De Filipps' DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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WATCHING OUT FOR

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. THE TWO BIGGEST TAX PROBLEMS FOR <u>DEALERS RIGHT NOW</u> are (1) the disallowance of replacement cost for parts in *Mountain State Ford Truck Sales* and (2) the uncertain status of service technician tool rental and reimbursement plans.

<u>Mountain State Ford Truck Sales</u>*.** How in the world are the IRS and NADA going to work their way out of the Tax Court's "catch-22" holding that dealers can't use replacement cost for valuing parts inventories? Recently, NADA suggested four different alternatives for politely finding some way around the ***impossibility of computing actual cost in accordance with the Tax Court Judge's wishes. The IRS has taken these and other suggestions under advisement, but it is really hung up on what to do about the whole mess.

The IRS is now saying that it just recently woke up to the fact that this issue likewise affects thousands of other taxpayers in many different industries! We shouted this out loud and clear over 5 years ago, but it all fell on deaf ears. The IRS–required to fulfill its mission of fairness and consistency to all taxpayers on this issue which extends far beyond auto and truck dealers–is now finding out that the light at the end of the tunnel is an onrushing locomotive.

<u>Service Technician Tool Rental & Reimbursement Plans</u>. This is the second biggest dealer tax problem at this time. We wrote extensively about these plans in our last issue. Mary Burke Baker, the IRS Motor Vehicle Industry Specialist out of Grand Rapids, told an audience at the Michigan Association of CPAs Industry Mega-Conference recently that a Coordinated Issue Paper addressing Section 62(c) Accountable Tool Plans is now in the works.

We received several replies from the tool rental/reimbursement plan sponsor organizations mentioned in our article, and we have had a few interesting conversations over the past weeks. We plan to revisit this entire area as soon as the IRS comes out with its Coordinated Issue Paper.

One big problem relating to these plans is whether unreturned excess payments and/or pure rental payments are subject to self-employment tax. If they are, these programs clearly lose much of their attractiveness. One plan marketer told us in so many words that an overpayment situation could never happen because they continually adjust their formulas so that payments under their reimbursement plans can never exceed reimbursement amounts. Their tax counsel said that he had not even looked into the question of taxability of these "rents" for self-employment tax purposes.

More, much more, on this later.

LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients—and, in the process, to help yourself.

see **DEALER TAX WATCH OUT**, page 2

A Quarterly Update of Essential Tax Information for Dealers and Their CPAs

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#2. IRS CONCEDES USED CAR WRITE-DOWNS AT YEAR-END TO INDUSTRY BOOK VALUE.

The IRS has decided to allow used cars to be written-down to the lower of cost or market at the end of the year under Revenue Ruling 67-107. The IRS Motor Vehicle Specialist recently indicated that the IRS will follow Rev. Rul. 67-107 and treat used cars as normal goods–not as subnormal goods–in the context of a used vehicle inventory.

REVENUE RULING 67-107

> "It is a common practice for the car dealer to sell a car and as part of the payment to take in trade the purchaser's old car. The dealer values the car taken in trade at cost which is an amount representing the average wholesale price listed by an official used car guide at the time of trade-in. If not sold, the used car is carried in inventory at the cost figure until the end of the year. The inventory value is then adjusted to conform to the average wholesale price listed at that time. This is the practice recommended by the auto industry and used by nearly all car dealers.
>
> "Section 471 provides that inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income. Reg. Sec. 1.471-2(c) provides that the bases of valuation most commonly used by business concerns and which meet the requirements of Section 471 are (1) cost and (2) cost or market, whichever is lower. Reg. Sec. 1.471-4(a) defines *market* as 'the current bid price prevailing at the date of inventory for the particular merchandise in the volume in which usually purchased by the taxpayer.'
>
> "Accordingly, a car dealer may value his used cars for inventory purposes at valuations comparable to those listed in an official used car guide as the average wholesale prices for comparable cars."

For any audits in progress where used vehicle writedowns are an issue, if the agents are not aware of this recent concession, they should be asked to call the Specialist's Office in Grand Rapids at (616) 235-1725 for further instruction.

This concession by the IRS relating to *used* vehicles should not be confused with the National Office holding in LTR/TAM 9522002. In that TAM, the IRS held that a retail auto dealer was not permitted to write-down the value of its *demonstrator* vehicles at year-end by referring to the *NADA Official Used Car Guide*.

(Continued from page 1)

#3. VEHICLE SERVICE CONTRACTS UPDATE.

There's only one major court case reported in this issue of the *Dealer Tax Watch*. The Appeals Court for the Eighth Circuit heard the appeal of *Rameau Johnson, et al.* from the Tax Court, and it decided that the dealer should get a break.

Although the Appeals Court upheld the full taxation in the year of sale of all of the VSC contract proceeds, it said that "what is sauce for the goose is sauce for the gander." So it held that the dealer should be entitled to deduct in full (in the year paid) the fees paid to the third-party administrator.

Notwithstanding this setback, the IRS has announced that its position is still that fees paid to a third-party administrator should be allocated over the term of the contract instead of being deducted up front.

In addition to reviewing the Appellate Court's decision, we have updated an earlier report on vehicle service contracts, dealer obligors and the SWIM (Service Warranty Income) Method. See pages 10-16 and especially the checklist on pages 14-15.

#4. DEALER REINSURANCE COMPANY ARRANGEMENTS.

A broad area that is less frequently encountered involves dealer reinsurance companies, captive insurers, exotic off-shore and non-controlled foreign corporations, and other related gambits and games. Information from the IRS recently made available now shows how dealers may structure their aftermarket product sales activities in very tax-beneficial ways.

Obtaining a current deduction for insurance premiums paid into a controlled "captive" and the structuring of those controlled entities as brother-sister groups blend together nicely in the article on page 17. This article discusses recently issued Technical Advice Memorandum 199924001, Field Service Advice 1999-953 and Technical Assistance Memorandum/ITA 199932007.

As usual, we are indebted to our generous friend and off-shore guru, Steve Mailho, for his help in putting these new developments into practical perspective.

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#5. *CORDES FINANCE CORP.* LOSES BIG TIME TO THE IRS: IT'S FINAL NOW ... R.I.P. In the June 1997 *Dealer Tax Watch*, we reported a Tax Court Memo Decision involving *Cordes Finance Corporation v. Comm.* (T.C. Memo 1997-162). This case showed how a dealer can really be hit by the IRS when it comes in and requires a change in accounting method involving big dollars.

CORDES FINANCE ADJUSTMENTS

All four adjustments in this case were decided against the taxpayer:

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

2. The adjustment required 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 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.

In the December 1998 *Dealer Tax Watch*, we reported that the Tenth Circuit Court of Appeals upheld the IRS and the Tax Court's decision on all issues. This was especially painful because the dealer had attempted to avoid these penalties by relying on his long-standing (over 25 years) association with his CPA firm. In the final analysis, that reliance didn't matter one bit, and it didn't save the dealer in the least.

On April 26, 1999 the Supreme Court denied *certiorari* in *Cordes Finance Corporation v. Comm.* This means that *Cordes* has no further place to plead its case, and it's now all over ... there's nowhere else to go.

