DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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MEMORANDUM FOR DISTRICT COUNSEL, MICHIGAN DISTRICT, DETROIT

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: CAPITAL COST REDUCTION PAYMENTS

This Chief Counsel Advice responds to your memorandum for Technical Advice. It is not binding on Examination or Appeals and is not a final case determination. This document may not be cited as precedent.

ISSUE

Under the situations described below, whether capital cost reduction (CCR) payments made by Customer (lessee) at the inception of a lease relating to a vehicle constitute rental income to the financial institution that acquires the lease. If not, whether the CCR payments reduce the financial institution's basis in the leased vehicle for depreciation purposes.

CONCLUSIONS

The issue of whether and to what extent a CCR payment is advance rental income to a dealer in an arrangement where a lease and the underlying vehicles are sold by the dealer after execution of the lease by the customer depends on the facts and circumstances. As to the five situations presented below, we conclude as follows:

Situation 1

The CCR payment made by Customer (lessee) to Dealer as agent for the financial institution (Bank) at the inception of lease constitutes advance rental income to Bank and does not reduce Bank's basis in the leased vehicle for depreciation purposes.

Situation 2

The CCR payment made by Customer (lessee) to Dealer at the inception of lease constitutes advance rental income to the financial institution (Subfin) and does not reduce Subfin's basis in the leased vehicle for depreciation purposes.

Situation 3

The CCR payment made by Customer (lessee) to Dealer at the inception of lease constitutes advance rental payments to Subfin and does not reduce Subfin's basis in the leased vehicle for depreciation purposes.

Situation 4

The CCR payment made by Customer (lessee) to Dealer at the inception of lease constitutes advance rental income to Subfin and does not reduce Subfin's basis in the leased vehicle for depreciation purposes.

Situation 5

The Service should attempt to use a method of reconstruction that will allow it from the records available to reasonably determine the cost basis of leased vehicles and the CCR payment applicable thereto. The amount of the CCR payment made by Customer to Dealer at the inception of lease that is in lieu of rental payments due during the period Subfin is the owner or will be the owner of the leased vehicle constitutes advance rental income to Subfin. The CCR payment does not reduce Subfin's basis in the lease vehicle for depreciation purposes.

FACTS

General

Subfin is the wholly-owned subsidiary of Corp X. Corp X is a manufacturer of consumer durables and Subfin is used to extend credit (for both sales and leasing transactions) to customers of Corp X's network of independent dealers. Under the Lease Agreement designed by Subfin to facilitate its purchase of leased vehicles, Dealer is named the lessor. Dealer as "lessor" originates the lease with Customer. Subfin then purchases both the vehicle and lease from Dealer. Subfin records the capitalized cost of the vehicle as a depreciable asset. Dealer is neither contractually responsible for Customer's performance during the lease period nor for the value at the time of lease maturity.

Initially, Subfin approves Dealer for its program by executing the Subfin Lease Plan "Dealer Agreement." The Dealer Agreement, between Subfin and Dealer, sets forth the terms under which the leases (between the Customer and Dealer), and the underlying vehicles are sold to Subfin.

Specifically, prior to executing a Lease Agreement, Customer negotiates the product price, and if applicable, the down payment or capital cost reduction (CCR) payment with Dealer. Dealer submits Customer's lease application to Subfin for review and approval. Dealer obtains credit approval from Subfin for Customer prior to the execution of the Lease Agreement. Upon obtaining approval, the Lease

Agreement is executed by Customer as lessee and Dealer as lessor. The Lease Agreement specifically provides that Dealer is not an agent or representative of Subfin. There may be other scenarios where a Lease Agreement specifically provides that Dealer is an agent or where the facts and circumstances indicate that Dealer is an agent of the financial institution that later acquires the leased property. See, for example, situation 1 below.

