLDINGS IN LTR 9840001

1. The used car dealer's [Taxpayer's] transfers of customer notes to an unrelated loan servicing company [Company] were ***sales.***

2. The ***amounts realized*** from sales of the customer notes equaled the sum of (a) the cash received for the customer note, plus (b) the fair market value of the dealer's right to receive the distribution payments created by the sale.

3. The one-time, non-refundable enrollment fee paid by the dealer to the loan servicing company was a capital expenditure under Section 263, and it was amortizable over 15 years as a Section 197 intangible.

Letter Ruling 9840001 is long and somewhat formidable reading. It includes lengthy discussions of (1) the factors to be considered in distinguishing between "sales" and "financings," and (2) the Code, regulations and case law rationale for determining the amount to be considered as ***realized*** from the sales. These analyses, somewhat abridged, are included on pages 17-22.

MORE DETAILS REGARDING THE CONTRACT TERMS

The used car dealership was wholly owned by a single shareholder, it employed an overall accrual method of accounting, and it reported for tax purposes on a calendar year basis. For qualifying purchasers who were unable to arrange third-party financing (because of perceived credit risk or actual credit impairment), the dealer accepted installment notes (customer notes), secured by a lien on the automobile, as part of the consideration for sales.

To finance its own operations and to divest itself of the customer notes, the dealer entered into a "dealer agreement" with a loan servicing company. Under the dealer agreement, as subsequently modified, the dealer paid the Company a one-time, non-refundable enrollment fee, and the dealer agreed to periodically sell a minimum number of customer notes to the Company.

If the Company accepted a customer note, it made an advance payment to the dealer, and it agreed to make distribution payments, which were monthly payments conditioned on the Company's collections on the customers' notes. The advance payment was the lesser of 50% of the outstanding principal balance of the customer note or 150% of the net down payment made on the purchase of the financed automobile. Under a subsequent dealer agreement between the dealer and the Company, the advance payment was changed to be an amount that was agreed upon by the Company and the dealer, but in no event was it be

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more than 50% of the outstanding principal balance of the customer note.

If a customer/purchaser defaulted on the note, that did not obligate the dealer to return the advance payment to the Company or to repurchase either the customer note or the financed vehicle. As a matter of suggested good business or operating policy, the Company generally advised dealers to require a 25% down payment so that between the customer's down-payment and the Company's advance payment, the dealer would be likely to earn a profit on the sale of the used vehicle, regardless of whether or not the dealer received any subsequent distribution payments.

The Company determined the distribution payments to be made to the dealer by pooling the customer notes the dealer transferred, and then by applying payments on the pool in the following order:

ORDER OF PAYMENTS

1. To pay the Company's collection costs (i.e., all of the Company's out-of-pocket costs incurred in the administration, servicing and collection of the customer notes),
2. To pay the Company's fee of 20% of the total payment (net of any collection costs),
3. To repay the Company for all advance payments it had made to the dealer, and
4. The remainder, if any, was payable as a distribution payment to the dealer.

The dealer's right to distribution payments was subordinated to the Company's obligation to repay its senior indebtedness, which was defined as the Company's indebtedness secured by the customer notes.

In the year under audit, the dealer did not receive any distribution payments from the Company. Furthermore, as of a given date (possibly the year-end), the dealer had received only 2.8% of the total principal of all customer notes transferred to the Company in distribution payments.

Once the Company accepted a customer note, there was a "transfer, sale and assignment" of the customer note and of the dealer's security interest in the financed vehicle. The Company received all of the dealer's files relating to the customer note, and the Company was entitled to endorse the dealer's name on any payments made to the dealer and on any other instruments concerning the customer note and/or the financed vehicle. The dealer was obligated to ensure that the customer obtained and maintained adequate automobile insurance.

The Company, in its discretion, could determine whether or not there was a default on a customer note, and it could waive any late payment, charge, or any other fee that it was entitled to collect in the ordinary course of servicing the customer note. The Company agreed to use reasonable efforts to collect all payments under the customer note and to repossess and sell or otherwise liquidate the financed vehicle if the customer defaulted on its note.

Both the dealer and the Company had the right to terminate the dealer agreement on 30 days notice to the other party. Under a subsequent agreement, the dealer could terminate by giving the Company 10 days notice. The Company could also terminate the dealer agreement without notice if (1) the dealer "defaulted," (2) the dealer did not sell at least 10 customer notes to the Company within the first six months of the agreement, or (3) the dealer did not sell at least 15 customer notes to the Company during each calendar quarter.

On termination of the dealer agreement, the dealer generally had no obligation to repurchase any customer notes that it had sold to the Company, and the Company remained obligated to make distribution payments for customer notes that it had bought from the dealer. If the dealer had not sold the required number of customer notes within the first six months of the agreement, the Company could terminate the agreement and require the dealer to repurchase all of the customer notes that the dealer had sold to the Company. Also, if the dealer had misrepresented any information regarding a customer note sold to the Company, the Company could require the dealer to repurchase that customer's note.

The dealer's customers were told at the time they signed a customer note that their note would be assigned without recourse to the (loan servicing) Company. The assignment was stated on the face of the customer notes. The Company pledged the customer notes as security for its own indebtedness, and the Company later transferred the customer notes to a wholly-owned business trust to securitize the customer notes.

The Company fell on hard times and subsequently initiated bankruptcy proceedings. After that happened, the dealer filed an unsecured, non-priority claim against the Company. The dealer described the basis for its claim as being founded on the fact that it had sold customer notes to the Company, receiving a partial advance thereagainst with the balance to be paid as the notes were paid out.

see **TRANSFER OF SUB-PRIME...**, page 14

notes; (2) its 20% servicing fee on the customer notes; and (3) any outstanding advances on the customer notes.

These circumstances resulted in reasonable doubt as to whether any future distribution payments would be made to the dealer. In light of these facts and circumstances, which were not present in the *Hansen* case, the dealer's right to distribution payments was contingent upon future events that were uncertain at the time the dealer sold the notes to the Company.

Accordingly, the dealer was not required to include the amount of future distribution payments as part of the amount it realized on the sale of the customer notes. The amounts realized from the sales of the customer notes were equal to the sum of (a) the cash received for the customer note, plus (b) the fair market value of the dealer's right to receive the distribution payments created by the sale.

Apparently, this second factor–i.e., the fair market value of the right to receive subsequent distribution payments–generally would be zero...or so one might hope.