#6. DEALERS HOLDING UNCLAIMED FUNDS SHOULD TREAT THEM PROPERLY. One reader alerted us to a special compliance notice received from the Ohio Department of Commerce which was sent to Ohio CPAs earlier this year. Attached was a cover letter from the Ohio Department of Commerce, Division of Unclaimed Funds. This letter addressed to registered CPAs said: "...In the past when we have done audits of holders of unclaimed funds, we were dismayed to learn that some Ohio CPAs have told their clients that it is permissible to write-off unclaimed accounts rather than report them as unclaimed to the Division. This in direct conflict with the law and exposes their clients to the imposition of penalties and interest by the Division."

The letter, dated April 1999, indicated that the State of Ohio had elected to participate in a Voluntary Compliance Program sponsored by the National Association of Unclaimed Property Administrators (NAUPA). The letter added that the states which are participating in that Program have agreed to waive penalties and interest on holders who come forth voluntarily to remit unclaimed funds. Although the Program may have already ended in some states, some other states have extended the Program through December 31, 1999.

Accordingly, CPAs advising dealers on the treatment of unclaimed funds should be especially alert to one more law (such as the Ohio Unclaimed Funds Law) which they need to be familiar with. The NAUPA website is www.unclaimed.org. Ohio's Unclaimed Funds Law can be accessed from Ohio's website—www.com.state.oh.us—and your own state may have similar information on its website.

#7. CAR DEALERS CAN'T DEDUCT PAYMENTS TO AD ASSOCIATIONS UNTIL THE YEAR WHEN ECONOMIC PERFORMANCE OCCURS ... FSA 1999-1161. Recently, Field Service Advice 1999-1161 was published under the Freedom of Information Act. This FSA is dated September 18, 1992, and it presents a very interesting summary of the litigating hazards that the IRS encountered at that time in fighting with dealer ad associations over their organization status under Section 277 and with dealers over the deductibility of their payments to the ad associations.

These issues seem to be somewhat settled and are not much in contention at the present time. However, this old FSA is a good reminder that dealers are not entitled to deductions for amounts sent to advertising trade associations until the economic performance actually occurs. In other words, under Section 461(h), the advertising services have to be provided before the dealers are entitled to deduct their payments.

In LTR/TAM 9243010, the Service ruled that advertising fees were deductible as ordinary and necessary business expenses under Section 162. The real question, obviously, was the year in which the payments were deductible. Since 1986, it's been a matter of timing for more and more of these issues. It seems that most dealer ad associations make sure that by year-end they have spent all the funds they

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15-YEAR LIFE FOR CERTAIN (SERVICE BAY AREA) DEPRECIABLE REALTY?

One new item appearing on the IRS current tax issues list involves the depreciable life of certain dealership realty, essentially service bay areas. Some dealers are claiming these should be treated as Section 1250 property associated with "the marketing of petroleum products."

The argument has been made that under Revenue Procedure 87-56 (1987-2 C.B. 674), Class Life 57.1 allows a 15-year depreciable life for certain Section 1250 property that is used in the marketing of petroleum and petroleum products.

Class Life 57.1 is entitled "Distributive Trades and Services–Billboard, Service Station Buildings, and Petroleum Marketing Land Improvements." This general grouping includes service station buildings and depreciable land improvements, whether Section 1245 property or Section 1250 property, used in the marketing of petroleum and petroleum products. ... It also includes car wash buildings and related land improvements and billboards, whether such assets are Section 1245 property or Section 1250 property. But, would dealership service bay areas also qualify?

Section 168(e)(3)(E)(iii) provides that the term "15 year property" includes any Section 1250 property which is "a ***retail motor fuels outlet*** (whether or not food or other convenience items are sold at the outlet)." This wording was added by P.L. 104-188 as part of the Small Business Job Protection Act of 1996, and further information on this change comes from the Senate and from the Conference Committee Reports.

COMMITTEE REPORT CLARIFICATION

The Senate Committee Report clarified what types of property qualify as a ***retail motor fuels outlet***. It said that any Section 1250 property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products will not qualify.

It also said that Section 1250 property will only qualify if it meets either one of two 50% tests: (1) 50% or more of the gross revenues that are generated from the property must be derived from petroleum sales ***or*** (2) 50% or more of the floor space in the property must be devoted to petroleum marketing sales. Note: the word "or" makes this a disjunctive test. In contrast, the IRS had previously taken the position in connection with convenience stores selling gasoline, food and sundry items that both tests had to be met. In other words, according to the IRS, the requirement was conjunctive–both tests had to be passed.

The Senate Committee intended that the determination of whether either part of this test is met will be made pursuant to a "recent IRS Coordinated Issue Paper" (April 11, 1995).

For property placed in service in taxable years after the date of enactment, the determination of whether the property meets the 50% test generally will be made in the year the property is placed in service. However, the test may be applied in the subsequent taxable year if the property is placed in service near the end of the taxable year and the use of the property during such short period is not representative of the subsequent use of the property.

With respect to property placed in service in earlier taxable years, the Senate Committee intended that the determination of whether the property meets the 50% test generally will be made in a manner consistent with the way the 50% test of the Coordinated Issue Paper is applied (but by using the disjunctive test intended by the Committee–rather than the conjunctive test expressed by the IRS in its Coordinated Issue Paper). The Committee also intended that if property initially met (or failed to meet) the disjunctive 50% test but subsequently failed to meet (or subsequently met) such test for more than a temporary period, such failure (or qualification) may be treated as a change in the use of property to which Section 168(i)(5) applies.

In addition, property the size of which is 1,400 square feet or less would qualify if such property would have qualified under the IRS Coordinated Issue Paper.

The Conference Committee Agreement stated that a taxpayer may elect the application of the provision for qualified property placed in service prior to the date of enactment. Also, the Conferees clarified than if a taxpayer had already treated qualified property that was placed in service before the date of enactment as 15-year property, the taxpayer would be deemed to have made the election with respect to such property.

IRS POSITION

Originally, convenience stores that sold gasoline along with food and other items were successful in establishing 15 years–rather than 39 years–as the depreciable life for their buildings. The key to being able to use the 15-year life involves satisfying tests relating to gross revenues and percentage of floor space to show that more than 50% is derived from, or

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15-Year Life for Certain (Service Bay Area) Depreciable Realty? (Continued)

devoted to, the proper petroleum sale and marketing activities.

The IRS opposition to dealers wanting to use 15 years appears to center around these technical tests. It is the IRS position that neither the labor revenue nor the space necessary to store the "petroleum products" are to be aggregated with the petroleum product itself for purposes of the "50% of revenues" or "50% of space" tests.

Also, questions involving what kinds of products fall within the broad term of "petroleum products" need to be resolved: Oil changes? ... Yes! But are tires or anti-freeze derivatives from petroleum products for purposes of 15 year depreciable life eligibility? ... Who knows?

As the IRS becomes more involved with this issue, the need for formal guidance will become apparent. Right now a change in the depreciable life of allowable service bay areas would seem to require approval of the National Office.

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have received for advertising in the current year. That way, there can't be any excess of funds received over expenditures, and the dealers' payments into the fund for advertising during the year should be fully deductible in that year.

#8. HIGHLIGHTS OF *1999 NATIONAL BUY-HERE, PAY-HERE CONVENTION*. On June 9-11 the National Association of Buy-Here, Pay-Here Dealers held its first annual Convention at the Silver Legacy in Reno, Nevada. This Convention was attended by over 300 dealers, CPAs and BHPH industry representatives and service providers.

