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?"... In addition to "Best Wishes for a Happy New Year as we start the new Y2K millennium" ... Here's what I'd say:

#1. EVERYONE HAS THEIR FINGERS CROSSED HOPING THE IRS WILL NOT BE Y2K UNPREPARED AND HAVE TO PROCESS REFUND CHECKS BY HAND IN THE FILING SEASON THAT IS NOW UPON US. Commissioner Rossotti has been less than reassuring in some recent comments to the Congress on this subject. Although optimistic in previous reports, his last report was strong with the implications that processing refund claims manually out of the Service Centers could happen this time around. Let's hope not.

According to Rossotti, it would probably be well into the new millennium before the IRS ever got around to processing any refund checks to the more wealthy taxpayers... since the IRS would start manual processing on a "need basis," essentially refunding overpayments to taxpayers whose returns showed low income type credits and allowances.

#2. STILL NOTHING NEW TO REPORT ON THE TWO MAJOR ISSUES OF THE YEAR. You'll recall that these two issues are (1) the *Mountain State Ford Truck Sales* decision in the Tax Court which involves the industry-wide use of replacement cost, and (2) the tax treatment of service technician tool rental and reimbursement plans which involve smoke, mirrors and the accountable plan rules in Section 62(c). There are sure to be some developments on both of these next year.

To fill you in a little more on service tech tool rental plans, our update article on page 10 includes a recently published Field Service Advice involving the accountable plan rules, Ms. Baker's comments at the AICPA National Auto Dealership Conference in October, and a suggestion to the IRS for taking the *bull* by the horns.

WATCHING OUT FOR

#3. "CURRENT REAL WORLD INCOME TAX ISSUES FOR DEALERSHIPS" ACCORDING TO THE IRS MOTOR VEHICLE SPECIALIST. We have summarized many of the comments made by Mary Burke Baker on other dealer tax issues in the article on page 4. In the June 1999 *DTW*, our *Mid-Year Tax Issues Round-Up* was based on the comments Ms. Baker and others made at our *Spring 1999 CPA-Auto Dealership Niche Conference* in Las Vegas. With the passing of a few months, one can see the rounding out of several developments by comparing her comments in May with hers in October.

Ms. Baker provides insight on what IRS agents should be thinking about in auditing auto dealerships. Carefully read her comments on page 9 on demonstrator vehicles. There are still some devils lurking in the yet-to-be released details. Do you think it's any coincidence that you find a ***demon*** staring back every time you look at the word "***demon***strator?"

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

Dealer Tax Watch Out

Based on recent conversations with several practitioners, it seems many examining agents aren't thinking much about any of these issues at all. It's no secret that, as a result of the recent legislation, IRS employee morale is not nearly as high as it used to be. One might also observe that in reviewing IRS audit activity over the last 12 to 18 months, dealers are definitely the beneficiaries of a kind of lethargy/sluggishness on the part of many "kinder and gentler" IRS field agents.

Ms. Baker's more detailed comments on inventory and LIFO-related matters were reported in the December 1999, *LIFO Lookout*, and are not repeated here in the *DTW*.

#4. TERMINAL RENTAL ADJUSTMENT CLAUSES (TRACs) IN VEHICLE LEASING TRANSACTIONS. In *Peaden v. Commissioner* (13 T.C. No. 6, August, 1999), the Tax Court recently held that terminal rental adjustment clauses which kicked in at the end of the leases (i.e., that's why they are "terminal") are to be disregarded in determining initially whether a transaction is a purchase or a lease transaction.

For a discussion of this case, see page 14.

#5. REFERENCES FOR CPAs NICHED IN DEALERSHIP PRACTICE. Practitioners' Publishing Company recently released two references for CPAs working with dealerships. In our opinion, both should be part of your reference library.

The Fourth Edition (September 1999) of PPC's two volume *Guide to Dealerships* contains well-developed up-to-date material.

Volume I consists of nine chapters: (1) Overview of dealerships, (2) Operations of dealerships, (3) Accounting considerations, (4) Tax considerations, (5) Financial statement considerations, (6) Compilation and review engagements, (7) Audit engagements, (8) Valuing dealerships, and (9) Consulting services for dealerships.

Volume II consists of practice aids: (1) Firm policies, (2) Checklists, (3) Confirmation and correspondence letters, (4) Dealership audit programs, and (5) Compilation and review practice aids. In addition, an extensive self-study continuing professional education program is included.

One caution: Be careful to understand the limitations of many comments that, for audit and reporting purposes, certain transactions and lesser amounts may be ignored because they are not material. In the real world of income taxes, according to the IRS, **everything is material**.

(Continued from page 1)

Other than this qualification, the *Guide to Dealerships* is a resource well worth using in your practice.

Practioner's Publishing Company has also released the First Edition (August, 1999) of its *Specialized Industry Tax Guide*. This *Guide* includes a 34 page chapter (Chapter 8) devoted exclusively to used car dealers' tax and accounting problems.

This chapter includes: (1) **Reporting Sales from Vehicle Inventory** (Sources of Income, Customer Financing, Fees, Titling and Taxes); (2) **Handling Other Sources of Dealer Income** (Sales Commissions, Insurance Commissions, Warranty Contracts, Repossessions); (3) **Changing (A Dealer's Method of Accounting) to the Accrual Method**; (4) **Understanding and Meeting the Code's Cash Reporting Requirements**; (5) **Reporting a Dealer's Cost of Sales** (Cost of Purchased Vehicles, Auctions, Cost of Trade-ins, Determining the Cost of Trade-ins, Trade-ins Other than Automobiles, Reconditioning and Repair Costs, Transportation Expenses); (6) **Using the Proper Inventory Valuation Method**; (7) **Using Related Finance Companies** (How an RFC Works, Business Reasons for Creating an RFC, Bona Fide Entity, Economic Substance of the Receivables Purchase); (8) **Dealing with Expense Issues** (Commissions, Personal Use of an Automobile, Rent Expense, Bad Debts, Travel and Entertainment, Compensation, Reasonableness of Compensation, Undercompensation); (9) **Handling a Proposed IRS Worker Reclassification** (Dealing with an Independent Contractor Issue, Classification Settlement Program [CSP]); and (10) **Dealing with the Hot Audit Issues**.

Appendices to the used car dealers chapter include: (1) Completed Form 8300 (Report of Cash Payments over $10,000), (2) Summary of Requirements for Having a Bona Fide Related Finance Company, (3) 20 Factor Test for Worker Classification and Independent Contractor Status, and (4) Citations of Sources.

This chapter on used car dealers in PPC's *Specialized Guide* contains a number of very good "practice pointers" and other valuable information. One shortcoming, however, is the absence of any effort to cross-reference or integrate references in any of the technical discussions to any of the recent Letter Rulings and Technical Advice Memoranda issued by the IRS. Even a simple listing of these LTRs and TAMs, with a key word or topic reference, might at least alert readers to the IRS positions expressed in these sources.

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Dealer Tax Watch Out

While possibly amusing to some, one editorial practice may be annoying or distracting to others. That is the *Guide*'s selection of derogatory names in the examples throughout the chapter (i.e., *Flatbroke, Crooked, Scruples, Wreckless, Buy-A-Wreck, Shady, Sham, Jalopy, Legbreakers, Sellawreck* ... get the point?) These names probably could be replaced by more generic and possibly less-offensive choices.