CAPITALIZATION & AMORTIZATION OF THE NON-REFUNDABLE SIGN-UP OR ENROLLMENT FEE

The dealer paid a non-refundable enrollment fee to the loan servicing company when it signed up to participate in the Company's program. The dealer deducted that payment, in full, in the year of payment. The IRS held that the initial enrollment fee was a capital expenditure that could only be amortized over 15 years as a Section 197 intangible.

The general principles relating to capitalization versus deduction of expenditures are familiar. The determination of whether an expenditure is capital or ordinary must be based on a careful examination of the particular facts and circumstances of each situation. An expenditure incurred in a taxpayer's business may qualify as ordinary and necessary under Section 162 if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure under Section 263.

Under Section 161, if a cost is a capital expenditure, the capitalization rules of Section 263 take precedence over the deduction rules of Section 162. Thus, a capital expenditure cannot be deducted under Section 162, regardless of whether it is ordinary and necessary in carrying on a trade or business.

Furthermore, in determining whether a cost is a capital expenditure, the Supreme Court in *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992), noted that a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is a current deduction or a capital expenditure. An expense that "is of value in more than one taxable year" is a non-deductible capital expenditure.

Initiation fees payable to an organization, the services of which benefit the taxpayer's business beyond the taxable year, are nondeductible capital expenditures. See *Harmon v. Commissioner*; *Wells-Lee v. Commissioner*; *Iowa-Des Moines Nat'l Bank v. Commissioner*; *Webb v. Commissioner*; and Rev. Rul. 77-354.

Another factor to be considered is whether the fee is nonrecurring. The distinction between recurring and nonrecurring expenditures provides a crude, but nevertheless serviceable, demarcation between deductible expenses and capital expenditures. In *Central Texas Savings & Loan*, the Court held that fees paid to obtain permits to open new branch offices were capital expenditures..."The permit was a one-time payment that gave the taxpayer the right to operate for an indefinite period of time. The benefit secured by the permit clearly extended beyond the year in which the fee payment was made. Furthermore, the fact that the fee payment was made only once supports the proposition that the outlay was a capital asset, rather than an annual expense."

The National Office said that the enrollment fee under consideration in LTR 9840001 was similar to an initiation or admission fee. By making a one-time payment, the dealer was able to sell customer notes indefinitely to the loan servicing company. The Company's purchase of the customer notes provided long-term benefits to the dealer's business by eliminating the need to carry and service high-risk customer notes. This, in turn, freed up the dealer's cash flow, enhanced the dealer's ability to maintain a greater inventory of used vehicles, and increased turnover. These benefits to the dealer were significant, and they extended substantially beyond the end of the taxable year. Accordingly, the National Office held that the dealer's enrollment fee was a capital expenditure under Section 263, and that it was not currently deductible under Section 162.

APPLICATION OF SECTION 197 TO THE ENROLLMENT FEE. Section 197(a) allows an amortization deduction, ratable over a 15-year period, for any amortizable Section 197 intangible acquired after August 10, 1993 and held in connection with the conduct of a trade or business.

A "Section 197 intangible" includes any supplier-based intangible (Sec. 197(d)(1)). The term "supplier-

see **TRANSFER OF SUB-PRIME...**, page 16

notes; (2) its 20% servicing fee on the customer notes; and (3) any outstanding advances on the customer notes.

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A "Section 197 intangible" includes any supplier-based intangible (Sec. 197(d)(1)). The term "supplier-

see **TRANSFER OF SUB-PRIME...**, page 16

(Continued from page 15)

based intangible" means any value resulting from the future acquisition of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer (Sec. 197(d)(3)). To the extent provided in the regulations, an exception from inclusion as a Section 197 intangible is provided for any interest under a contract if such right has a fixed duration of less than 15 years (Sec. 197(e)(4)(D)(i)).

The dealer's agreement with the loan servicing company provides the dealer with a program for financing its automobile sales. The dealer's agreement is a contractual relationship for the future acquisition of services in the ordinary course of business for the dealer. Thus, the dealer's agreement meets the definition of a supplier-based intangible under Section 197(d) of the Code.

Furthermore, the dealer's agreement does not have a fixed duration of less than 15 years. Therefore the exception from inclusion under Section 197 does not apply. Since the dealer entered into the agreement after August 10, 1993...the effective date of Section 197, the dealer agreement meets the requirements of Section 197(c), and the non-refundable enrollment fee is amortizable as a Section 197 intangible.

Accordingly, the adjusted basis of the dealer agreement is amortizable ratably over a 15-year period beginning with the month in which the contract was entered into. Since the dealer had deducted the entire fee in the year paid, rather than capitalizing it, an adjustment under Section 481 of the Code would be necessary to eliminate the improper deduction.

CONCLUSION: CONTRADICTION & CONFUSION

As discussed earlier, the second conclusion in the letter ruling is that the amounts realized from sales of the customer notes equal the sum of (a) the cash received for the customer note, plus (b) the fair market value of taxpayer's right to receive the distribution payments created by the sale.

The last sentence in the detailed discussion of this issue states: "Accordingly, Taxpayer should not include the amount of future distribution payments in the amounts realized on the sale of the customer notes."

Most dealers and CPAs will interpret that sentence to mean that the fair market value of the right to receive subsequent distribution payments would be zero. In October, 1998 at the AICPA Conference, the IRS Motor Vehicle Industry Specialist, Mary Burke Baker, said that ***"THE TAM IS NOT SAYING THAT THE FAIR MARKET VALUE IS ZERO."***

The determination of the fair market value of the back-end payments depends on the facts and circumstances and other considerations, including whether or not the pools are capped.

The practice of some finance companies to "cap" their pools by grouping them into batches of 100 (or some other number of) contracts increases the probability that some of the back-end distribution payment will be recovered in whole or in part. The National Office determined that the back-end payments in this case were contingent on future events, subject to reasonable doubts and uncertain, being dependent on whether or not the loan servicing/finance company would be able to recover its advance payments to the dealer.

The determination that the back-end payments are contingent thus invokes the application of Section 483. This section deals with contracts where there is inadequate or no stated interest. Section 483 recharacterizes payments subject to its provisions into principal and into interest components. Furthermore, where Section 483 applies, it overrides any other terms in the contract.

The essence of LTR 9840001 is that once the fair market value of the back-end distribution payments is determined, then Section 483 will apply to recharacterize a portion of these payments into principal and interest components.