After reviewing the Convention highlights video, we believe that anyone interested in the buy-here, pay-here and related finance company areas of practice would be well-served by viewing the Convention videotapes to hear some of the more interesting presentations.

Ken Shilson, whose BHPH resource guide we reviewed in the last issue of the *Dealer Tax Watch*, was the Convention Chair and the driving force behind the entire event. For more information on the Convention, call Ken at (713) 290-8171 or fax him at (713) 680-BHPH. In addition to his presentation on used car operations, other Convention topics included the latest in used car industry technology (including VIN decoder technology) software for BHPH dealers and presentations by Finova Capital, Ugly Duckling, Manheim Auto Auctions and other industry stalwarts.

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APPEALS COURT UPHOLDS IMMEDIATE TAX ON DEALER'S SERVICE CONTRACT SALES ... BUT ALLOWS IMMEDIATE DEDUCTION FOR MATCHING COSTS

In June of 1997, the Tax Court decided the cases of several dealerships selling extended warranty vehicle service contracts (VSCs) where the dealerships were dealer obligors using escrow funds under programs administered by unrelated third-parties. These cases involved sales from 1989 through 1992 in the State of Missouri. In the four cases consolidated in the Tax Court under *Rameau A. Johnson, et al.* (108 T.C. 448 (No. 22)), the IRS positions were upheld in all respects by the Tax Court.

IN THE TAX COURT

The Tax Court upheld the IRS in requiring the dealerships to currently include in gross income the entire amount of VSC sales proceeds received, even though a substantial portion of the proceeds was immediately deposited in escrow accounts. The Court concluded that the dealers could not justify excluding portions of the VSC sales under the theories that the amounts were either "customer deposits" or were held in a "trust fund" for the benefit of the VSC purchasers.

The Tax Court held that the dealerships should be treated as the **owners** of the amounts placed in the escrow accounts. Accordingly, the dealerships were required to include the investment income of the escrow accounts in their own gross income.

As for off-setting deductions, the premiums paid by the dealerships for insurance policies to protect the dealerships against excess losses arising under the VSCs were held to be capital expenditures that must be recovered through amortization deductions.

In similar fashion, the deductibility of the fees paid by the dealerships to the third-party program administrators were also limited. The Court allowed these fees to be deductible only based on a (limited) formula that measured the administrators' performance of services over the lives of the service contracts. Thus, the Tax Court looked to the contract provisions that governed how fees were to be earned by the administrators <u>for refund purposes</u> as the measure of the allowable deduction for the fees paid by the dealerships.

The result was that the deductions allowable were not based on either straight-line amortization, or a front-end loaded assumption. The Tax Court held that the payments could not be currently deducted against the income that was required to be recognized with respect to the sales of the corresponding contracts, nor could the recognition of that income be deferred until the offsetting deductions were allowable.

Clearly, the dealers were stuck with reporting all the VSC income up front while stretching out all related deductions over much longer periods of time. Rameau Johnson and the other dealers did not like this result, so they appealed.

ON APPEAL IN THE EIGHTH CIRCUIT

On appeal from the United States Tax Court, *Rameau Johnson* was heard by the United States Court of Appeals for the Eighth Circuit. The decision of the three Circuit judges was filed July 21, 1999 (84 AFTR 2d Par. 99-5073; No. 98-1324).

In a decision replete with common sense and catchy idioms, the Appeals Court upheld the IRS and the Tax Court on the immediate taxation of all income from the sale of vehicle service contracts. However, the Appeals Court slightly reduced a portion of the dealerships' tax burdens on the escrow investment income. More significantly, in a victory for the taxpayer, the Tax Court was reversed on its treatment of the deductions for insurance premiums and other administration fees paid by the dealerships.

The Appeals Court, among other things, said "fairness matters," "...the hair should follow the hide," and "...what is sauce for the goose is sauce for the gander." The Court observed that the arguments and authorities were all thoroughly discussed in the Tax Court's detailed decision, and it saw "no need to re-plow that ground." In deference to that theme, we, too, shall be brief and not restate all of the details which can be found elsewhere. (For lengthy discussions of the Tax Court's decision, see the September 1997 *Dealer Tax Watch.*)

THE MAIN ISSUE: FULL TAXABILITY OF ALL VSC INCOME IN THE YEAR OF SALE

With respect to the main issue, the Appeals Court agreed with the Tax Court that the money received by the dealerships upon sale of the VSCs, and immediately paid over into the escrow accounts in accordance with the contracts between the taxpayers and the buyers of the cars, was includible in income in the year of receipt.

The Appeals Court observed that it was "plausible and certainly not irrational" that the dealers would argue that the VSC income should be recognized only at such later time as they in fact received money when repairs on the cars were performed. Balanced against this, the Court recognized that the Commissioner of

see **APPEALS COURT & *RAMEAU JOHNSON*...**, page 8

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AT A GLANCE	**RAMEAU A. JOHNSON, ET AL. V. COMM.*** **DEALER OBLIGOR VEHICLE SERVICE CONTRACT SALES**
ISSUES	***HOLDINGS***
1. Whether accrual basis auto dealerships may exclude from gross income for the year of sale of a vehicle service contract (VSC) that portion of the contract price that they are required to deposit in escrow accounts to secure their obligations under the VSC contracts.	1. The Tax Court held that at the time the dealerships sold the vehicle service contracts (VSCs), they acquired a **fixed right** to receive the portion of the contract price deposited in escrow. Accordingly, the dealerships must currently include in gross income the entire amount of the VSC sales proceeds. The reasoning in *Comm. v. Hansen* controls. The amounts received from the sales of VSCs did not constitute purchaser deposits, and the amounts received on the sale of VSCs and deposited in the escrow accounts did not constitute "trust funds" for the benefit of the VSC purchasers. ***The Appeals Court upheld the Tax Court on these holdings.***
2. Whether the dealerships may exclude from gross income the investment income earned by the funds held in escrow accounts.	2. The Tax Court held that the dealerships should be treated as **owners** of the amounts placed in escrow accounts. Therefore, they must currently include the investment income of the escrow account in gross income. ***The Appeals Court agreed in general. However, it said that it would not be appropriate for the dealerships to be taxed on the accrual investment income attributable to unconsumed reserves in the escrow funds because this income belonged unconditionally to the VSC plan administrators.***
3. Whether the dealerships may exclude or deduct from gross income for the year of the sale of vehicle service contracts those portions of the contract price that they remitted to third-parties as prepayments of: • Service fees for administration of the VSC program, and • Insurance premiums for the indemnification of their losses under the VSC program.	3. The Tax Court held that premiums paid for insurance policies to protect the dealerships against excess losses arising under the VSCs are capital expenditures that must be recovered through amortization. It also held that fees paid to the third-party program administrator are deductible in accordance with a formula that reasonably measures the administrator's performance of services over the life of the VSCs. (The Tax Court allowed the provisions that govern how fees are earned <u>for refund purposes</u> to be used as a reasonable estimate of the liability accrued.) ***The Appeals Court said that to answer the question of whether the accounting method proposed by the Commissioner clearly reflects income, <u>both income and deductions must be considered</u>. If the income is to be recognized, the deduction associated directly with it should also be recognized. "What is sauce for the goose is sauce for the gander."*** ***As a matter of fairness, "If taxpayers are going to be required to take into income the entire amount paid into the escrow fund in the year of receipt and payment, ...they should also be allowed to deduct, <u>in that year</u>, the entire amount of the fee paid to the Administrator."***
4. Whether a Section 481(a) adjustment was required for one of the dealerships.	4. An adjustment under Section 481(a) is required. ***This holding was not disputed in the appeal.***
* Citations	United States Tax Court ... 108 T.C. No. 22 (June, 1997) ***United States Court of Appeals for the Eighth Circuit ... 84 AFTR 2d. Par. 99-5073; No. 98-1324 (July 21, 1999)***

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the Internal Revenue Service has broad powers to determine whether the accounting method used by a taxpayer clearly reflects income (citing *Commissioner v. Hansen*, 360 U.S. 446 (1959)).