#6. YEAR-END REMINDERS REGARDING LIFO fill the December 1999 issue of the *LIFO Lookout*. This issue includes a "Year-End Alert on Conformity Reporting Requirements and Projections for Year-End Planning" and information for "Quick Year-End Inflation Estimates for Auto Dealers: 1999-2000 New Vehicle Inflation Survey Assuming Ending Inventory Mix of One-of Each Item Category." This issue of the *Lookout* was mailed on December 20 and included a round-up of all of the LIFO-related comments Ms. Baker made at the AICPA Conference. We repeat below one reminder of great importance.

(Continued)

#7. DON'T FORGET JANUARY 31, 2000 IS THE DUE DATE FOR DEALERS' PENALTY SETTLEMENT PAYMENTS FOR CONFORMITY VIOLATIONS. For auto and light-duty truck dealers, January 31, 2000 is the due date for their third and final installment payment. For medium and heavy-duty truck dealers, January 31, 2000 is the due date for their second installment payment.

In October at the AICPA Conference, Mary Baker indicated that she anticipates the IRS will probably do some type of "compliance checking" to follow-up on collections from dealers paying settlement fees to avoid termination of their LIFO reserves. Ms. Baker had previously reported that some auto dealers had made their first payment, but not the second. These dealers deliberately gave up all amnesty protection they might otherwise have had under the Revenue Procedure. They'd better be right!

So far, there is no evidence of any follow-up effort by the IRS. Will those who urged errant dealers to comply and pay up look foolish for having done so? Will the IRS see this follow-up as a way to demonstrate its commitment to its mission statement to apply the law with integrity and fairness to all?

Maybe we'll know in a few more years.

CURRENT REAL WORLD INCOME TAX ISSUES FOR DEALERSHIPS... AN UPDATE FROM THE IRS MOTOR VEHICLE INDUSTRY SPECIALIST

HOT TOPICS

At the AICPA Dealership Conference in October, Mary Burke Baker had two opportunities to discuss dealer tax issues and other inventory-related issues. In the morning, she spoke for an hour on "Current Real World Income Tax Issues for Dealerships." After lunch, she participated in a question and answer session, along with James Minnis, Esq., from NADA, and Leslie J. Schneider, Esq., of Ivins, Phillips & Barker, Washington, D.C.

Ms. Baker's comments on LIFO-related matters included: (1) IRS policing of conformity violation payments and non-payments, (2) the use of replacement cost for valuing parts inventories, (3) the lack of any current activity by the Service to formulate an "officially approved" method for used vehicle LIFO computations, and (4) the so-called "52-week" method set forth in TAM 9853003 for determining used vehicle inflation indexes. These comments are discussed in the December 1999 issue of the *LIFO Lookout*.

In this article, we have recapped–or in some cases, reproduced almost verbatim–Ms. Baker's comments regarding current (non-LIFO) tax issues.

On page 6, we have reprinted from the June 1999, *Dealer Tax Watch* all of the slides Ms. Baker used in her mid-year update at our Conference. Where appropriate, we have mentioned new material that she added for her October presentation. If you would like a copy of all of her October presentation slides, you can request them directly from her by phone at (616) 235-1725 or by e-mail: Mary.B.Baker @m1.irs.gov.

HOT TOPICS

- Used Car Writedowns
- Sub-Prime Financing & Related Finance Companies
- Dealer Software & Replacement Cost for Parts Inventories
- Leasing Issues: Substance vs. Form
- Equipment Leasing
- Technician Tool Rental and Reimbursement Plans
- Extended Service Contracts
- Manufacturers' Incentive Payments
- Depreciable Life of Certain Dealer Realty
- Demonstrator Vehicles
- Reporting Factory Finance Assistance Payments
- Other Audit Activity Considerations

USED CAR WRITEDOWNS

Ms. Baker said that if she is invited back next year, the subject of used car writedowns "is not going to be on (her) list." She indicated that the Service is "...conceding to all of your demands, and we're dropping the issue." In her view, the issue hinged on whether a used car was a *normal* good or a *sub-normal* good ... and she said, "I just don't see it going any other way than that a used car is a *normal* good in the context of a used car market."

Ms. Baker said that Revenue Ruling 67-107 is applicable, and that she would be advising agents who are calling on this that "it is an issue no more."

Although there may be situations that do not fit or fall under Rev. Rul. 67-107, in general the Service should not be pursing this issue any more. She told the audience, "If you have any live audits where this is an active issue, please encourage the agent to contact us, and we will advise them of this."

SUB-PRIME FINANCING & RELATED FINANCE COMPANIES

Ms. Baker noted that sub-prime financing and RFCs are other areas that the Service has spent a lot of time on during the past year. These have to do with customers that can't go to a bank or a credit union to get credit to buy a car. Instead, the dealer writes a note directly with the customer. That note, then, is transferred almost immediately to a finance company. She said that there was one TAM out in late 1998, and two TAMs in early 1999 which are very similar to the first TAM. Her slides referred to TAMs 9848001, 199909002 and 199909003. For detailed discussions of these TAMs, see the December 1998, and the March 1999, issues of the *Dealer Tax Watch*.

Ms. Baker said, "The primary issue is whether or not transfer of that contract to the finance company is a sale or an assignment or a loan or some other arrangement. In all three TAMs, the National Office determined that there was a sale (rather than a loan or some other type of financing arrangement) based →

on an analysis of the benefits and burdens of ownership. It concluded in all three cases that more of the benefits and burdens transferred to the finance company than stayed with the dealer.

"Once that decision is made, then you have to determine how much the amount is that the dealer has to report as the proceeds from this sale. And that's where it gets sticky. We have a nice, slick, little formula in the TAMs that says that the amount realized is the cash advance received plus the fair-market value of the right to any back-end distribution payments. Well, the cash received ... the cash advance is real easy. But that fair-market value is real difficult, particularly when you consider that Section 483 comes into this where you have contingent payments. You have to factor in the time value of the money and recharacterize some of the back-end distributions into interest and not principal. So, it becomes sort of a circuitous computation that is very, very difficult.

"When you have sub-prime customers, you don't know **if** you're going to collect...you don't know **when** you're going to collect...and you don't know **how much** you're going to collect. So, this a very complex problem. ***We recognize that we have a technical answer, but we probably don't have a practical answer to the problem.*** We're hoping that we can try to get some sort of guidance out there–whether it's through a Revenue Ruling, Revenue Procedure, Coordinated Issue Paper. We've discussed all sorts of alternatives to try to approach this, to try to give some practical guidance.

"In the *Hansen* case (the Supreme Court case where the issue was a dealer reserve that was held back by the finance company), the dealer was not recording that reserve in income. The Supreme Court determined that it (i.e., the holdback) did need to be included in income all in the year of sale of the notes. There is still a lot of controversy as far as whether *Hansen* applies or whether these payments are truly in the nature of a contingent payment, and that the reserve can be relegated to the fair-market value of the reserve as opposed to the full face value of the reserve.

"At this point, I think that the TAMs have indicated the direction that we are going at this point, but I will tell you that there is dissension within the halls of the National Office on whether *Hansen* overrides or whether Section 483 overrides. So, it is entirely possible that you could see some decisions coming out or some sort of guidance coming out that may be in contrast to what the TAMs say. This is quite controversial, and we will keep you posted as this develops."

Ms. Baker's slides included a listing of the sub-prime financing issues. The issues include: (1) Is the transaction a sale or a financing transaction? (2) Are all back-end payments contingent payments? (3) How should the fair market value of the right to receive back-end distributions be valued? (4) How do the Section 483 imputed interest provisions apply? and (5) How can the economic reality of these transactions be rationalized with their income tax treatment?