Accordingly, there is far more complexity underlying what the Service really ***means*** in LTR 9840001. One way of looking at it is that all LTR 9840001 has really done is to raise more questions than it has answered. These questions include: (1) how does one determine the fair market value of the back-end payments, and (2) how does the IRS intend to apply Section 483 to these payments?

There is no guidance on either of these questions at the present time. If the IRS and dealer representatives, including NIADA, are unable or unwilling to expend the further time and effort necessary to see these issues addressed more definitively in a formal revenue ruling or revenue procedure, we can expect more audits and confusion in the wake of LTR 9840001.

"SALE" vs. "FINANCING"

FACTOR-BY-FACTOR ANALYSIS

In LTR 9840001, the IRS held that the transfer of sub-prime customers' notes by a used car dealership [Taxpayer] to an unrelated loan servicing company [Company] were "sales," rather than assignments, secured financings or borrowings. In determining that the transfers were sales, the National Office included an analysis of the eight factors below.

WERE THE TRANSFERS TREATED AS SALES?

The dealer agreement states that the Company will purchase the customer notes from the Taxpayer. For tax and for non-tax purposes, the Taxpayer treated the transactions as sales of the customer notes. For non-tax purposes, the Company held itself out as the owner of the customer notes - the Company pledged the customer notes as security for its own indebtedness and later transferred the customer-notes to a wholly-owned business trust to securitize the customer notes.

WERE THE TAXPAYER'S CUSTOMERS NOTIFIED OF THE TRANSFER OF THE CUSTOMER NOTES TO THE LOAN SERVICING COMPANY?

Customers were told at the time they signed a customer note that it would be assigned without recourse to the Company. See, e.g., *United Surgical Steel Co.*, 54 T.C. at 1229-30, 1231 (customers' lack of notice of assignment was a factor supporting financing treatment).

WHICH PARTY HANDLED COLLECTIONS AND SERVICED THE CUSTOMER NOTES?

The loan servicing Company collected payments, serviced the customer notes, and repossessed the financed automobile if a customer defaulted. The Company was not acting as the Taxpayer's agent. The used car dealership/Taxpayer did not exercise any control over the Company. Aside from agreeing to use reasonable efforts, the Company had the sole discretion to determine whether a default had occurred and to elect to pursue remedies. Compare *United Surgical Steel Co.*, 54 T.C. at 1229-30, 1231, and *Town & Country Food Co.*, 51 T.C. at 1057 (taxpayers collected payments and serviced installment notes) with *Elmer*, 65 F.2d at 570 (taxpayer did not collect payments on installment notes). See also *Mapco*, 556 F.2d at 1111.

DID PAYMENTS TO THE COMPANY CORRESPOND TO COLLECTIONS ON THE CUSTOMER NOTES?

The payments that the Company received were the payments that the Company collected on the customer notes. The Taxpayer had no obligation to make payments to the Company. The Company received payments only if and when it collected amounts on the customer notes. Compare *United Surgical Steel Co.*, 54 T.C. at 1230 and *Town & Country Food Co.*, 51 T.C. at 1057 (lenders looked to taxpayers for repayment, not payments on pledged installment notes) with *Branham v. Commissioner*, 51 T.C. 175, 180 (1968) (taxpayer's payments to purported lender were exactly the same in amount and timing as payments on underlying installment notes).

Furthermore, an advance payment was based on a fixed amount of a customer note, not on the Taxpayer's creditworthiness. This implies that the Taxpayer sold the customer notes. Cf. *United Surgical Steel Co.*, 54 T.C. at 1231 (taxpayer did not borrow maximum amount allowable under agreement); *Yancey Bros. Co.*, 319 F. Supp. at 446 (taxpayer had access to additional funds without providing additional collateral).

DID THE COMPANY IMPOSE RESTRICTIONS ON THE OPERATIONS OF THE TAXPAYER THAT ARE CONSISTENT WITH A LENDER-BORROWER RELATIONSHIP?

The relationship between the Taxpayer and the Company had none of the characteristics that are common in a lender-borrower relationship. The Company imposed no restrictions on the operations of the Taxpayer. For example, the Company did not require the Taxpayer to maintain a specified ratio of assets to liabilities or current assets to current liabilities. The Company did not receive the right to review the Taxpayer's books and records. The Company received only the right to documents that were necessary for the Company to exercise its rights and duties concerning the transferred customer notes.

Since the Company imposed no restrictions on the Taxpayer's operations, the Company is less like a lender and more like a purchaser of the customer notes. See, e.g. *United Surgical Steel Co.*, 54 T.C. at 1230 (bank's imposition of restrictions on operations of the taxpayer was a factor showing lender- borrower relationship). That conclusion is further supported by the Company's failure to require the Taxpayer to maintain a minimum amount of collateral. See, e.g., *Union Planters Nat'l Bank of Memphis*, 426 F.2d at 118, (purported seller required to make margin account payments); *Yancey Bros. Co.*, 319 F. Supp. at 446 (taxpayer obligated to maintain ratio of collateral to debt of not less than 105%) .

WHICH PARTY HAD THE POWER TO DISPOSE OF THE CUSTOMER NOTES?

The loan servicing Company had the power of disposition. Once the Company accepted a customer note, there was a "transfer, sale and assignment" of the customer note and of the Taxpayer's security interest in the financed vehicle to the Company. The Taxpayer also gave the Company the Powers of Attorney necessary for the Company to exercise its rights and duties concerning the customer notes. The dealer agreement did not restrict the Company's right to dispose of the transferred customer notes. In fact, the Company pledged the customer notes as security for its indebtedness to a different party. The Company later contributed the contracts to a wholly-owned business trust that sold notes that were secured by the customer notes to institutional investors in private placements. Cf. *Town & Country Food Co.*, 51 T.C. at 1057 (finance company could acquire and dispose of installment notes only if dealer defaulted on its indebtedness).

The Taxpayer, on the other hand, could not sell the customer notes after they were transferred to the Company. The Taxpayer did not have possession of the customer notes or the affiliated files. The Taxpayer had neither the right to substitute different customer notes for the ones transferred to the Company, nor the right to reacquire the customer notes. If the Company were a lender, then it would be reasonable to expect the Taxpayer to have the ability to substitute collateral of equal value to secure the outstanding loan. Cf. *American Nat'l Bank of Austin*, 421 F.2d at 452 (purported seller could dispose of the securities without prior approval from purported buyer).

WHICH PARTY BORE THE CREDIT RISK ON THE CUSTOMER NOTES?