The Court observed that even though a certain method of accounting meets generally accepted commercial accounting principles, that does not necessarily mean the IRS Commissioner must accept that method for income tax purposes. Along the same line, even accrual basis taxpayers–like the dealerships in the present case–are not necessarily entitled to defer the recognition of income until the performance of those acts which are necessary to earn that income. The Court said, "It is the right to receive the income, and not necessarily its actual receipt, that is controlling for tax purposes."

Accordingly, the Court held that "the Commissioner did not exceed his broad powers when he determined that the method of accounting used by the taxpayer–[i.e.,] deferring recognition of the income until repairs were performed, or other events took place that would result in payment of money to the taxpayer out of the escrow fund–did not clearly reflect income."

The Court added: "The ledger will be corrected, so to speak, in future years, when the taxpayers will be allowed to take deductions for money paid out of the escrow fund to other persons (for example, to the car buyers on the exercise of their option to cancel the VSCs)."

The Court acknowledged the taxpayers' arguments that the vehicle service contracts entitled the car owners to have their vehicles repaired at other →

THE FACTS IN *RAMEAU A. JOHNSON*

When a car is sold, the dealerships also offer for sale a VSC. This is a kind of warranty agreement, under which the dealership grants to the buyer the right to have parts or components covered by the VSC repaired or replaced, whenever the covered parts experience a mechanical breakdown.

Under the VSC, the car dealer agreed either to repair or replace covered parts itself, or to reimburse the car buyer for the reasonable cost of repair or replacement. Normally, the buyer would return the vehicle to the dealer for repair, but the buyer could also elect to have repairs made elsewhere, by other qualified facilities. In either case, the repairs or replacements had to be authorized in advance by an Administrator employed by the dealership to oversee the arrangement. The program was administered for a time by Mechanical Breakdown Protection, Inc. (MBP), and thereafter by Automotive Professionals, Inc. (API).

A buyer could cancel a VSC at any time. If he or she did so, a portion of the payment for the VSC, computed on the basis either of time elapsed or miles traveled, would be returned to the buyer.

The proceeds of the sale of VSCs were distributed in the following manner: all of the money would be initially paid to the dealership, the taxpayer. Some of it the dealership would retain, and the taxability of this portion of the sale proceeds is not at issue in this case. The taxpayers concede that this portion of the price paid for the VSCs is properly includible in income for the year of the sale of the car.

The rest of the money received for a VSC would be paid into an escrow account. According to a contract between the taxpayer-dealership and the buyer of the car, this escrow account was known as "the Primary Loss Reserve Fund" (PLRF). The purpose of this fund was to secure the performance of the taxpayer's obligations under the VSCs. The fund would be administered by the Administrator, and investment income accrued on the fund would itself be deposited in the fund. When authorized repairs or replacements were performed by a taxpayer-dealership, it would receive, from the PLRF, the agreed-upon price for this work. If authorized repairs or replacements were performed by another facility, this facility would receive payment from the fund, thus discharging the obligation of the dealership to cause the appropriate repairs or replacements to be made.

At the termination of a VSC, the unconsumed reserves attributable to that particular contract would, in the ordinary course, be returned to the dealership. The accrued investment income attributable to the expired contract would also go to the dealership, except that, under the MBP program, the Administrator was entitled to keep the investment income attributable to any unconsumed reserves. The right of the dealership to receive unconsumed reserves was subject to certain conditions.

The dealerships bought insurance for the VSC program from Travelers Insurance Company. Travelers issued an automobile dealers service contract excess insurance policy, under which it agreed to indemnify the dealerships for covered losses exceeding the aggregate amount of PLRF reserves on all VSCs.

The dealerships also paid a fee to the Administrator, and this fee would be paid immediately upon the receipt by the dealership of the price for a VSC.

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facilities, and that such repairs might not necessarily be made at the taxpayers' own facilities. The Court observed that the VSCs required the taxpayers to cause the appropriate repairs to be done, whether by themselves or by other persons. Therefore, the Court said that when money is paid from the escrow fund to other repair facilities, this money is used to discharge an obligation of the taxpayers, and is treated for tax purposes exactly the same as money that goes to the taxpayers directly. In either case, the taxpayers have a fixed right to receive the money, and that right is established with sufficient certainty in the year that the vehicle service contracts are sold.

DEALERS' TAXABILITY ON ESCROW INCOME

Concerning the taxability of income earned from investing the amounts placed in escrow, the Appeals Court upheld the Tax Court that this investment income should also be included in the taxpayers' income, in whatever year the investment earnings were realized.

The Appeals Court said, "***The hair should follow the hide*** ... The escrowed amounts are held for the benefit of the taxpayers, either for payment directly to them or for discharge of their obligations under the vehicle service contracts. Money earned by these amounts should follow the same path for tax purposes."

However, the Appeals Court then drew a distinction: It noted that the escrow account was administered, during successive periods of time, by two separate administrators. The government's brief had conceded that under the Mechanical Breakdown Protection (MBP), Inc. program, the Administrator was entitled to accrued investment income attributable to unconsumed reserves in the escrow fund. The Court said that it was "...Not certain what view the Tax Court took of this species of accrued investment income. The taxpayers never had, and would never achieve, a right to these particular funds. They belonged unconditionally to MBP. Accordingly, it would not be appropriate for this sort of investment income to be taxed to the taxpayers."

The Appeals Court directed the Tax Court to modify its judgment to take these factors into account.

CURRENT YEAR DEDUCTIBILITY OF ADMINISTRATORS FEES

When the vehicle service contracts were sold, a portion of the sales proceeds was paid into an escrow fund. Some of this portion was then paid to the third-party administrators as a fee for services. The dealers had claimed a deduction, ***in the year of payment***, for the amounts paid over as fees in this manner.

The Tax Court rejected the claim: It held that no deduction would be allowed until the years in which services were actually performed. However, the Appeals Court disagreed with the Tax Court on this.

The Appeals Court said, "If taxpayers are going to be required to take into income the entire amount paid into the escrow fund in the year of receipt and payment, we think, ***as a matter of fairness***, that they should also be allowed to deduct, in that year, the entire amount of the fee paid to the Administrator. Just as taxpayers, in effect, are selling a service warranty to the buyers of cars, and assuming, in the year of sale, the entire risk attendant on such warranty, the Administrator is selling to the taxpayers its undertaking to administer the fund-with respect to the particular VSCs sold in a given year.