Her slide on the resolution "status" of these issues indicated that the Service was working with industry associations and practitioners toward a technically correct and practical computation. Eventually, guidance may come in the form of (1) an MSSP Audit Technique Guide, (2) a Revenue Ruling, (3) a Revenue Procedure, and/or (4) a Technical Advice Memorandum. Obviously, only the second and third alternatives would provide taxpayers with any assurance that is really binding on the IRS.

DEALER SOFTWARE & REPLACEMENT COST FOR PARTS INVENTORIES

The dealer software issue is another one mentioned last year that has greatly troubled the Service. Concerning *Mountain State Ford*, the Service recognizes that "the software that the dealers are using to measure their parts inventory is loaded up using replacement cost, and that there's no place in there for actual cost or the actual date of acquisition. We have been working with some software venders to try to figure out what we can do about this, and it all dovetails into the *Mountain State Ford* situation and the work that we're doing with NADA to try to resolve this issue."

Speaking candidly, Ms. Baker added, "Although I would like to say that we've made progress on the general issue of dealer software and whether or not it meets the requirements of our Revenue Procedure 98-25 (as far as the retention of electronic records), we can only juggle so many balls at one time. We have not made any further movement on this...we have recognized that there are some problems when our computer people go out to a dealership, and try to load up the electronic information, they're having a problem accessing that. That is something that I hope that in the next year we will have some more time to focus on."

The number of slides in Mary's presentation discussing the use of replacement cost expanded from two at mid-year to seven for her October presentation, indicating that her Office–as well as the rest of the IRS–has been very busy with *Mountain State Ford* and its implications.

see **CURRENT REAL WORLD INCOME TAX ISSUES**, page 7

INTERNAL REVENUE SERVICE
MOTOR VEHICLE INDUSTRY SPECIALIZATION

*Presented by Mary Burke Baker**
at the SPRING 1999 CPA-AUTO DEALERSHIP NICHE CONFERENCE
* (616) 235-1593

MVISP TEAM MEMBERS

- Mary Baker, Industry Specialist
- Terry Harris, Assistant Specialist
- Tim Coyle, Team Member
- Fred Gavin, Appeals
- Grant Gabriel, District Counsel
- Jeff Mitchell, Chief Counsel
- Richard Berken, Chief Counsel
- Willie Armstrong, Chief Counsel
- Melissa Brainard, Audit Aide

IRS MISSION STATEMENT

- Provide America's taxpayers top quality service
- Help them understand and meet their tax responsibilities
- Apply the tax law with integrity and fairness to all

ROLE OF THE ISP

- To coordinate the identification, development and resolution of issues common to the motor vehicle industry
- This requires communication and cooperation between industry personnel and IRS personnel

CURRENT EVENTS

- Inventory issues
  - LIFO - Parts inventory
  - LIFO conformity
  - Used car LIFO
  - LIFO pooling
  - Used car writedowns
- Subprime financing
- Dealer software programs
- Manufacturers' incentives
- Leasing issues
  - Capital cost reduction
  - Interest subvention
  - Residual value insurance
- Demonstrators
- Service technicians' tools
- ISO 9000
- Remanufactured cores
- Research credit

LIFO - PARTS INVENTORY

- *Mountain State Ford*, 112 TC No. 7
  - Cost is actual cost
  - Replacement cost doesn't clearly reflect income
  - Termination appropriate
  - Restoration of reserve not abusive
  - Administrative burden not determinative
- Impact on industry
  - "No harm, no foul?"
  - Termination?
  - Change in method?
  - Software considerations
- IRS response
  - Analysis of case
  - Discussions with the industry
  - IRS pronouncement?

LIFO CONFORMITY

- Revenue Ruling 97-42
- Revenue Procedures 97-44 and 98-46
- "Election" of settlement
- "Unelection" of settlement
- Mathematical errors
- Compliance checks
  - Initial settlement
  - 2nd and 3rd payments

USED CAR LIFO

- An oxymoron?
- How to value the item
  - Age to age, or model to model?
- Other problems inherent to LIFO
  - Valuation Dates
  - Pricing
  - Recordkeeping
- TAM 9853003
- Simplified method-revenue procedure?

LIFO POOLING

- TAM 199911044
  - Franchises
  - Geography
  - Management
  - Recordkeeping
  - Advertising
- Sport utility vehicles
  - Cars or trucks or other?

USED CAR WRITEDOWNS

- Revenue Ruling 67-107
- Reg. 1.472-2 or 1.472-4?
- PLR or TAM

SUB-PRIME FINANCING

- 2-sided issue - Dealer & finance company
- Dealer TAMs 9840001, 199909002, 199909003
- Sale
  - Amount realized = cash + FMV other
  - Back-end distributions
    - Determining FMV
    - Contingent payments - Section 483
      - Principal
      - Interest
    - Payment trail
- MSSP Audit Techniques Guide
- Revenue procedure
- Consistency between dealers and finance companies

DEALER SOFTWARE

- Revenue Procedure 98-25
  - Electronic records
  - Retention/Accessibility
  - Hardware & software concerns
- *Mountain State Ford* (parts)
  - Revision of programs for actual cost
- IRS/Industry initiative
  - Identify & rectify problems

MANUFACTURERS' INCENTIVES

- Current policy
  - Revenue Ruling 70-337 Benchmark
  - Wages? - No!
    - FIT? - No!
    - FICA? - No!
  - Self-employment income? - No!
    - SECA - No!
    - Schedule C deductions? - No!
  - Taxable income? - Yes!!!
- Affects many industries
- Ongoing questions
  - Degree of dealer involvement
  - Specific programs

LEASING ISSUES

- Capital cost reduction
  - Dealer role - lessor or agent for lessor?
  - Current income
  - Adjustment to basis?
- Interest subvention
- Residual value insurance
  - TAM 9830001

DEMONSTRATOR VEHICLES

- Section 61
- Section 132
- Section 274
- Notice 89-110
- LTR 9801002
- LTR 9816007
- Recordkeeping requirements

SERVICE TECHNICIANS

- Service technicians
  - Reimbursement for tools in lieu of wages
  - Escape FIT & FICA
  - Accuracy of valuation
  - Accountable plan?

IN CONCLUSION...

- A mutual goal - to understand complex tax law so it can be applied fairly and consistently
- We need your help to accomplish our mission
- Your comments and suggestions are welcome and appreciated.

(Continued from page 5)

LEASING ISSUES: SUBSTANCE VS. FORM

To introduce her discussion on leasing issues, Ms. Baker said, "Some other issues that were not on my list last year have really taken a leap to the front again–they seem to kind of rear their heads and then they settle down for a while and now they seem to be back up again." This was evident from the fact that she had 6 slides on leasing issues, compared to only one general slide on leasing for her mid-year update.

Ms. Baker indicated that for most dealers the gist of these leasing issues is a ***substance versus form*** determination. It all hinges on who is the original lessor: The dealer...or the finance company to whom the car is immediately transferred when the lease is written.

She explained, "... At issue, and what is important about who is the original lessor, is when you look at the capital cost reduction payments–whether it be just a down-payment or the full payment of the lease front-loaded and also the first month's lease payment –whose income is that? Is that the dealer's income?...Or is that the finance company's income? ...The finance companies are saying that it's the dealer's income. It really turns into a controversy over whether you look at the *form* of the transaction or at the *substance* of the transaction."