By transferring the customer notes to the Company, the Taxpayer eliminated almost all of its exposure to credit risk on the customer notes. Aside from breaching a representation or warranty, in the event of a customer's default, the Taxpayer had no obligation to repurchase either the customer note or the financed vehicle, or to return the advance payment. Further, the Taxpayer fixed its economic loss in the customer notes. After transferring a customer note, the only loss the Taxpayer could realize was a diminution in value of its right to receive distribution payments. The Company, on the other hand, was at risk for the advance payments it had made to the Taxpayer.

It may be argued that the Company's risk of loss was insubstantial because (1) it advanced the Taxpayer no more than 50% of the face amount of each customer note, and (2) the distribution payments were based on the entire pool of customer notes, which meant that the Taxpayer's right to payments was subordinated to the Company's right.

This argument assumes that the fair market value of the customer notes equaled their face amounts. The evidence, however, is to the contrary. Between a customer's down payment and the advance payment from the Company, the Taxpayer generally profited on the sale of an automobile. Given the value of the automobiles sold, the credit quality of the customers, and statutory limits on interest charged in consumer credit sales, it is reasonable to conclude that the face amounts of the customer notes exceeded their fair market values. See, e.g., *Hercules Motor Corp. v. Commissioner*, 40 B.T.A. 999, 1000 (1939) (taxpayer inflated sales price to account for buyer's uncertain credit status). The Taxpayer transferred customer notes to the Company for cash payments of no more than 50% of their face amounts and permitted the Company to retain substantial fees on all collections. The Taxpayer would not have agreed to these conditions unless the fair market value of the customer notes was less than their face amounts. Accordingly, we are unwilling to conclude that the Company's risk of loss was insubstantial.

THE POTENTIAL FOR GAIN ON THE CUSTOMER NOTES.

The Company's potential for gain on the customer notes was greater than the Taxpayer's. The Company gave the Taxpayer cash, namely, the advance payments when the Taxpayer transferred customer notes to the Company. The Company's right to recover those advance payments plus payment for its collection costs and fees was limited to its collections on the customer notes. The Company's profits, therefore, depended on the timing and amount of the collections rather than on any interest charged to the Taxpayer while the advance payments were outstanding. Consequently, the greater the collections on the customer notes, the greater the Company's rate of return on the advance payments made to the Taxpayer. In addition, the Company stood to gain more than the Taxpayer if customers defaulted at a rate lower than expected.

This paragraph and the following contain the example included in the notes to LTR 9840001 to illustrate why the Company's rate of return on its investment (the advance payments) depended solely on the performance of the customer notes. Assume that the Taxpayer transferred to the Company a customer note with a face amount of $3,600, a term of 22 months, an interest rate of 21.82% per annum, and monthly payments of approximately $200. Also assume that the Company had no collection costs and that the Taxpayer transferred only the one customer note. The Company would be entitled to receive its fee of 20% of each payment (approximately $40). The Company would also be entitled to the remaining $160 of any payment ($200 - $40 fee) until it recovered the advance payment of $1,800. Thus the Company would be entitled to eleven payments of $200, one payment of $80, and ten payments of $40. The Taxpayer would be entitled to receive, starting in month twelve, one payment of $120 and ten payments of $160.

The Company's rate of return on the advance payment made to the Taxpayer increases as more payments are collected on the customer note. If the Company were to collect all payments, then the Company's yield to maturity would be approximately 68% per annum, compounded annually. If the Company were to collect enough payments for it to recoup its collection costs, its 20% fee, and its advance payment, then the Company's yield to maturity would be approximately 48%. And if the Company were to collect only one-half of the payments, then its yield to maturity still would be approximately 42%. As the example shows, the more payments the Company collects, the greater the Company's rate of return on its advance payment to the Taxpayer.

In cases addressing transfers of debt instruments or other rights to future payments, courts have pointed to a fixed rate of return on the loaned amount as evidence that the transactions were financings. E.g., *Mapco*, 556 F.2d at 1111 -12; *Union Planters Nat'l Bank of Memphis*, 426 F.2d at 118; *American Nat'l Bank of Austin*, 421 F.2d at 452; *United Surgical Steel Co.*, 54 T.C. at 1229. A debt instrument can provide for a variable rate of return and even contingent payments. Nevertheless, to be a financing there must be a debtor-creditor relationship between the Company and the Taxpayer. Since the Company's economic return was based solely on the performance of the customer notes, rather than on its relationship with the Taxpayer, the Company was more like an owner of the customer notes than a creditor of the Taxpayer.

After transferring the customer notes, the Taxpayer had little potential to realize gain on the customer notes. Only after the Company recouped its out-of-pocket costs, its fees, and all of the advance payments would the Taxpayer receive any distribution payments. While the Taxpayer had the potential for some benefit if the pool of customer notes had a low default rate, that potential benefit does not in itself make the Taxpayer the owner of the customer notes. Further, the Taxpayer could not realize any economic benefit of changes in market interest rates by disposing of the customer notes.

DETERMINATION OF "AMOUNT REALIZED"

CODE, REGULATIONS & CASE ANALYSIS

In LTR 9840001, the IRS held that the transfer of sub-prime customers' notes by a used car dealership [Taxpayer] to an unrelated loan servicing company [Company] were "sales," rather than assignments, secured financings or borrowings. In determining what amount(s) should be treated as realized on the sale of the customers' notes, the analysis below was included in the text of the Letter Ruling.

SECTION 1001

Under Section 1001(b) and Reg. Sec. 1.1001-1(a), the amount realized from the sale of property is the money received plus the fair market value of any other property received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value.

In return for the customer notes, the Taxpayer received advance payments and the right to distribution payments. The advance payments are clearly "money received" under Section 1001(b) of the Code. The amount realized attributable to the Taxpayer's right to receive the distribution payments must be determined.

Under the dealer agreement, the Taxpayer's receipt of distribution payments depended on the Company's ability to collect on the customer notes and the Company's cost of making those collections. Distribution payments were determined under a complex formula. No amount or time of payment was specified for any particular customer note or any group of customer notes. Payment, if any, was deferred until an indefinite time in the future. Moreover, there was no provision for interest regardless of when the Taxpayer might receive any distribution payments.

SECTION 483

The deferred nature of the distribution payments and the absence of any stated interest implicates Section 483. (Note: The deferred receipt of the distribution payments superficially resembles the deferred receipt of payment in *Commissioner v. Hansen*, 360 U.S. 446 (1959). Nevertheless, under the facts and circumstances, the Taxpayer had no fixed right to receive the distribution payments at the time the Taxpayer sold the customer notes.)