"In addition, the Administrator immediately performs substantial services, including supplying promotional materials and forms necessary to implement the contract. To be sure, the Administrator would later do other work, but its undertaking to do this work was unconditional. ***It is not fair*** to require the taxpayers to recognize as income all of the money paid into the escrow fund, while denying them a deduction for amounts actually paid out of that fund in the same year.

"In so holding, we mean to establish no general rule. We hold only that ***what is sauce for the goose is sauce for the gander***. In the tax year in which the fees are paid to the Administrator, all events have occurred that establish liability for that payment, and the amount of the liability can be determined with reasonable accuracy. The Commissioner argues that economic performance has not yet occurred with respect to the liability, because the services in connection with which the Administrator must incur costs have not yet all been performed [citing Reg. Sec. 1.461-4(d)(4)(i)].

"While this is certainly true in the abstract, the question in this case is whether the method of accounting proposed by the Commissioner *clearly reflects income*. To answer that question ***both income and deductions must be considered***. If the income is to be recognized, and we have upheld the Commissioner's decision on that point, the deduction associated directly with it should also be recognized."

WHAT'S NEXT?

The case was sent back to the Tax Court with instructions to enter judgment consistent with this opinion. Notwithstanding this setback by the Appeals Court, the IRS announced recently that its position is still that fees paid to a third-party administrator should be allocated over the term of the contract instead of being deducted up front.

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VEHICLE SERVICE CONTRACTS, DEALER OBLIGORS & THE SERVICE WARRANTY INCOME METHOD

VSCs SWIM

This is an update of the article entitled "Vehicle Service Contracts, Revenue Procedure 97-38 & the SWIM Method for Dealer Obligors," which appeared in the September 1997 *Dealer Tax Watch*. That article was written when the Tax Court decided *Rameau A. Johnson* (a case involving dealer obligors). As part of our current coverage of the Eighth Circuit's hearing of *Rameau Johnson* on appeal, it seems appropriate to update our earlier article on VSCs.

Individuals familiar with the dealer aftermarket over a number of years recall the major shake-out that occurred in the mid- to late 80s as many companies selling extended warranty or vehicle service contracts went out of business for a number of reasons. In the early 90s, the IRS was intensively auditing dealerships and taking the position that dealer obligors were required to pay tax on all of the VSC revenues in the year of sale.

The IRS position was formalized in TAM 9218004 and subsequently followed by the promulgation of the SWIM or Service Warranty Income Method in Revenue Procedures 92-97 and 92-98. Since then, a number of considerations have had some impact on the viability of service contracts.

CONSIDERATIONS AFFECTING VSCs

- The trend toward longer manufacturers warranty terms,
- The increase in frequency of selling VSCs on used vehicles,
- The growth of leasing: Almost one-third of the number of leasing customers end up buying their cars, and this seems to make it less expensive for them to buy a service contract up front if they think that they will keep their car,
- Car buyers have kept their cars longer and spread their payments out over longer periods of time,
- Many purchasers of service contracts seem willing to accept at $100 or $200 deductible on repairs, while still insulating themselves from major repair bills that run into considerably more money,
- More actuarial data has been collected for the purposes of establishing more accurate rates, and
- The quality of used vehicles and maintenance requirements have helped to keep VSC rates more competitive.

Exclusionary contracts which spell out only those repairs excluded from coverage under the vehicle service contract are also becoming more popular, and this has become significant in connection with vehicles coming off lease and program cars.

Manufacturers warranties vary greatly in what they cover, and usually there is a 3-year / 36-month time limit or a 36,000 (or longer) mileage limit, with the manufacturers' warranty expiring as soon as either the time or the mileage limit is reached.

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

DIFFERENT OBLIGORS

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

Under different VSC variations, different parties may be contractually obligated to the purchaser of the vehicle to repair it when covered repairs are needed.

The party obligated to the purchaser of the VSC to repair the vehicle is called the ***obligor***. There are four potential parties who may be the obligors under a VSC: (1) the dealership, (2) a third-party administrator, (3) the manufacturer, and/or (4) a property and casualty insurance company.

DEALER OBLIGOR. Some programs sold to customers are contractual relationships in which the dealership is the obligor, contractually liable to the purchaser to repair the vehicle. Where the dealership is the obligor, the dealership may either self-administer the plan or contract with an administrative service company (known as a third-party administrator) to

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handle the claims. The dealership then decides whether it will self-insure or purchase insurance to protect itself against adverse risk. Often, the third-party administrator will be affiliated with an insurer providing that insurance product. Many insurers have different programs. This, in turn, results in dealers "negotiating" different prices to customers for their VSCs.

THIRD-PARTY ADMINISTRATOR AS OBLIGOR. In some instances, the third-party administrators function as service companies that are named as the obligor, thus relieving the dealership of its liability. In these instances, the third-party-administrator markets a package or program through the dealership which the dealership sells to customers for prices which vary depending on the terms of the VSC and the type of vehicle being insured. In these instances, the dealer is not the obligor and is only acting as an agent. In these situations, a dealership that sells a VSC for $1,000 and remits $600 to the third-party administrator is entitled to fully deduct the $600 payment at the time of the payment. The dealership is taxed on only the net $400 it retains as a "commission" for selling the VSC.

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

Other possible obligors include (1) the manufacturers who have similar programs in which the administrators and the insurers are both affiliated with the manufacturer, and (2) certain property and casualty insurance company obligors who sell their mechanical breakdown insurance policy through an insurance agent on a commission basis in the dealership.

CHANGING LEGISLATION

Over the years, the service contract industry was populated by many small companies that had poor service records. Often these companies were inadequately capitalized to service warranty customer claims. In the early days, nearly every state required the dealer to be the obligor. Over a period of time, however, these states have decreased in number.

At the present time, it appears that there are only 10 states left with statutes that specify the dealer as the obligor in the sale of a service contract:

DEALER OBLIGOR STATES

- Connecticut
- Montana
- Nevada
- New Hampshire
- New Jersey
- New Mexico
- North Dakota
- South Dakota
- Vermont
- Virginia

The National Association of Insurance Commissioners (NAIC) drafted model legislation several years ago and that has been circulated among the states, resulting in a significant reduction of remaining dealer obligor states.

In Illinois, service contract legislation was passed during the final days of the 1998 legislative session. The major provision of HB3464 changed Illinois from a dealer obligor state to an administrator obligor state under which the third-party administrator became financially responsible for all service contracts. The Illinois Service Contract Act was approved by Illinois Governor Jim Edgar on August 7, 1998 and became effective applying to all service contracts sold or offered for sale 90 days after the effective date of the Act.

The intent of the model legislation is simply that dealers should be considered as sales agents and not the obligors, in the sale of service contracts. *Rameau Johnson* and the associated dealers were dealer obligors whom the IRS challenged successfully in the Tax Court and slightly less successfully on appeal.

MINIMIZING ADVERSE TAX TREATMENT

Clearly, the general rule is that payments received by an accrual-basis taxpayer for services to be performed in the future must be included in gross income in the taxable year of receipt. The IRS recognized that this treatment created a significant cash flow problem for auto dealers who were obligors under the VSC contracts they sold. The Service wanted to provide relief, but still have a method that would "generally conform economically to the tax treatment of advance payments under current law." Accordingly, the IRS/Treasury devised a method that permits dealers "to recognize and include in gross income, generally over the period of their service warranty contracts, a series of equal payments, the present value of which equals the portion of the advance payment qualifying for

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(Continued from page 11)

deferral." This method is referred to as the "SWIM" method (Service Warranty Income Method), and it is not limited to retail automobile dealers.