This apparently is another issue over which there's a lot of controversy in the National Office... "There's one school of thought that you stick squarely with the *form* of the contract, and there's another school of thought that says you stick with the *substance* of the contract. And, although the dealer is specifically named as the lessor in these leases, if you look at some of the other clauses in the lease, it's clear that the finance companies have a lot of control over that lease."

"Our program was pivotal in this because there were people in the National Office who were ruling one way and there were people in the National Office who were ruling another way, and they didn't know that they were doing this. They just never made a nexus. Our program played the role of that nexus and brought these people together. We had a meeting a couple of weeks ago in the National Office where the sole purpose was for me to try to bring together all the people and all the different areas in the National Office (the code sections, the industries and the issues) that would be impacted by these issues. I think we ended up with about 30 people in a room–and everybody is kind of looking around at each other, saying, *'WOW.'* They realized that...you can't make a decision in a vacuum because it's going to impact on a lot of other areas, a lot of other industries, a lot of other issues...."

Interest Subvention. Similar issues exist with the rate support with the interest subvention. "Once again, whose income is it? Who has to report it? And then what is the basis? We (the IRS) care about this– what is the basis for depreciation on the part of the finance companies? Is it the gross amount sale price of the vehicle? Or is it the net ... net of the capital cost reduction or any other types of support payments?"

Residual Value Insurance. Residual value insurance is not very controversial anymore and there is a TAM that says that these payments are deductible over the term of the lease. This is one of the leasing issues the IRS was active on in the past.

TRACs: Terminal Rental Adjustment Clauses. One of her slides referred to the recent Tax Court decision in *Peaden* dealing with how terminal rental adjustment clauses (TRACs)are to be treated in evaluating whether vehicle transactions are "purchases" or "leases."

In *Peaden*, the determination was made that "you do not look at the TRAC clause at the end of a lease in determining up-front whether it was a sale transaction or a lease transaction. It was ruled to be a lease transaction. The Court ruled that a terminal rental adjustment clause at the end of the lease period could not be considered." (For more on this case, see page 14.)

EQUIPMENT LEASING

A still controversial question is whether equipment that is leased out should remain in inventory or whether it becomes a depreciable asset. Her slides highlight TAM 9448004 (inventoriable asset status) and TAM 9811044 (depreciable asset status) which address this.

TECHNICIAN TOOL RENTAL AND REIMBURSEMENT PLANS

In introducing this subject, Ms. Baker noted its prominence by saying, "(I) probably should have moved this next one up to the front of the list ... When I spoke to you last year, I was still new to the issue, and I was learning about it. I didn't understand all of the nuances about the issue. There is some question as to what the role of third-party administrators was in administering an accountable plan. But it (this issue) has certainly burgeoned to the forefront to the degree that we have a proposed Coordinated Issue Paper in process in the National Office that is being considered. We feel that this is an issue that is so much on the minds of the dealership community and the practitioner community that we want to make sure that we can try to address it head-on, and try to avoid problems in the future."

see **CURRENT REAL WORLD INCOME TAX ISSUES**, page 8

(Continued from page 7)

She discussed this area in much greater detail, armed with 5 slides replacing the single general slide that she had at mid-year. Her comments appear in the Update article on tool rental plans on pages 11-13.

EXTENDED SERVICE CONTRACTS

In connection with extended service contracts, mention was made of the Eight Circuit decision on the appeal of the *Rameau Johnson* case. The decision upheld the Tax Court on three of the four points. It upheld the Tax Court in the determination that the income all has to be reported up-front at the time that the warranty contract is sold. The distinction between the Eighth Circuit decision and the Tax Court decision was that amounts that were paid to the third-party administrator–the third-party administrator fee–would be currently deductible.

Ms. Baker said, "In the opinion, the Judge...put Section 446 ahead of Section 461. He put *clear reflection of income* ahead of *economic performance* and rejected the Service's arguments that you should allocate the cost of the fees at a minimum at least over the term of the contract. ...To the Judge (it seemed) only *fair* that if you have to include the income up-front, then it's only fair that you be able to deduct the fee that's paid to the administrator up-front, as well.

"At this point, we have not changed our position on the issue. We're still awaiting to see what shakes out on this. So, at this point, our position is still that those third-party administrator fees should be allocated over the term of the contracts as opposed to be deducted up-front. I would encourage you to read the case. It's short and the Judge uses some colorful language and terms that I hadn't heard before–like 'The hair (sic, *fur*) should follow the hide,'–that was his rationale in saying that the expense for the third-party administrator should follow the reporting of the income. I think he threw in 'What's sauce for the goose, is sauce for the gander,' so it's colorful and it's entertaining reading."

The citation for the *Rameau Johnson* appeal is 84 AFTR 2d Par. 99-5073; No. 98-1324. For more on this decision, see the September 1999, *Dealer Tax Watch*.

MANUFACTURERS' INCENTIVE PAYMENTS

Referring to her remarks last year, Ms. Baker said that the Service had determined that its policy on manufacturers incentive payments would be that although such payments would be taxable income to the salespeople, those payments would not be subject to any type of employment taxes or self-employment tax. She noted that the Service has continued to maintain that policy.

She added, however: "Now, there has been some discussion during the past year over to what degree can the dealer be involved and still not be considered to be responsible for these payments. But, we really have not had any significant activity on this. It is my perception that the flier ... Publication 3204 (that would go into the employee's W-2s or their paychecks that advised them about our policy on the payments) ... was quite effective in getting the word out, and we did try to undergo a pretty massive publicity campaign to make sure everyone was aware of our policy on this."

DEPRECIABLE LIFE OF DEALER REALTY

Ms. Baker explained that instead of depreciating a building over 39 years (as is normally done), some dealers' service bay areas were being carved out and being depreciated over a 15 year life. See "15-Year Life for Certain (Service Bay Area) Depreciable Realty?" in the September 1999, *Dealer Tax Watch* (pages 4-5) for more on this.

She included 4 slides in her presentation dealing with the development of this "newer" issue and asked for feedback from practitioners on this in terms of how prevalent this practice is in the dealership community. When this issue first came up, it was not in the context of a dealership, but it has been represented to the IRS that there are dealerships following this practice.

The IRS sees a number of problems inherent in this issue: One is the use of component depreciation–which is not available anymore. Another is: When you're talking about the sale and marketing of a petroleum product (let's stick to the oil change example), the oil is definitely a petroleum product, but are the labor charges also lumped in with the revenue from the sale of that can of oil for purposes of the 50% test?

Another question on the space issue: Do you attribute the space to change the oil, not just store the oil, but to do the oil change, is that lumped in there for purposes of the 50% space test? Ms. Baker indicated that it is the Service's position that neither the labor revenue nor the space are aggregated in with the actual petroleum product itself to see if the percentage tests are satisfied.

Another key question: "What is a petroleum product?" Are tires *petroleum* products? Some people seem to think they are. She said that just because there may be a modicum of petroleum in that product, that doesn't necessarily make the end-product a petroleum product.

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She concluded by saying, "So, please don't go home and put all of your clients on 15 year life on the service bays. This is an issue that we have identified. Please be cautions as you approach this issue if you run into it. And I would be interested in your feedback on it."

DEMONSTRATOR VEHICLES COMING SOON: A BRIGHT-LINE TEST

On this subject, Ms. Baker indicated that there has been some recent activity in the National Office with private letter ruling requests, although nothing had been ruled on so far, and there was nothing "that's going to be hitting the shelf real soon."