Section 483 generally applies to payments under a contract for the sale of property if the contract provides for one or more payments due more than 1 year after the date of sale, and the contract does not provide for adequate stated interest. For purposes of Section 483, a sale is any transaction treated as a sale for tax purposes and property includes debt instruments such as customer notes. Reg. Sec. 1.483-1(a)(2).

Section 483 is intended to ensure that a minimum portion of the payments under a sales contract is treated as interest. In other words, if a sales contract provides for deferred payments but not adequate stated interest, Section 483 recharacterizes a portion of the deferred payments as interest for tax purposes. Thus, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange. Reg. Sec. 1.483-1(a)(2). See Sections 1.1001-1(9) and 1.1012-1(9).

Because the dealer agreement calls for deferred payments but no interest, some portion of the distribution payments must be characterized as interest under Section 483. This, in turn, reduces the amount realized under Section 1001 attributable to those payments. Had the dealer agreement called for a single $100,000 payment due three years after sale of a pool of customer notes, fixing the amount realized would be relatively simple. It would involve nothing more than calculating the present value of the $100,000 on the date of sale. This, however, is not the case. The conditional nature of the distribution payments raises additional questions under Section 483(f).

Section 483(f) of the Code authorizes the Secretary to issue regulations applying Section 483 to any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment cannot be determined at the time of-the sale or exchange. Reg. Sec. 1.483-4 contains rules applying Section 483 in the case of a sales contract that calls for one or more "contingent payments." (Note: Reg. Sec. 1.483-4 applies to sales or exchanges that occur on or after August 13, 1996. For a sale or exchange that occurred before August 13, 1996, a taxpayer may use any reasonable method to account for the contingent payments.)

In general, Reg. Sec. 1.483-4 establishes the treatment of contingent payments by reference to Reg. Sec. 1.1275-4, which was issued simultaneously with Reg. Sec. 1.483-4 and addresses the taxation of contingent payment debt instruments. Specifically, Reg. Sec. 1.483-4(a) states that interest under the sales contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to Reg. Sec. 1.1275-4(c). Thus, each contingent payment under the contract is characterized as principal and interest under rules similar to those in Reg. Sec. 1.1275-4(c)(4).

Neither Reg. Sec. 1.483-4 nor Reg. Sec. 1.1275-4 define the term "contingent payments." Nevertheless, the statutory basis for the Reg. Sec. 1.483-4 is Sec. 483(f), which pertains to payments which "the liability for, or the amount or due date of," cannot be determined at the time of the sale or exchange. Payments are not contingent payments, however, merely because of a contingency that is remote or incidental at the time of the sale or exchange. See Reg. Sec. 1.1275-4(a)(5).

The distribution payments called for in the dealer agreement are contingent payments under Section 483 and Reg. Sec. 1.483-4. At the time the Taxpayer sold a customer note, the Company's liability for, and the amount and timing of any distribution payments could not be reasonably determined. The Company's liability to make distribution payments depended on its ability to collect on the customer notes and its collection costs. ***In this case, these contingencies were neither remote nor incidental. Nor were they predictable.***

At the time of sale, both the Taxpayer and the Company understood that customers' defaults and the Company's collection costs would reduce the amounts left for distributions to the Taxpayer. The face of the customer notes generally exceeded the value of the underlying collateral. Given that fact, together with the high credit risk of the Taxpayers' customers, the Company would fail to collect the entire principal amount of a significant but uncertain number of customer notes. The Company would also have significant but uncertain collection costs. Thus, reductions due to default and collection costs would be significant, and because of the formula for determining the distribution payments, could reasonably be expected to leave the Taxpayer with minimal, if any, distribution payments. For these reasons, and in light of other unique circumstances, the Company's liability for, and the amount and timing of those payments to the Taxpayer could not be determined at the time of the sale of the customer notes.

SECTION 1275

Because the distribution payments are contingent payments under Reg. Sec. 1.483-4, each payment must be accounted for using rules similar to those contained in Reg. Sec. 1-1275-4(c)(4), under which the portion of a contingent payment treated as interest is includible in gross income by the holder and deductible from gross income by the issuer in the year in which the payment is made. A contingent payment is characterized by Reg. Sec. 1.1275-4(c)(4)(ii) as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date.

Under Reg. Sec. 1.1275-4(c)(5)(iii), the holder's basis in the contingent payments under a contract is reduced by any principal payments received by the holder. If the holder's basis in the contingent payments is reduced to zero, any additional principal payments are treated as gain from the sale or exchange of the contract.

Reg. Sec. 1.1001-1(g)(2)(ii) provides the rule for determining the amount realized attributable to a debt instrument subject to Reg. Sec. 1.1275-4(c)(4) or Reg. Sec. 1.483-4. Under Reg. Sec. 1.1001-1(g)(2)(ii), the amount realized attributable to contingent payments is their fair market value. Since the distribution payments are contingent payments for purposes of Section 483 of the Code, the amount realized attributable to the distribution payments is the fair market value of the distribution payments. Thus, the amounts realized from the sales of the customer notes equal (a) the cash received plus (b) the fair market value of the Taxpayer's right to receive the distribution payments.

SECTION 451

The conclusions reached on this issue are consistent with Section 451 of the Code. Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Reg. Sec. 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income 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. See also Reg. Sec. 1.446-1(c)(1)(ii)(A). **Thus, it is the right to receive - and not the actual receipt - that determines inclusion.** *Spring City Foundry Co. v. Comm.*, 292 U.S. 182.

COMMISSIONER V. HANSEN

In *Comm. v. Hansen*, 360 U.S. 446 (1959), the Supreme Court addressed the issue of whether accrual method taxpayers have a fixed right to receive income even though payment is withheld. The taxpayers were two automobile dealers and a trailer dealer who accepted installment notes from their customers. Each dealer sold their notes to a finance company for a price determined by a fixed formula. The finance company paid 95 to 97% of the formula price in cash and held the remainder in reserve. The reserve served as security for payment of the dealers' obligation to repurchase a note that went into default. If the accumulated reserve exceeded a designated percentage of the unpaid principal balances of the notes, the finance companies paid the excess to the dealer.