The IRS needed to do something to placate dealers and the National Automobile Dealers Association over the front-end taxation of all of the VSC proceeds in the year of sale. Accordingly, the IRS issued Revenue Procedure 92-97 dealing with the deduction/expense side of the VSC transaction and Revenue Procedure 92-98 dealing with the income side. These Revenue Procedures were issued in November of 1992.

Subsequently, they were updated and superseded by Revenue Procedures 97-37 and 98-60, while

see **VSCS, DEALER OBLIGORS & THE SWIM METHOD**, page 16

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Gross income is reported by A as follows:

Description of Item	1997	1998	1999	2000	2001	Total 5 Years
Non-deferred Income	$2,000	-	-	-	-	$2,000
Deferred Income	1,439	$ 1,439	$ 1,439	$ 1,439	$ 1,439	7,195
Gross Income	$3,439	$ 1,439	$ 1,439	$ 1,439	$ 1,439	$9,195

S CORPORATION STOCK BASIS ADJUSTMENT

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

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

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

SWIM METHOD TABLE OF FACTORS[†]

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

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

NOTES

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

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

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

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

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

THE SWIM METHOD ENTAILS AN ADDITIONAL COST EACH YEAR FOR THE PRIVILEGE OF DEFERRING A PORTION OF THE VSC INCOME BEYOND THE FIRST YEAR.

As the example on the facing page shows, the cost of the Service Warranty Income Method deferral is the additional tax ***each year*** on the imputed income amount of $239 ($1,439 - $1,200 = $239). For some taxpayers, the additional tax cost of this deferral benefit may not be justified: If so, obviously they should not make the SWIM election. This conclusion will vary depending on the calculations and the facts and circumstances of each case.

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CHECKLIST FOR VSC ISSUES & PROBLEM AREAS

1. ***Review the dealership's tax return filed for 1992 (or for a later year) to verify that the dealership did voluntarily change to the Service Warranty Income (SWIM) Method under Rev. Procs. 92-97 and 92-98.***

2. ***Determine that the dealership was eligible to adopt or to change to the SWIM method, and that it was not "outside the scope" of the applicable Revenue Procedure when the election was made.***

These "eligibility requirements" are found in Sections 4.03 and 4.04 of Revenue Procedure 97-38, and they may have been overlooked in some cases. The dealer already must be following an IRS approved method - consistent with the *Schlude* case - for including the entire amount of the advance payments in income in the year of receipt, and the dealership already must be capitalizing insurance premiums paid and amortizing that expense over the life of the contract.

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

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

3. ***If the dealership adopted the SWIM method by attaching a statement to its timely filed income tax return, verify that the statement contained all of the required elements:***

    a. A paragraph stating that the dealer is electing the Service Warranty Income Method (SWIM) for all advance payments (as defined in Rev. Proc. 97-38) received in the current taxable year and to be received in subsequent taxable years;

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

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

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

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

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

NOTE: These statements were also required for SWIM elections under Rev. Proc. 92-98.

(continued)

4. ***Review the dealership's tax returns for each subsequent year (i.e., after the election of the SWIM method) to be sure that the dealership has complied with the SWIM annual reporting requirements by attaching a statement setting forth:***

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

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

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

   Be especially careful with respect to the changing interest factors from year to year and to the different "classes" of VSCs (...3yr-4yr-5yr...), each of which requires different factors.

5. ***Confirm that the dealership has made payments on all VSC contracts within sixty (60) days after customer payment to an unrelated party.***

6. ***Review all existing VSC contracts and programs (with counsel) to determine that appropriate reporting and elections have been made for all VSCs for which the dealer is the dealer obligor. Some older plans may have been replaced over time by newer plans, or the dealership's status as obligor may have changed due to a change in state law or due to other circumstances.***

7. ***Be especially careful of the GAAP requirements for reporting VSC income.***

8. ***If the dealer obligor is eligible to elect the SWIM method, but hasn't, compute the after-tax comparison of SWIM and non-SWIM methods to support a decision to elect or not to elect the SWIM method. Possible scenarios for dealer obligor situations include:***

   a. The SWIM method has not been elected. One reason: the SWIM method was never heard of, nor considered, even though the dealership is the obligor on the VSCs. Another reason: the dealership is "not within the scope" of Rev. Proc. 97-38 and is ineligible to make the SWIM election because it is using improper methods for reporting VSC income and deducting premium payments. Still another reason: Computations were made comparing the after-tax results (1) using the SWIM method and (2) not using the SWIM method, and the decision was consciously made not to elect the SWIM method even though the dealership was eligible to make the election.

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

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

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

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

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

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the Service Warranty Income Method was updated in Revenue Procedure 97-38. Section 5.02 of the Appendix to Revenue Procedure 98-60 (1998-51 I.R.B. 16) permits eligible taxpayers to make the change to the SWIM method using a cut-off method, thus avoiding the need for an adverse Section 481(a) adjustment.

It should be noted that under Revenue Procedure 97-38, a dealer not already amortizing insurance premium payments may not use the SWIM method without first changing to amortize the insurance premium payments. For further details relative to the updated IRS procedures for automatic accounting method changes, see Revenue Procedure 98-60.

TWO IMPORTANT CAUTIONS IN USING THE SWIM METHOD

First, the typical dealer who sells VSC plans with different years of coverage will have more than one factor for each year. This is because the Table has a different column/factor for each different "Term of Service Agreement in Years."

Second, there is likely to be a different "Applicable Interest Rate" factor for each year. This is because interest rates usually change from year to year. So if you are reviewing a dealers' calculations over a period of years, and the applicable interest rate being used for every year is the same, there could be something (significantly) wrong with the calculations.

As indicated earlier, Revenue Procedure 97-38 now describes the SWIM method for treating part of the income payments received in the year of sale in a specialized manner. Revenue Procedure 98-60 contains the procedures for obtaining automatic IRS consent to change to the SWIM method, as well as to make a corresponding change in the treatment of deducting insurance premiums related to the multi-year service warranty contracts. If a dealer had properly changed to the SWIM method ... in 1992 or a later year ... pursuant to Revenue Procedure 92-98, it was <u>not</u> required to do anything further to comply with the restatement Revenue Procedure 97-38, nor to refile any Forms 3115.

Included in the previous pages are an example of how the SWIM method works and a checklist relating to vehicle service contract issues and problem areas.