She said, "There is activity in the National Office on the age-old demonstrator questions: What is limited personal use? What is adequate recordkeeping? What is the true fair-market value of a vehicle for purposes of the valuation tables? What's a full-time salesperson? These are all different areas that are being addressed ***at this time*** in the National Office."

"I am pushing very hard to try to get some sort of a ***bright-line test on what is limited personal use.*** I am doing that not only to help you folks ... but also to help the agents in the field that can spend an inordinate amount of time and go through a lot of hassle for them and for you to try to determine that. I think that if we could come up with some sort of bright-line test of what is *limited personal use*, it's going to save us all a lot of headaches, a lot of trouble and a lot of time ... and give agents more time to find ...other tax issues."

Ms. Baker asked for feedback from practitioners on ... "What would you feel would be a reasonable bright-line test for purposes of what would be *limited personal use* in addition to the commuting miles that a salesperson would drive?"

Her slides on demos also mentioned *BMW of North America, Inc. vs. U.S.* (83 AFTR 2d Par. 99-413). For more on this case, see the March 1999, *DTW*.

During the afternoon Tax Panel, Ms. Baker was asked: ***What's the IRS' current position if salespeople don't have a demo usage log? Is their non-tax status on demo use no longer applicable?*** She replied, "...The technical answer is: If there is not the appropriate recordkeeping, you do lose the benefit of the demonstrator rules. So, yes, you are required to maintain adequate records to record your use."

HOW SHOULD FACTORY FINANCE ASSISTANCE PAYMENTS BE TREATED?

Another afternoon Tax Panel question was: Is it possible to reflect Factory finance assistance payments–where the Factory is reimbursing dealers for interest–as income when the related cars are sold... rather than taking them into income when the assistance payments are received? Apparently, some dealerships record that money as income when received, others apply it to the cost of the car, and still others place it in a reserve until the car is sold.

Ms. Baker indicated that these payments would be current income to the dealer upon receipt because, from that time on, the dealer has constructive receipt of those funds.

RESOLVING ISSUES ... FASTER ... EVENTUALLY

Concerning efforts to speed up and conclude time consuming audits, someone asked: ***What's the best way to deal with an agent that wastes time on a case that lingers on and on?*** Ms. Baker diplomatically responded: "If you have an examination of an auto dealership...and maybe the agent just really doesn't understand the issues...it might be totally appropriate to suggest to the agent that they give our Program a call. Maybe we can get them off the dime and get things moving again."

In other situations, agents seem to have so many things going on that they don't get the audit finished. Possibly, the agent has too many cases in inventory, or has been on other IRS assignments. If you really can't resolve the matter of time delays by discussing that directly with the agent, Ms. Baker's suggestion was to then speak to the agent's manager.

Ms. Baker expressed some optimism about the possibility of establishing "industry working groups" in the future. This approach would be patterned after the concept initiated by Revenue Canada: A group of industry people and practitioners meet with tax authority representatives on a regular–but informal–basis to discuss issues, identify problems and constructively consider how these issues and problems can be dealt with.

Finally, someone asked: ***Why are we educating the IRS on dealership issues? The more they know, the more they will create new issues. The Packers don't give the Cowboys their playbook.*** Ms. Baker's response: "The flip-side of that is: The better educated we are, the less frivolous issues we're going to (look into) and the less stupid questions we're going to ask.

"Perhaps, if you look upon it as a more efficient utilization of time, that we can get in there and do what we need to do and get out, rather than wasting your time and becoming one of those agents that you can't get rid of... You know there are two sides to this coin." Touche! ✻

SERVICE TECHNICIAN TOOL RENTAL & REIMBURSEMENT PLANS

UPDATE PART 2

Technician tool rental and reimbursement plans are still high on the list of IRS hot topics. This article updates the June *DTW* coverage (Part 1) on this subject and includes discussion of a recent Field Service Advice and Mary Baker's comments at the recent AICPA Auto Dealer Conference. At this time, a Coordinated Issue Paper dealing specifically with auto dealer technician applications has not been released by the IRS.

FADA NOTICE

In a letter to members on September 21, 1999, the Florida Automobile Dealers Association (FADA) said that its representatives came back from a law conference at which Mary Burke Baker had discussed some of the problems with technician tools programs. The newsletter indicated that FADA "is not aware of any motor vehicle dealers using these Plans, but the presentation caught our attention because FADA heard a proposal for this type of program, but subsequently declined to offer it as a sponsored program."

The literature of one plan provider includes a list of many prominent Florida dealerships which have already adopted its tool reimbursement program, so FADA should be hearing a lot more in the future about member experiences with these plans.

The FADA newsletter wisely advises, "If you are using a program similar to the above, we would suggest that you contact the provider or administrator to determine if they have *IRS approval* for your Plan." (Emphasis in the original.)

NADA WEEKLY FACTS

NADA Weekly Facts, the official news vehicle of the National Automobile Dealers Association, gave tool plans prominent discussion in its October 11, 1999 issue under the heading "IRS Rep Knocks Tool Plans."

In this piece, NADA reported that "Service technician tool reimbursement or rental programs being touted in the marketplace do not comply with the Tax Code and Regulations, according to Mary Baker, the Internal Revenue Service's Motor Vehicle Industry Specialist."

One week later (October 18, 1999), here's what NADA said in an effort to clarify its misreporting a week earlier and to soften the impact: "Baker said she had reviewed ***some*** of the available plans, and the views she expressed were based only on those. Accordingly, some plans may measure up to IRS requirements; consult your tax professional about the viability of any tool plan." (Emphasis in the original.)

FIELD SERVICE ADVICE 199940002

FSA 199940002, released October 8, 1999, evidences how the IRS is looking at equipment rental payments that are made by other businesses. In our Part 1 article on technician tool plans in the June 1999 *DTW*, we discussed two IRS Internal Legal Memoranda (ILM 199917011 and ILM 199921003).

The more recently issued FSA 199940002 actually started out as a request by an IRS examining agent for technical advice with respect to rig rental payments. However, since the agent did not provide facts that were case-specific, the National Office closed the request for Technical Advice and instead opened a request for Field Service Advice. This request had originated in late July 1998, and the FSA was dated February 16, 1999, but not released generally until early October of 1999.

This FSA concluded: "Whether rig rentals are wages depends on whether the rentals are paid pursuant to an accountable plan. If so paid, the payments are not wages for employment for tax purposes. Thus, the issue that must be resolved ***based upon the facts and circumstances of each case*** is whether the rig rentals are paid pursuant to an accountable plan." (Emphasis added.)

This FSA does not add anything substantial to what the IRS already said in the two earlier ILMs, nor to what Mary Burke Baker has said publicly about these plans either before or after its release. The FSA says that the authors understood there were many similar cases, and that IRS examiners would like the same conclusion to apply to all cases. However, the authors explain that that is not possible because determining whether or not rig rentals are paid pursuant to an accountable plan requires performing a factual analysis (of the specific facts) of each case.

The employer under consideration in this FSA is engaged in the business of specialized industrial construction. The welders whom it employs are highly skilled to perform welding services, and that is the only function they perform at the job site. These rig welders provide all of their own equipment, which generally includes a truck, welder, welding tanks and related items.

The ratio of the hourly wage payment component ($10 per hour) to the rig rental component ($20 per hour) for the use of the employees' welding equipment is1 to 2 (i.e., $1 wages:$2 rental). Note that this ratio is →

significantly different from the ratio of the same components for automobile dealer technician plans which is more like 2 to 1 (i.e., $2 wages:$1 or less rental).