The Supreme Court held that the dealers had to currently include in income the amounts withheld in reserve. Even though the dealers' actual receipt of the reserve amounts was subject to their contingent liabilities to the finance companies, the Court concluded that the dealers had received a fixed right to the reserve amounts. *Id.* at 463. Only one of two things could happen to the reserve amounts - either the amounts would be paid to the dealers or would be used to satisfy the dealers' guaranty obligations to the finance companies. *Id.* at 465-66. As the dealers effectively received the entire amount of the reserves in all events, the right to the receive the reserves was not conditional but absolute at the time they were withheld and the dealers had to include the reserves in income at that time. *Id.* (Note: Section 483 was not applicable in *Comm. v. Hansen*. Section 483 was added by the Revenue Act of 1964, and applies to sellers of ordinary income property as a result of the Tax Reform Act of 1984.)

CONCLUSION

Under the particular facts and circumstances of the instant case, the Taxpayer does not have a fixed right to distribution payments at the time the Taxpayer sells a customer note. The Taxpayer's case is distinguishable from *Hansen*. The Taxpayer's customers had poor credit, and the customer notes were of poor quality. Because of the poor creditworthiness of the customers, the Company's collection costs were uncertain and sometimes significant. The Company was obligated to pay distribution payments to the Taxpayer only if it collected enough from the customers to recover (1) all its collection costs on the transferred customer notes; (2) its 20% servicing fee on the customer notes; and (3) any outstanding advances on the customer notes.

Under these circumstances, there was reasonable doubt that any future distribution payments would be made to the Taxpayer. In light of these facts and circumstances, which were not present in *Hansen*, the Taxpayer's right to distribution payments were contingent upon future events that were uncertain at the time the notes were sold to the Company.

Accordingly, the Taxpayer should not include the amount of future distribution payments in the amount realized on the sale of the customer notes.

IRS CHANGE IN DEALER'S INTEREST INCOME AND $300,000 PENALTY FOR UNDERPAYMENT UPHELD BY TENTH CIRCUIT COURT OF APPEALS

In the June 1997, *Dealer Tax Watch*, we reported the Tax Court Memo Decision involving *Cordes Finance Corporation v. Comm.* (T.C. Memo 1997-162). This case is an excellent example of how a dealer can really be hit by the IRS when it comes in and finds something akin to a change in accounting method involving a large amount of dollars. In this case, the IRS also imposed a relatively small fraud penalty and a $300,000+ accuracy-related penalty for the substantial understatement of income tax.

FOUR ISSUES IN *CORDES FINANCE CORPORATION*

1. The Company's method of accounting for interest earned on its portfolio of car loans... approximately $3.1 million.

2. The adjustment made by the IRS to eliminate the discrepancy between the deferred interest control account balance and the total of the underlying individual loan records... approximately $1.6 million.

3. The imposition of a fraud penalty because the dealer instructed the Corporate bookkeeper to credit a shareholder loan account, rather than a current income account, for amounts (such as bankruptcy receipts, late charge fees and other miscellaneous receipts) that should have been reported as income...approximately $33,000 fraud penalty.

4. The imposition of the accuracy-related penalty under Section 6662(a) for the substantial understatement of income tax...approximately $303,000 penalty.

Under the dealer's accounting method or practice, it accrued interest only when a loan was fully paid or when it repossessed the vehicle securing the loan. As a result of the IRS change, the Company had to accrue interest over the life of each loan, and this produced an adjustment of almost $3.1 million. The Service also found that the Company had understated interest income by another $1.6 million which was the difference between the interest reported on individual customer note cards and the total of the control account which had not been reconciled to the detail for 20 years. The taxpayer really had no good argument that it could raise in its own defense.

The Tax Court upheld the IRS on all adjustments and penalties. The taxpayer appealed the second and fourth issues above. The U.S. Court of Appeals for the Tenth Circuit rendered its decision on October 23, 1998 (Docket No. 97-9015) upholding the Tax Court. In short, the taxpayer lost on all counts.

Since a portion of this case involves the dealer's attempt to avoid penalties by relying on its long association with its CPA firm...and in the final analysis, that reliance didn't save the dealer...this case is relevant in considering the risks CPAs take in working with dealers...and vice-versa. One can only speculate on how the CPA fared in the overall process.

BACKGROUND FACTS

Mr. Cordes owned and controlled three Oklahoma automobile dealerships. These dealerships referred their customers to the related finance company to provide financing for the customers' purchases of automobiles. If the customer credit was acceptable, the finance company would issue a check to the dealership for the purchase price of the car, and the customer would issue a promissory note to the finance company under which the customer would agree to pay the principal amount of the note plus interest. Payment of the customer's promissory note was secured by a mortgage on the automobile that was being financed.

Every lending transaction was supported by a ledger card which contained the customer's name, the vehicle identification number (VIN) of the vehicle being financed, the principal amount of the loan and the total interest that would accrue during the life of the loan. The date and amount of each payment were recorded on the respective ledger card. The Company did not maintain a list of all loans outstanding, and it had no way of knowing if a ledger card had been lost or misplaced ... unless the borrower subsequently made a payment on the loan.

Since 1964, the Company had used the same method of accounting to record loan transactions. When a loan was made, the "Loan Receivable" account was debited for an amount equal to the sum of the principal amount of the loan plus the total interest income that would accrue over the life of the loan. The "Cash" account was credited for an amount equal to the principal of the loan (since that reflected the payment of the purchase price of the car back to the dealership by the finance company for the purchaser) and the "Deferred Interest Income" account was credited in an amount equal to the interest to be paid by the customer over the term of the loan.

see **IRS CHANGE IN DEALER'S INTEREST INCOME...**, page 24

 (Continued from page 23)

Interest income was not accrued while the loan was outstanding and the customer was making payments. After the loan was initially recorded, only the date and amount of each payment made by the customer was entered on the ledger card for the loan. Interest was not accrued until the principal amount of the loan was fully paid or the vehicle was repossessed. At that time, the Company recognized for book and for income tax purposes all of the interest that had been paid on the loan.

At the end of 1990, there were about 1,300 loans outstanding representing $17.3 million in loans receivable with a corresponding credit of $7.8 million in the deferred interest income account. Thus, at that date, the deferred interest income account on the balance sheet reflected interest of $7.8 million to be realized after 1990 on the portfolio of outstanding loans. This account had not been reconciled with the customer ledger cards for approximately 20 years.

IRS RECOMPUTATION & ACCRUAL METHOD ISSUE

The IRS recomputed the interest income by working from the customer ledger cards for all loans outstanding at the end of 1990. From the ledger cards and other loan documents prepared at the time when loans were made, the agent computed

1. the amount of deferred interest on each outstanding loan,
2. the interest that should have been reported each year on that loan using the accrual method of accounting, and
3. the amount of deferred interest with respect to each loan at the end of 1990.