CONCLUSION

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

Some dealers may have made the election to use the SWIM method...even though at the time they were ineligible to do so. Therefore, the status of the dealership as being "within the scope" of the SWIM Revenue Procedure when the election was made should not be taken for granted. Instead, it should be confirmed and documented for obvious reasons. ✲

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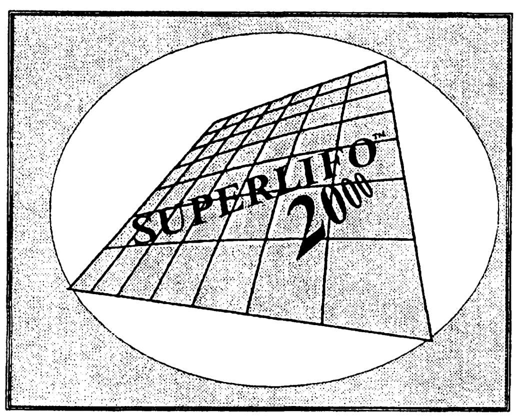

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DEALER OFF-SHORE REINSURANCE ARRANGEMENTS GET SOME FAVORABLE GUIDANCE FROM THREE RECENTLY PUBLISHED IRS DOCUMENTS

Many dealers have realized significant tax savings—not to mention greater profits—by setting-up off-shore reinsurance companies in connection with the sale of extended warranty (vehicle service) contracts, credit, accident and health insurance, and other after-market products. Recently, these dealers received some good news as the IRS shed further light on off-shore arrangements in several documents.

Clearly, one of the reasons a business would have for setting up a captive insurance company would be so that premiums it paid to insure its property and risks would be deductible under Section 162. However, if there were no shifting of economic risk or distribution of the risk insured, the payments would not be deductible under Section 162. (Rather, they would be treated as non-deductible amounts set aside for self-insurance.) Another incentive for using captive insurance companies is that, if properly structured, they pay little or no income tax and, thus, afford significant tax-sheltering opportunities.

The Internal Revenue Service and the courts have consistently held that amounts set aside as a reserve for self-insurance, although those amounts may equal commercial insurance premiums, are not deductible for income tax purposes as being "ordinary and necessary expenses paid or incurred during the taxable year." Even if a self-insurance fund is administered by an independent agent, that fact alone does not make payments to the fund deductible.

In October of 1991, the IRS released a Coordinated Issue Paper entitled, "Deductibility of Captive Insurance Premiums Paid to Parent Company." This CIP addressed the issue of whether insurance premiums paid directly or indirectly to a captive insurance company would be deductible by its parent (and related entities) under Section 162 where:

- the captive insures only related entities,
- the captive insures third-parties in addition to related entities, and
- the captive is owned by associations or groups of unrelated entities.

In this CIP, the IRS said that since the publication of Revenue Ruling 77-316 and other rulings and its success in the *Carnation Company* case, many taxpayers had reoriented their operations of captives to include the insuring of third-party unrelated business. Taxpayers hoped that this would differentiate them from Revenue Ruling 77-316 and the *Carnation* holding in which the captive insurance company insured only its parent and related entities. Accordingly, they believed that by issuing third-party insurance (through pooling arrangements, reinsurance agreements, reciprocal deals, direct underwriting, and other association activities), they should be able to substantiate the deduction of insurance premiums as a Section 162 expense.

The CIP "concluded" that in order to have a valid deduction for insurance premium expense in all three situations listed above, there must be (1) true shifting of risk and (2) risk-distribution. Insurance contracts that contain these two requisites will qualify as valid insurance agreements. It would appear that this vaguely worded CIP simply became the support document enabling any field agent to take the position that either one or both requisites were missing from whatever arrangement happened to be under review.

TAM 199924001

In IRS Technical Advice Memo 199924001 dated February 9, 1999, the National Office ruled that a taxpayer ***could*** deduct the premiums which it paid for insurance to an unrelated insurance company where its risks were partially reinsured by a related insurance company.

The issue as stated in the TAM was: whether a portion of the payment by the taxpayer to an unrelated Insurance Company A for insurance coverage should be disallowed under Section 162 as self-insurance to the extent that a portion of the payment was allocated to that taxpayer's Redemption Account in an off-shore Insurance Company B. In this case, the National Office was favorably impressed because the taxpayer's Redemption Account was impacted by the loss experience of other unrelated shareholders participating in the Program, and the Account balance was not required to be refunded to the taxpayer in the event the taxpayer had favorable loss experience.

Insurance Company A was a multi-line insurer writing property and casualty insurance for institutions and individuals nation-wide. It was not related to the taxpayer or to Insurance Company B. Insurance Company B was an insurance corporation that was a multi-line indemnity reinsurer. It was domiciled in a foreign country where it satisfied all applicable reinsurance laws and regulations and all requirements as to

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minimum capitalization and financial strength. The taxpayer involved in the TAM was one of approximately 40 unrelated shareholders of Insurance Company B, whose business consisted solely of the provision of indemnity reinsurance of policies issued by Insurance Company A to Insurance Company B's shareholders. The policies issued by Insurance Company A to the taxpayer were partially reinsured by Insurance Company B during the year.

In this TAM, the IRS said that in order to determine whether a premium paid to a related company was insurance (rather than self-insurance), all of the elements of a broader three-part test must be satisfied:

1. The arrangement must involve an ***insurance risk***,
2. There must be risk-shifting and risk-distribution, and
3. The arrangement must be for ***insurance***.

In this situation, the Appeals Officer apparently believed that risk-shifting and risk-distribution had not occurred because of the presence and involvement of a related reinsurance company (B). As noted above, the taxpayer was one of approximately 40 shareholders in one of the insurance companies (i.e., it was an "exotic" company). This company had two classes of stock with significantly detailed rights and privileges attaching to each class of stock.

The TAM contains a detailed discussion of the terms, rights and privileges and potential adjustment sources for each of the classes of stock and the related Redemption Account computations. The Appeals Officer had taken the position that a portion of the payment made to the unrelated insurance company which was ceded to the related insurance company and ultimately allocated to the taxpayer's Redemption Account was not deductible as a premium "paid" or "insurance." The Appeals Officer believed that because the taxpayer's Redemption Account was to be adjusted for claims made by the taxpayer, and because the Redemption Account was actually redeemed by the taxpayer, the amounts paid into the Redemption Account during the year in issue were amounts set aside for self-insurance (and, therefore, non-deductible).

The taxpayer had argued that the fact that its Redemption Account was adjusted by claims made by it did not, in and of itself, establish that amounts paid into the Redemption Account were amounts set aside for self-insurance. The taxpayer argued that the losses of the other participants would reduce the value of the taxpayer's Redemption Account balance, and such charges might cause the taxpayer's Redemption Account balance to become negative. The bottom line was that the Redemption Account was simply a method by which the taxpayer's equity interest in the related insurance company was measured.

In TAM 199924001, the National Office held that the portion of the payments made to the unrelated insurance company which were ceded to the related insurance company and ultimately allocated to the Redemption Account balances satisfied the concepts of (1) ***risk-shifting*** from the taxpayer to both the unrelated and the related insurance company, and (2) ***risk-distribution*** because all participants holding Redemption Accounts were potentially affected by each other's negative experience.

The National Office focused on the fact that the taxpayer's Redemption Account could be impacted by the negative experience of other participants and that this adverse experience by other participants could reduce that Redemption Account balance without limitation. Conversely, while the taxpayer's own adverse experience could reduce its own Redemption Account balance to a negative amount, the unrelated insurance company could not charge any additional premium for the relevant period.

The taxpayer had no right to the return of amounts paid into the Redemption Account even if it had no insurance claims which would otherwise reduce the balance in its account. Its premiums could not be adjusted to accommodate unexpectedly adverse loss experience which it might suffer. All of these influenced the National Office in reaching the conclusion that the portion of the payment by the taxpayer to the unrelated insurance company for insurance coverage which is allocable to its Redemption Account in the related insurance company should not be disallowed under Section 162 as self-insurance.