The analysis of the law in this FSA includes the requirements for accountable plans under Section 62(c) which the Service concedes is applicable. It also includes an analysis of Revenue Ruling 68-624. The FSA concludes that Rev. Rul. 68-624 should not be relied upon now to exclude rental payments for equipment from wages. It also states that "An employment contract that merely allocates compensation between wages and rentals will not satisfy the requirements of Section 62(c)."

The case law discussion refers only to *Trans Box Systems* and to *Welch*, both of which were discussed in the earlier ILMs, and to which nothing new is added.

IRS MOTOR VEHICLE SPECIALIST COMMENTS RE: PLAN ISSUES ...OCTOBER, 1999

In her remarks on technician plans in October at the AICPA Dealership Conference, Mary Burke Baker indicated that this is an area that the Service is spending "an awful lot of time on." She said, "This issue has really mushroomed during the past year.

NOTHING'S IMPOSSIBLE...BUT...

"I want to preface my remarks by saying that it is not impossible that there could be a plan formulated that would fall under Section 62(c)–that would meet the requirements of Section 62(c) which governs accountable plans. It is also not impossible that there could be a plan formulated that is not under Section 62(c), but would be perhaps some sort of a reimbursement program that is not intended to be tax exempt that possibly could fit in as a bona fide arrangement for reimbursement expenses."

"Unfortunately, the plans that we have reviewed and have had occasion to look at, at this point, we have not seen something that fits. Particularly with respect to Section 62(c), the requirements to qualify are pretty clear and for one reason or another the plans that we've reviewed at this point just don't seem to fit. ***It seems to us it's more like fitting a square peg into a round hole.*** So, I want to be very careful not to disparage all plans–I have not seen all plans, but the ones that we have seen, we have some very serious concerns about."

Ms. Baker indicated her awareness "of pressure out there, a lot of marketing going on, and we want you to be very careful if you're considering this. If it doesn't seem to fit, there's a possibility that it doesn't."

SOME BASICS

"The gist of the issue is that the character of payment to the service techs is changed from being entirely a wage to partly wages and partly a payment for the tools. Whether you call that a *flat allowance* for the tools, a payment *for the use of* tools, a payment *for the rent of* tools, or a payment *under an accountable plan*...it is some sort of a payment–a reconfiguration of the payment structure from wages into something else.

"When I first became aware of this, it was in the context of Section 62(c) which is an accountable plan. An accountable plan (involves) employer reimbursements to employees for business expenses–legitimate, otherwise deductible business expense–that if they fit under that category, then they are not taxable income to the employee, nor are they subject to any type of employment taxes.

"In order to qualify for this exemption, ***there has to be a bona fide business purpose, other than just circumventing employment taxes.*** There has to be substantiation of actual expenses. There has to be a provision for the return of any excess reimbursement. There may or there may not be a third-party administrator. ***It is not required that there be a third-party administrator to handle these plans."***

THE IRS IS CURIOUS ...WHAT'S THE BUSINESS PURPOSE?

"The issues that we are finding with respect to Section 62(c), is that many times there is no business purpose that is established. The service techs are being paid the rate before this reconfiguration of their wage base. They're generally being paid what service technicians are normally being paid. So, ***we're very curious*** about the reconfiguration of wages if suddenly their wage base would drop as low as it does, and that this reimbursement would be taking place. ***We are very curious*** about whether or not that is for the purpose of accurately reflecting a true wage rate, or whether it is to circumvent employment taxes."

SUBSTANTIATION & CURRENT DEDUCTIBILITY ISSUES

"The second problem that we see is that there doesn't appear to be in the plans that we have seen actual substantiation of actual expenses. Now, we're talking when we talk about substantiation–if I go buy a tool for $50, I turn in the receipt to the dealer and the dealer reimburses me the $50 ... There has to be an actual expense that is incurred.

"Another problem that we run into then, is that if we are not actually substantiating actual expenses that are incurred...In many of the plans that we've reviewed, instead of submitting the actual expense or the actual receipt, what we're finding is that there is a list that is made of the tools that the service tech has.

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"Whether the service tech got them yesterday, a year ago, five years ago, whatever tools are in the service tech's inventory are put on this list, and there's some sort of a computation that is done, which then, in turn, determines an hourly rental rate or a weekly rental rate or some way of computing how much those tools are worth. That amount is then applied to the hours that the service tech is working–whether it be actual hours or maybe their "flag rate" –and then that is the amount that the tech is being reimbursed.

"There are problems with that: First of all, these are not actual expenses that incurred, because if you're putting down the *value* of the tool, then that's not the actual expense. Another problem is that the tool may have been purchased a year ago. ***Well, if it was purchased a year ago, outside the tax year, it's not going to be otherwise currently deductible this year.*** If it was purchased ten years ago, it's not going to be otherwise currently deductible this year. So, it is a problem, even if the tech was able to substantiate the actual expense, if it was not something that was currently deductible in the current tax year, it still doesn't fit under Section 62(c)."

MEASURING EXCESS REIMBURSEMENTS

"Putting all of these problems in place, then, it's very difficult to determine if there are excess reimbursements. How do you measure those? Unless they're being reimbursed for the actual expense that they are incurring, how can you measure what the excess reimbursements are? I mean, it would appear that all of them would be excess reimbursements, and under Section 62(c) any excess reimbursements have to be returned. So, those are the problems with Section 62(c).

RENTAL PLANS...NOT JUST SEC. 62(c)

"As we are becoming more familiar with this issue, we are finding that the issue is not just Section 62(c). The issue is also a ***rental*** issue. Maybe you're not even trying to fit it (i.e., the payments) in under Section 62(c), but you're trying to say that it's just rental. Then there are all sorts of other questions that come into play because there has to be some benefit there in order for it to be determined to be a rental as opposed to a wage. That has to fall into the employment tax arena.

"So, by saying that it is a rental, what we're finding is that there is a recommendation that the income just be reported on line 21 as "other income," and it escapes any type of employment taxes.

"Another alternative is that the income would be reported on a Schedule E, which is the rental form, and that would not be subject to self-employment tax or any other type of taxes. The IRS' position on the rental of personal property is that it goes on a Schedule C. Only the rental of real property goes on a Schedule E. So, if it goes on a Schedule C, then you're still back on the same boat of being subject to self-employment tax.

"Then you also get in the business of whether or not the state sales taxes apply to these transactions. That's something that I don't have a lot of personal knowledge about, but as I'm learning about the issue and talking with folks from a lot of different states, there is apparently a sales tax applicable on the rental of personal property in several states.

"So, if you have a rental situation, if it (i.e., the rental payment) goes on Schedule C and the tech has to pay self-employment tax and these state sales taxes, ***the tech may end up in a worse position than if it was just included in the wage base all along."***

THE THRESHOLD: BONA FIDE RENTAL

"Another question with the rental is the threshold question before you get into what form does it go on is, "Is it a truly bona fide rental situation?" If I am going out to rent something, ... if I'm paying rent, I expect that I'm going to have free use of whatever it is I am renting. That doesn't appear to be the case here. The service techs are the ones who use the tools. The dealer can't go in and use those tools; nobody else who works for the dealer can use the tools either. They are the service technician's sole property. So, there seems to be a threshold question that needs to be answered: "Is this a bona fide rental situation?" and then you move on to the other questions.

COORDINATED ISSUE PAPER COMING SOON

"The status of this issue, at this point in time, is that we are trying to work with the industry and the practitioners. Once again, I will caution you that we're not saying that there can't be a plan out there that doesn't fit, that doesn't work. Toward that end, to try to find those plans, and see if they're out there, I have had a lot of contact in the last month with a lot of third-party administrators asking me for a discussion of their plan and trying to get some insight on where we might perceive there might be problems with those plans.