The taxpayer refused to cooperate with the agent's requests for certain bank information. Based upon the taxpayer's records of loans outstanding at the end of 1990, the IRS found that almost $3.1 million interest had been earned through the end of 1990. The IRS computation of that amount was not challenged by the taxpayer.

The major issue involved the Company's failure to use the accrual method to report interest income earned on its portfolio of car loans. The Company had used a method under which it did not accrue interest on any outstanding loans, but instead it treated interest as having been earned only when a loan was fully paid off or after the vehicle securing the loan was repossessed.

The Tax Court said that the change of accounting method that was made by the IRS was to require interest to be ratably included in income over the life of the loan. Neither the purpose nor the necessary effect of the IRS adjustment was to include in gross income for 1990 interest that would accrue after 1990. The Tax Court also said that under the taxpayer's method of accounting, the amount of interest earned during the year was reflected as a decrease (debit) in the balance of the deferred interest account. That meant that the ending balance of the deferred interest account was (i.e., it represented) nothing more than the interest that potentially would be earned on the portfolio of loans in the future. Therefore, it was necessary for the IRS to decrease the ending balance of the deferred interest account by the additional earned interest that the IRS had computed for the year.

The Company had made a halfhearted attempt at trial to argue that it had consistently used its method for over 30 years, and that historically it had suffered an "unusually high incidence of repossessions." However, the Company did not prove its allegation of a high incidence of repossessions, and it apparently abandoned the argument that its method of accounting was appropriate. In upholding the IRS, the Tax Court said that it was evident that the taxpayer's method of accounting for interest income ***did not clearly reflect income.*** Therefore, it was well within the Commissioner's discretion under Section 446(b) to change the taxpayer's method which, although consistently used over a period of years, was erroneous and did not clearly reflect income.

As noted previously, the taxpayer did not appeal the holding of the Tax Court on this issue.

ADJUSTMENT OF CONTROL ACCOUNT BALANCE TO TOTAL OF INDIVIDUAL LOAN RECORDS

This second issue was based upon the discrepancy between the deferred interest control account balance and the total from the underlying customers' individual loan activity cards. Although the 1990 tax return balance sheet reported $7.8 million as the balance of the deferred interest account at the end of 1990, the aggregate deferred interest recorded on the ledger cards for all of the loans outstanding at that year-end was $6.2 million.

To reconcile this discrepancy and bring the balance of the deferred interest account into agreement with the ending balance computed by the IRS from the loan ledger cards, the IRS further increased income by $1.6 million.

In the Tax Court, the taxpayer argued that:

"The Commissioner's proposed method of accounting requires that any interest which has not already been recognized and which could possibly be earned at any time in the future on any contract outstanding at the end of 1990 be recognized as income in 1990. (Taxpayer) object(s)... because it required the inclusion in income in 1990 of interest on →

installment note payments that are not due at the end of 1990 and won't be due for months or even years in the future."

The taxpayer claimed that the IRS was, in effect, placing it on an erroneous method of accounting to the extent that the IRS computed income by reference to unearned interest. The taxpayer said that this exceeded the Commissioner's authority to change a method of accounting under Section 446(b).

TAXPAYER BEARS THE BURDEN OF PROOF. The Tax Court said that to overcome the IRS determination as to this accounting adjustment, the taxpayer bears a ***heavy*** burden of proof. The taxpayer must show that the IRS determination is arbitrary and unsupported by any basis in law.

The Tax Court also said that the Company's objections were based upon the premise that the $1.6 million difference is interest that did not accrue in 1990 or in any prior year. However, the Company had not introduced any evidence to rebut the IRS determination or to explain the difference. "Contrary to the premise of petitioner's argument, the ledger cards for loans outstanding at the end of 1990 substantiate deferred interest of $1,596,968 (i.e., $1.6 million) less than the ending balance of the deferred interest account as shown on (the) balance sheet."

The Tax Court held that the taxpayer had not proven that the Commissioner "abused her discretion by determining that the difference described above is interest that accrued prior to 1991." The burden of proof was on the taxpayer, not the IRS, in this matter, and accordingly, the IRS was upheld on this issue.

TENTH CIRCUIT COURT OF APPEALS HOLDS THAT THE IRS ADJUSTMENT WAS NOT A "CHANGE IN METHOD OF ACCOUNTING"

In its appeal to the Tenth Circuit, Cordes Finance argued that the Tax Court had erred in requiring it to change from one erroneous method of accounting to another erroneous method of accounting. Cordes argued that the change in accounting methods did not accurately reflect taxable income because the IRS adjustment improperly included deferred interest which had not been received or realized as income in 1990.

In prefacing its holding, the Appeals Court made the following observations, to which the taxpayer had conceded in its petition:

1. The Commissioner has broad discretion to determine the propriety of a taxpayer's method of accounting.

2. The Commissioner has broad discretion to require a taxpayer to change its method of accounting if the method employed does not clearly reflect income.

3. The Commissioner's discretion to prescribe a method that clearly reflects income cannot be disturbed unless it is clearly unlawful or plainly arbitrary.

The Appeals Court stated that in this case, the IRS/Commissioner did not prescribe a method of accounting that was clearly unlawful or plainly arbitrary. The only change in the taxpayer's method of accounting required the taxpayer to report its interest income on the accrual method, and the taxpayer had not appealed that portion of the Tax Court's holding. "The inclusion of the deferred interest income in 1990 was not a change in the method of accounting. Rather, it was a ***one-time adjustment to include as income the discrepancy*** between the deferred interest amounts shown on the petitioner's balance sheet and on its ledger cards...Thus, we conclude respondent (i.e., the IRS Commissioner) did not abuse her discretion in changing petitioner's method of accounting and the Tax Court did not err in upholding the change."

The second argument the taxpayer raised regarding this issue was that the Tax Court erred in requiring it to include the deferred interest in its income for 1990. In this regard, the Court noted that "Contrary to the [IRS] determination that the discrepancy between the amount of deferred interest shown on petitioner's balance sheet and that shown on its ledger cards represented interest that [Cordes] had failed to report as income, the petitioner contends the deferred interest had not been realized at the end of 1990."

The Appeals Court was reviewing the Tax Court's factual findings under a "clearly erroneous" standard. This means that unless the findings of the Tax Court were ***clearly*** erroneous, those findings would not be disturbed. The Appeals Court observed that the Tax Court had found that the taxpayer had not met its burden of proof and that it had failed to rebut the Commissioner's determination or to explain the discrepancy. The Appeals Court said that its review of the Tax Court record "discloses no clear error...petitioner failed to support this argument with any specific facts or legal authority...Accordingly, we conclude the Tax Court did not err..."