NO FIREWALLS

One very astute observer on dealer reinsurance and exotic company arrangements is Steve Mailho. Steve (actually John S. Mailho or JSMailho @ReinsuranceNet.com) publishes a periodic "Reinsurance Network E-News/E-Mail" which is very informative. In discussing TAM 199924001, Steve observed, "If a preference shareholding (dealer's stock) is insulated from loss of other preference shares (dealers), the result would be self-insurance and fatal to the tax structure." In other words, dealers must be "at risk" to incur the adverse experience of other dealers participating in the exotic off-shore company.

In his E-News article *Dealers **MUST** Share Risks With Other Dealers in an Exotic Company* discussing this TAM, Steve asks the question: "Do any of your

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dealers or prospects belong to any "exotic" company where the promoter exclaimed, '...No, no, no, your stock profits are not diluted when losses occur in the other dealerships!'?" He continues that if the dealers do own shares in this type of exotic company, then that reinsurance company structure would be faulty for tax purposes or the promoter was mistaken in his or her statements.

Steve concludes: "Thus, if there is a firewall around the dealer's profits, the company structure does not work for tax purposes. This would also apply to the claim that the company is a non-controlled, foreign corporation for tax purposes. ***If there is a firewall, the tax structure fails.*** The IRS will consider the preference share to be a 'company within a company' controlled by the dealer ... and the income would be forced upon the dealer's personal tax return."

This recent TAM development makes it important for CPAs who have dealers involved in exotic companies to review the structuring of the different classes of stock and the Redemption Account calculations.

MORE ON STRUCTURING AFTERMARKET ENTITIES... FSA 1999-953

As the above TAM indicates, the IRS has been actively challenging deductions claimed for premiums paid by a dealership to a *dealer*-owned reinsurance company. Some IRS agents still will take the position that such payments are in the nature of non-deductible, self-insurance reserve additions.

In another E-News, Steve recommended that to better defend against the IRS, the dealer should personally own his reinsurance company. This would assure a brother-sister corporate relationship and avoid the parent-subsidiary relationship (which would result if the reinsurance company were directly owned by the dealership). By employing a brother-sister corporate structure, the dealer would more closely align his fact pattern with those in *Kidde, Humana Hospital Corp. of America* and other cases which have held that brother-sister type transactions did not involve self-insurance.

As a further preventative or defensive measure, Steve recommends that the dealer's reinsurance company assume other third-party unrelated risks, such as credit life and accident and health. This would support another distinction highlighted in several other cases: Where a sufficient amount of third-party unrelated risk ensures distribution and, thus, risk-shifting, the Courts have held favorably for a number of taxpayers, including *The Harper Group, Sears, Americo, Ocean Drilling and Exploration* and others.

In recent Field Service Advice 1999-953, the issue was whether the IRS should concede a "captive insurance" adjustment that would have disallowed the deduction for insurance premiums paid. The wily IRS, of course, redacted all of the key percentages from the published FSA. However, the FSA states, "In cases in which the captive insurance company derives at least 'x' percent of its total business from unrelated entities, the rationale and holding of Revenue Ruling 77-316 ... has been specifically rejected by the Courts in (a number of cases)."

In the FSA 1999-953 situation, the taxpayer "would be able to prove that its captive insurance company derived at least 'x' percent to 'y' percent of its total insurance business from sources unrelated to the affiliated group of corporations. ...The Courts have refused to sustain the Services' adjustments in cases in which the percentage of unrelated business was as low as 'z' percent. See *The Harper Group.*"

In *The Harper Group v. Commissioner* (96 T.C. 45(1991)), affirmed 979 F.2d 1341 (9th Circuit, 1992), the Tax Court observed, "We held that where unrelated insureds comprise over 50% of a captive insurance company's business, there was risk-distribution; in *Gulf Oil Corporation*, we held that where less than 2% of a captive insurance company's business comes from unrelated insurance, there was no risk-distribution. Here (i.e., in the *Harper Group* situation), the relatively large number of unrelated insureds comprise approximately **30%** of Rampart's (the related company) business, (and) such a level of unrelated insureds, in our opinion, constitutes a sufficient pool of insureds to provide risk distribution."

Accordingly, it would appear that **30%** is the "benchmark" or "bright-line" amount. In FSA 1999-953, the IRS concluded that it should back away and pose no further challenge to the taxpayer over the deductibility of the insurance premiums paid.

In a Note (10), commenting on the brother-sister relationship of corporations, the Tax Court in *Harper Group* said, "If brother-sister corporations are considered unrelated parties, then in the instant case the percentage of gross premium income received by Rampart from unrelated parties for the years in issue would be greater than 50%. If brother-sister corporations are considered related parties, then the percentage of such income for the relevant years would approximate 30%. For purposes of this case, we need not consider whether brother-sister corporations are to be characterized as unrelated parties for ***we believe that when 30% of the captive insurer's income is received from a relatively large number of unrelated insureds, there is a sufficient pool for the occurrence of risk distribution.***"

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AND STILL MORE INSIGHT FROM ITA 199932007

In IRS Technical Assistance (ITA) Memorandum 199932007, the IRS addressed another case where the field was seeking advice on whether to concede the "captive insurance" adjustment to a taxpayer. In this case, the dealer personally owned both the reinsurance company and the automobile dealership which was selling service contracts. This was another brother-sister corporate structure relationship. The captive insurance company was formed under the laws of a foreign country, and it received substantial premium income from reinsuring unrelated risks.

This ITA dated April 12, 1999 discusses Revenue Ruling 77-316 in which the IRS expressed the position that parent-subsidiary type relationships fail to satisfy the overall "risk-shifting and risk-distributing" requirements. However, the ITA noted that in the case under consideration, it was likely that, if litigated, the Courts would look to the "recent trend among Appellate Courts in the captive insurance area to hold that the presence of unrelated risk creates risk distribution, which, in turn, results in the ability of the related parties to shift the risk of loss to their captive insurance subsidiaries. ...In these decisions, the amount of unrelated risks ranged from 29% to 99.75%. In addition, ... in *Ocean Drilling and Exploration Company*, a situation involving a captive insurance arrangement involving 44% unrelated risk was approved by the Court."

Although the IRS redacted the exact percentages of insurance business with unrelated parties from ITA 199932007, those percentages were sufficient to convince the IRS that it should not go any further in challenging the dealership's deductions for premiums paid. Therefore, the transaction was not "captive," and service contract premiums which ended up in the off-shore reinsurance company were deductible by the dealership.

COMPARING DOMESTIC VS. OFF-SHORE ARRANGEMENTS

There is a ready resource for anyone who would like a direct, side-by-side comparison of a single owner, U.S. tax-paying, off-shore domiciled company, to one of the more well-known non-U.S. tax reporting companies. All you have to do is e-mail Steve Mailho at JSMailho@ReinsuranceNet.com or call him at (800) 262-4546 in Sonoma, California.

Steve also has a modeling system that would be available to readers who might want to try it out with their own scenarios, rather than the basic fact pattern in the standard comparison. In one example we saw, based on $450,000 annual premium income, the difference in bottom line profit was almost 40% more net after-tax income ... and that was after paying U.S. income tax at an effective rate of 5.7%. *

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