"So, we are taking an active role to try to make sure that we have all the facts and all the fact patterns on this issue. There are some examinations, some live examinations, that have this issue. This issue started not in the motor vehicle industry, it actually started in the timber industry, and there are some other industries that have it as well."

"There is a proposed Coordinated Issue Paper in process in the National Office. That Coordinated Issue Paper only pertains to the Section 62(c) issue.

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It does not include the rental issue. We're debating whether we want to tack on a second question of the rental issue or whether we want to put forth a second Coordinated Issue Paper on just the rental. I think we will probably go with the option #2 of two separate Papers because the rental issue is probably a more dicey issue than the Section 62(c) issue–a little more difficult to get your hands around.

"There are no private letter rulings out there, no TAMs out there that are directly on point. There are no Court cases that are directly on point. There have been some private letter ruling requests that have been pending in National Office, and as you are aware: If a private letter ruling request is going to be negatively determined, the taxpayer has the option of withdrawing that request. ***As I indicated, there are no private letter rulings that have actually been promulgated. You can draw your own conclusions.***

"Revenue Ruling 68-624 is often cited as support for these plans. I would caution you that although 68-624 has not been revoked, it was pre-Section 62(c)."

Ms. Baker's slides accompanying her presentation referred to the ILMs previously mentioned and the Court cases cited in them. The key point that comes out of *Trans-Box* is that substantial compliance with an accountable plan is not persuasive. If you're going to be under an accountable plan, you have to meet all the requirements of the accountable plan.

WHAT ABOUT 1999 TAX RETURN REPORTING?

It's almost time for the moment of truth... thousands of technicians affected by these plans will be filing their 1999 income tax returns over the next few months.

The instructions for completing individual tax return Schedules C, E, and SE and for Line 21 reporting for 1999 returns to be filed in 2000 still are vague and not as specific as they could be (or should be) regarding payments made under rental and reimbursement programs.

The instructions to ***Schedule C*** indicate only that Schedule E should be used to report rental real estate income that is not subject to self-employment tax. At the very top of page 1 of the instructions for Schedule C, perhaps the only clue given is in the statement, "An activity qualifies as a business if your primary purpose for engaging in the activity is for income or profit and you are involved in the activity with continuity and regularity."

The instructions to ***Schedule E*** say that Schedule E should not be used to report income and expenses from the rental of personal property, such as equipment or vehicles. The instructions for Schedule E continue: "Instead, use Schedule C or C-EZ if you are ***in the business of*** renting personal property. You are in the business of renting personal property if the primary purpose for renting the property is income or profit, and you are involved in the rental activity with continuity and regularity." The instructions for Schedule E finally say that only "if your rental of personal property is not a business, see the instructions for Form 1040, lines 21 and 32, to find out how to report the income and expenses."

Query: How can a technician's tools be regarded as "not being used in a trade or business" while at the same time the employee who owns them and exclusively uses them is engaged in the trade or business of being an employee?

The instructions for ***Schedule SE*** (Self-Employment Tax) do not specifically include personal property rentals reported on line 21 of Form 1040 in the listing of other income and losses to be included in net earnings from self-employment. Conversely, these Schedule SE instructions do not include personal property rentals which are reported on line 21 of Form 1040 in the listing of examples of other income and losses that are not to be included in net earnings from self-employment.

With thousands of technicians potentially reporting amounts from Forms 1099 on line 21, hopefully, the instructions will be expanded at some time in the future to clarify the proper treatment of these payments for self-employment tax purposes.

A MODEST PROPOSAL FOR ADDRESSING THE ISSUES HEAD ON

In her remarks on tool plans, Ms. Baker said that she hopes "to address these issues head on and avoid problems in the future."

Here's one suggestion for doing this right now in a timely fashion. Why not use the same approach that was used a year ago in clarifying the IRS' position on manufacturer incentive payments? Why not *immediately* issue a short Pub. that dealers could put in their technicians' pay envelopes?

In dealing with the taxation of manufacturer incentive payments, the IRS issued Publication 3204 early in the year, but well before most affected individuals took their tax information to their return preparers. Why not issue the equivalent of a Publication 3204/envelope "stuffer" to automobile dealers for them to distribute to their service technicians if they have these rental or reimbursement programs in place?

This might increase technicians' awareness of the importance of reporting these payments properly in their income tax returns. With the filing season at hand, what could be more effective than this in "addressing these issues head-on?"

TAX COURT SAYS IGNORE TRACs IN DETERMINING THE SUBSTANCE OF LEASING TRANSACTIONS

TRACs PEADEN

Vehicle lease contracts often contain provisions which require the lessees to make additional payments at the end of the lease based upon the vehicle's actual value at that time. These provisions for dealing with the difference between (1) the residual value of the vehicle as *estimated* up front at the beginning of the lease and (2) the *actual* value as determined at the end of the lease...are called "terminal rental adjustment clauses" or TRACs.

In *Peaden v. Commissioner* (113 T.C. No. 6, Docket No. 14837-97, decided August 9, 1999), the Tax Court held that the terminal rental adjustment clauses contained in the master lease agreements cannot be taken into consideration in determining whether the agreements should be treated as leases or purchases.

In this case, Harry Peaden operated a business (Country-Fed) that sold meat, chicken and seafood products. Country-Fed leased over 550 trucks for distribution of its products in approximately 20 states. These leased trucks were provided by Country-Fed to direct sellers who used the trucks everyday to distribute Country-Fed's products.

There were three different agreements involving leases from as short as 12 months to as long as 50 months. Each of the trucks had a useful life that extended beyond its respective lease term. For each leased truck, there was a base rent and a monthly rental charge. The base rent represented the sum of all the monthly rent due throughout the lease transaction for the vehicle, and it was dependent on the lessor's cost of obtaining the truck and refitting to the lessee's specifications, which could include the purchase and attachment of refrigeration units.

Over the lease term, a fixed portion of the monthly rental was applied to reduce the base rent. The amount of the reductions was calculated to be equal to an amount that at the end of the lease term would effectively reduce the base rent to zero. The remaining portion of the monthly rent was a service and administrative charge that was not applied to reduce the base rent.

Country-Fed paid all registration and compliance fees not included in the base rent. It also paid any taxes that resulted from its use or possession of the vehicles during the term of the lease. Country-Fed was obligated to pay for any damage to the trucks and if a truck was damaged beyond repair, Country-Fed was obligated to pay the lessor the remaining amount of the base rent.

Under the master leases, title to the leased vehicles remained with the lessors throughout the term of the leases. At the end of the lease term, Country-Fed was responsible to return each leased vehicle to the lessor. If the truck remained in Country-Fed's possession beyond the term of the lease, Country-Fed was required to continue paying the lessor the monthly service and administrative fees.

THE RENTAL ADJUSTMENT CLAUSES

Although, there were three different master leases covering 565 leased vehicles, each had essentially the same requirements. Each master lease contained a terminal rental adjustment clause (TRAC) which obligated the lessor to sell the truck at the end of the lease term. Under the terms of the TRACs, the lessor was required to remit to Country-Fed the amount by which the sales proceeds of the truck exceeded the remaining lease price plus the cost of the sale. Conversely, County-Fed was required to remit to the lessor the amount by which the remaining base rent plus the cost of the sale of vehicle exceeded the proceeds. These provisions constituted terminal rental adjustment clauses within the meaning of Section 7701(h)(3).