$300,000 ACCURACY-RELATED PENALTY

With respect to the 1990 taxable year, the IRS had determined the taxpayer was liable for a $303,000 accuracy-related penalty under Section 6662(a). Generally, this penalty is equal to 20% of the portion of an underpayment of tax which is attributable to any substantial understatement of income tax. For this purpose, an understatement of tax is the excess of the amount of the tax required to be shown on the return for the taxable year over the amount of tax which is shown on the return. An underpayment of tax by a

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corporation will be considered substantial if it exceeds the greater of 10% of the amount of tax required to be shown on the return, or $10,000.

TAX COURT SUSTAINS PENALTY. In trying to avert the underpayment penalty, the Company had argued that it had "acted in good faith and with reasonable cause" because it relied on the advice of its accountants. In evaluating the merits, the Tax Court cited the following principles:

1. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking in to account all pertinent facts and circumstances.

2. In making this determination, the most important factor is the extent of the taxpayer's effort to assess its proper tax liability.

3. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer.

4. Reliance on a qualified professional such as an attorney or an accountant may demonstrate reasonable cause and good faith, if the evidence shows that the taxpayer contacted a ***competent*** tax adviser and provided the adviser with all necessary and relevant information.

The Tax Court's application of these principles to the facts of the case is clear and straightforward:

"We acknowledge that petitioner had a longstanding relationship with the same firm of certified public accountants who had initially advised petitioner concerning the creation of its accounting system. However, in this case, there is no evidence that the errors in petitioner's 1990 income tax return resulted from advice given to it by its certified public accountants. Mr. Hinman, who assumed primary responsibility for petitioner's tax returns in 1987, testified that he did not review petitioner's method of accounting for interest. Similarly, there is no evidence that he advised petitioner to omit income by booking receipts to account 312 or in any other fashion, or that he advised petitioner to deduct personal expenses of Mr. Cordes as repossession costs. Mr. Hinman was the only member of petitioner's firm of outside certified public accountants to testify at trial. Moreover, none of petitioner's employees who testified at trial attributed the errors in petitioner's return to advice received from its accountants. Therefore, we reject petitioner's contention that it acted with reasonable cause and in good faith."

APPEALS COURT UPHOLDS PENALTY. The Court of Appeals devoted little discussion to upholding the $300,000 penalty under Section 6662. The Appeals Court noted that the Company did not dispute that it substantially understated its 1990 tax liability; rather the Company cited "***its reliance on the same accounting firm for thirty years for tax advice and return preparation***" as its reasonable cause for avoiding the penalty.

The Appeals Court accepted the Tax Court's determinations that (1) the Company had failed to prove that its accountants had advised it to report its income under an erroneous method of accounting or that the errors in the 1990 income tax return resulted from the advice of its accountants, and that (2) accordingly, the Company had failed to show reasonable cause to avoid the penalty. The Appeals Court concluded, upon review of the record, that the Tax Court's determinations in this regard were not clearly erroneous, and it therefore affirmed the decision of the Tax Court.

One minor note regarding the underpayment penalty. The taxpayer had also argued that there had been no underpayment of tax because "(exclusive of the accounting charge issue) there were actually more adjustments in Taxpayer's favor than adjustments which would result in additional tax." The Tax Court rejected this collateral argument almost summarily, and the Appeals Court did not even mention it.

CONCLUSIONS

Several observations or conclusions are evident from the *Cordes Finance Corp.* decision.

FIRST: The overall results–considering how poorly the taxpayer fared in the Tax Court and in the Appeals Court–show that the IRS continues to be highly successful when it litigates accounting method issues.

SECOND: Based on the facts, the Tax Court's decision...and its ratification on Appeal... hardly seem surprising. Good accounting controls, not to mention common sense, suggest that ***all*** control account balances should be frequently reconciled to their underlying details. This case especially suggests that adjustments to agree control accounts to supporting subsidiary records should be made not less frequently than at the end of each year. These procedures should avoid the unpleasant consequences of having to take a very large "unlocated difference" adjustment entirely into income in one year.

THIRD: Taxpayers who think they can avoid penalties for substantial understatement of income by simply relying on "a longstanding relationship with their CPAs" have another thought coming. For convincing evidence of this, just look carefully at the Tax Court's analysis. It doesn't get any clearer than that.

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will have to work the numbers through in their 1040s in both Schedules C and A (as well as page 1) to see what the final net result will be. Also, the page 1 deduction for one-half of the self-employment tax paid will no longer be present...not to mention the interplay with the page 1 self-employed health insurance deduction.

IRS AGENTS & APPEALS OFFICERS SHOULD BE AWARE OF THIS POLICY CHANGE

Ms. Baker indicated that she had communicated the recent changes in the National Office position through the Assistant Commissioner of Examination, and that this communication made its way down through the various levels of examination, as well as to the Appeals Division. Accordingly, examining agents should be aware of the IRS position which is now more favorable to dealers, and if any such issues have been raised in current audits, they should be dropped.

CONCLUSIONS

Individuals who have previously received and reported Factory incentive payments in their personal income tax returns should review their tax return treatment for these payments and consider the consequences of the ***new*** IRS position that these payments are not self-employment income.

But do the math before filing an amended return!

Also, consistent with this recent change in IRS policy, any dealers who previously conceded these issues in audits and paid related employment taxes should now consider filing claims for refund.

However, favorable IRS action...in terms of current audit activity or honoring refund claims or amended returns...will be limited to only those situations where the facts and circumstances are the same as those in Revenue Ruling 70-337.

IRS Change in Dealer's Interest Income...

(Continued from page 26)

One can only speculate as to whether the result might have been different if other information had been introduced or if other questions had been asked for the record.

FINALLY: The less than thorough job done by the taxpayer in the Tax Court in establishing a factual record and/or its various defenses was ultimately detrimental to its case. The panel of three judges sitting as the Court of Appeals for the Tenth Circuit unanimously determined, after examining the briefs and appellate record, that oral argument would not materially assist it in its consideration of the Appeal. Therefore, the taxpayer had no further opportunity to present evidence or information in its defense.

This illustrates the importance of thorough preparation and the introduction of a complete record for the Tax Court to consider. A taxpayer usually doesn't get a "second chance" to place new or additional facts into the record on appeal.

Notes:

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