The Lease Agreement also provides that Dealer's participation in the lease plan is at its discretion, and Dealer is free to engage in leasing transactions with the financial institution of its choice. The Lease Agreement also includes a lease assignment provision, whereby Dealer, as lessor, assigns all rights, title, and interest in the lease and vehicle to Subfin.

The Leasing Worksheet is prepared by Dealer during the final negotiation stages between Dealer and Customer. Dealer submits the Leasing Worksheet and the Lease Agreement to Subfin together as part of a lease package for Subfin's review, acceptance, and purchase. Dealer submits the lease packages to Subfin on the same day the leases are executed, or several days after lease execution, depending on the volume and Dealer's business practices. If the lease package is acceptable to Subfin, Dealer assigns the lease and sells the underlying vehicle to Subfin.

Subfin records the acquisition of the lease and underlying vehicle on or after the date the lease contract is received, reviewed, accepted, and purchased. Subfin may be prevented from recording the acquisition on the same day the lease is received and accepted because of volume and other business demands.

At the end of a lease contract, Subfin takes possession of the related vehicle unless the vehicle is purchased by Customer or Dealer at lease-end. Subfin ceases calculating depreciation on the vehicle and sells the vehicle at auction.

Capital Cost Reduction Payments

Customer makes a Capital Cost Reduction ("CCR") payment in the form of a voluntary cash down payment to Dealer outside of the provisions of the Lease Agreement upon negotiating and entering into the lease. The CCR payment reduces Customer's monthly lease payment over the lease term by reducing the net capitalized cost of the lease vehicle, which is the starting point in calculating Customer's monthly lease payment.

For financial accounting purposes, Subfin treats Dealer's receipt of a CCR payment as a reduction in Subfin's basis in the lease vehicle sold by Dealer to Subfin. Although Dealer records the transaction as a sale of that vehicle at the negotiated sales price whether or not Customer makes a CCR payment, the Dealership Agreement does not contractually obligate Subfin to purchase the vehicle for this amount.

Subfin furnishes the Dealer Agreement, the Lease Agreement, and the Dealer Worksheet to Dealer, including the instructions to asist Dealer in completing these forms. Dealer is required to collect an acquisition fee and provide this amount directly to Subfin. Upon execution of the lease, Dealer is required to title and register the vehicle in the name of Subfin.

The circumstances under which we have been requested to address Subfin's or a lender's treatment of CCR payments are as follows:

Situation (1)

Dealer purchases vehicle from Corp X for $20,000. Dealer sells vehicle to Bank, unrelated to Corp X or Dealer, for a pre-negotiated price of $24,000. Dealer is not a party to the Lease Agreement. Customer leases vehicle from Bank for a 24-month period and makes a $2,000 CCR payment at lease inception. Dealer receives the CCR payment and consummates the lease on Bank's behalf, as Bank's agent. Bank actually pays the negotiated price less the CCR payment, (already in Dealer's possession), to the purchase of the vehicle. Customer pays an acquisition fee of $300 to Dealer. The $2,000 CCR payment reduces Customer's monthly payment from $400 per month to $315 per month. The residual factor is .67 resulting in vehicle having a residual value of $16,000 ($24,000 x .67).

Situation (2)

Dealer purchases vehicle from Corp X for $20,000. Dealer sells vehicle to Subfin (wholly-owned financial subsidiary of Corp X) for $24,000. The sale is pursuant to the Dealer Agreement that provides the eligible purchases of vehicles and leases shall not exceed the maximum that Subfin from time to time will establish. The acquisition fee of $300 is paid by Customer. Customer leases vehicle from Dealer for a 24-month period and makes a $2,000 CCR payment at lease inception. The CCR payment reduces Customer's monthly payment from $400 per month to $315 per month. The residual factor is .67 resulting in vehicle having a residual value of $16,000 ($24,000 x .67). Corp X's manual of Instruction to Dealer provides Dealer should not treat the transactions as sales. Both Dealer and Subfin treat Subfin as the actual lessor. Subfin included the entire amount of CCR payments in income as prepaid rent. Subfin now seeks the Commissioner's consent to change its method of accounting from its present method of currently including the CCR payments in income to its proposed method of reducing its basis in the underlying vehicles by the amounts of the CCR payment.