As part of each lease transaction, Country-Fed certified that it intended to use the vehicle in its trade or business for more than 50% of its overall use and that it (i.e.,., Country-Fed, as lessee) had been advised that it would not be treated as the owner of the property for Federal income tax purposes.

The lessors collected rental income over the period of each lease which exceeded the sum of its depreciation and its cost of financing its purchase of the leased vehicle. The lessors acquired title to most of the trucks at the end of the respective lease transactions.

LEASE vs. PURCHASE

On audit, the IRS took the position that the terminal adjustment clauses should be taken into consideration in determining whether the transactions were in substance ***leases*** or whether they were ***purchases***.

The IRS disallowed Peaden/Country-Fed's rental deductions of almost $3 million and other related expenses and instead allowed deductions for depreciation of the vehicles as if Country-Fed were the owner. →

The taxpayer (Peaden) took the position that in deciding whether the lease transactions should be treated as leases or purchases of the vehicles, Section 7701(h)(1) precludes consideration of the TRACs from that evaluation. Therefore, according Peaden, he was correct in treating all the vehicle transactions as leases.

SECTION 7701

Section 7701(h) contains the provisions for motor vehicle operating leases where terminal rental adjustment clauses (TRACs) are involved. Section 7701(h)(2) provides the definition of a "***qualified*** motor vehicle operating agreement." A ***qualified*** agreement is one which satisfies three requirements relating to (1) a determination of minimum liability of the lessor, (2) a certification by the lessee that it will use the leased vehicle more than 50% of the time in a trade or business, and (3) knowledge by the lessor that the lessee's certification is not false. All of these requirements were satisfied.

Section 7701(h)(3) provides two definitions for TRACs. One is a general definition, and the other is a special rule/definition for lessees who are dealers in motor vehicles. Essentially a "terminal rental adjustment clause" is a provision in an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon the sale or other disposition of the leased property.

THE TWO ISSUES

The IRS argued that the adjustment clauses in the master leases should be considered in determining whether the substance of the vehicle transactions was a ***purchase*** of the truck or a ***lease***.

The Court said that the issues for it to decide were (1) whether Section 7701(h)(1) precluded consideration of the "terminal rental adjustment clauses" contained in the vehicle agreements in determining whether the transactions were purchases or leases, and (2) whether such agreements should be treated as purchases or leases of the vehicles.

CASE & LEGISLATIVE HISTORY

The opinion in *Peaden* discusses the *Swift Dodge v. Commissioner* case and the legislative history leading up to Section 7701(h). This history involved TEFRA (Tax Equity Fiscal Responsibility Act of 1982), DEFRA (the Deficit Reduction Act of 1984) and TRA 1986 (the Tax Reform Act of 1986) which contains the current Section 7701(h).

In *Swift Dodge v. Commissioner*, the Tax Court had held that the agreement under consideration was a lease. Under the terms of that lease, part of the lessee's monthly payments were to be applied to the capitalized cost of the vehicle resulting in the "depreciated value." If, at the end of the lease term, the actual wholesale value of the car exceeded its "depreciated value," the lessor would remit the excess to the lessee. Conversely, if the "depreciated value" of the car exceeded its actual wholesale value, the lessee would pay the difference to the lessor. In concluding that the agreements in question in *Swift Dodge* were leases, the Tax Court noted that the depreciated value was calculated on the basis of expected depreciation of the vehicle over the course of the lease.

Accordingly, "the inclusion of a contract provision that shifts the depreciable loss to the extent of wholesale value away from the taxpayer in an attempt to minimize business risks does ***not*** control for purposes of determining whether the agreement is a lease or a conditional sales contract." The Tax Court had further stated in *Swift Dodge* that "this is not a case in which the total rental payments paid all but a nominal amount of the cost of the leased property."

The *Swift Dodge* opinion was issued in 1981. Shortly after that, the Tax Equity Fiscal Responsibility Act of 1982 (TEFRA) was enacted, and provisions in it precluded the Commissioner from considering TRAC provisions in determining whether an agreement was a lease until such time as a statute was enacted or regulations were promulgated covering this issue.

After the TEFRA legislation, the Tax Court decision in *Swift Dodge* was reversed by the Court of Appeals for the Ninth Circuit, and the agreement in question in *Swift Dodge* was held to be closer to a conditional sales agreement than to a lease. The Appeals Court did not consider the effect of the TEFRA provision in reaching its decision.

After the Appeals Court's decision reversing the Tax Court, the Treasury issued Regulations in proposed form which would have prevented leases containing TRAC provisions from being treated as leases. However, DEFRA was enacted in 1984, and this legislation was followed shortly thereafter in 1986 by the Tax Reform Act which included current Code Section 7701(h).

WHAT THE TAX COURT SAID

The Tax Court Judge said that the plain meaning of legislation should be conclusive, except in the isolated situations where the literal application of a statute will produce a result that is demonstrably at odds with the intentions of the drafters. In its analysis in *Peaden*, the Tax Court observed that Congress

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was well aware of the *Swift Dodge* decision, its reversal and the subsequent legislation. The Tax Court also observed that Congress, *if it had so chosen,* could have specifically denied the protection provided in Section 7701(h) to lease transactions such as those in issue in the *instant* case where "the total rental payments paid all but a nominal amount of the cost of the leased property."

In *Peaden*, the Court said "Congress, however, did not elect to place such limitations in Sections 7701, and it is not within our province to do what Congress failed to do or elected not to do. Consequently, we will adhere to the plain language of Section 7701(h) ... (and) analyze the lease transactions without the TRAC."

Accordingly, in *Peaden* the Tax Court looked at the vehicle transactions as if the lessors received possession of the trucks at the end of the lease terms without any obligation to sell them and remit to the lessee any of the proceeds which exceeded the base price plus the cost of arranging the sale. Furthermore, as a result of disregarding the TRACs, the Court regarded any sale of the trucks to the lessee (Country-Fed) under the provisions of the master leases as being sales at fair market value as required by those master leases.

THE "LEASES" ACTUALLY WERE LEASES

The Court found that the master leases contained standard equipment lease provisions (once the TRAC was disregarded) that did not preclude treatment of the transactions as leases. Net leases are common in commercial settings. Therefore, it is less relevant that the lessor was not responsible for the payment of property taxes or that the lessor had less of a risk of loss or damage to the property because the lessee was required to obtain insurance on the property. The Court recognized that it had long rejected any notion that a net lease shifts the burden of ownership from the lessor to the lessee (citations omitted). Accordingly, the Court concluded that *Peaden's* Country-Fed lease transactions all should be treated as leases.

Finally, the Court said that the form of a transaction, if imbued with tax-independent considerations, has economic substance and will be respected for Federal income tax purposes. Citing *Frank Lyon Company* and *Hulter v. Commissioner.* In Peaden's case, Country-Fed chose to lease the trucks instead of purchasing them outright because the lessors did not require Country-Fed to make down payments on leasing trucks. Consequently, Country-Fed was able to use its capital elsewhere in expanding its business.

Although the leasing of the trucks apparently resulted in additional tax benefits to Country-Fed in the form of accelerated deductions (i.e.,., the immediate deduction of its rental payments in full), the fact that a transaction is shaped in part by tax considerations is not a sufficient reason for disregarding its form. Citing again *Frank Lyon Company v. U.S.*

It is too early to know whether the IRS will acquiesce to the Tax Court's decision in *Peaden.* ✻

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