Situation (3)

Same facts as in Situation (2) except Customer's lease is under Subfin's Preferred Lease Program. Customer makes a single payment of $9,400. Dealer retains

Customer's payment of $9,400. Dealer continues to sell the vehicle to Subfin for $24,000. Subfin remits a payment to dealer for $14,600 ($24,000 - $9,400). For financial reporting purposes, Subfin recognizes the CCR payment on a straight-line basis over the term of the lease. Subfin has consistently included the $9,400 CCR payment (pre-payment of all rent due under lease) made to Dealer as advance rental income. Subfin seeks the Commissioner's consent to change its method of accounting for these CCR payments from its present method of currently including these amount in income to its proposed accounting method of reducing its basis in the underlying vehicles by these amounts.

Situation (4)

Same facts as Situation (2), except Dealer remits the CCR payment to Subfin and Subfin remits a check to Dealer for the entire $24,000 purchase price of the vehicle and Subfin is not requesting permission to change its method of accounting.

Situation (5)

Same facts as Situation (2) except Subfin does not maintain records supporting the amount of the CCR for a specific contract but only maintains records reflecting the average CCR payment per lease.

LAW AND ANALYSIS

It is well settled that income derived from property is taxable to the owner of the property. Helvering v. Horst, 311 U.S. 112 (1940). Therefore, to be entitled to receive rentals or rental income, one must be the lessor (i.e., owner or legal possessor) of the property being leased. In general, gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. Treas. Reg. § 1.61(a). Further, rental income includes the expenses of the lessor paid by the lessee. Treas. Reg. § 1.61-8(c). Additionally, advance rentals must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. Treas. Reg. § 1.61-8(b).

Regarding the issue of who is the lessor or seller of vehicle in a three party transaction involving a dealer, customer, and finance company, we believe it is helpful to look at the Supreme Court opinion in Hansen v. Commissioner, 360 U.S. 446 (1959). In Hansen, taxpayers were retail auto dealers who sold cars on credit to car purchasers. Each credit or loan amount was evidenced and secured by a note retaining a defeasible title on the car. Further, the note generally was on a form supplied by the finance company to which taxpayers planned to sell the note and the instrument was signed by the customer, delivered to the dealer, and made payable to dealers in monthly installments over an agreed period. Soon after the sale of a car, taxpayers discounted or sold the notes of car purchasers to finance companies and guaranteed payment, in whole or part, of the note.

Among other things, taxpayers argued that, in substance, the car purchasers obtained the loans directly from the finance companies. In rejecting taxpayers' argument, the Supreme Court observed that the installment paper (note) was executed by the car purchasers and made payable to the dealers and that the installment paper was later assigned or endorsed by the dealers and sent to the finance companies for purchase, under and subject to the dealers' contractually assumed contingent liabilities to the finance companies.

The facts of Hansen indicated that the dealers (taxpayers) made the loans to the car purchasers and not the finance companies. Thus, it follows from Hansen that a taxpayer can be the lender or lessor even if the loan or lease agreement is executed on a form provided by a third party that may or may not later acquire the loan or lease.

Regarding the purchase and sale of property, the basis of property acquired by purchase is usually its cost. The cost of property also includes amounts paid for property in cash or other property. Treas. Reg. § 1.1012-1(a). Additionally, the cost or basis includes the amount of any liability incurred or assumed by the purchaser in acquiring the property and liabilities to which the property is subject at the time of purchase, whether or not the purchaser assumes liability for the obligations. See e.g., Crane v. Commissioner, 331 U.S. 1 (1947).

The amount realized from the sale or other disposition of property is the amount of money received plus the fair market value of property other than money received. I.R.C. § 1001(b). The amount realized also includes the amount of liabilities from which the taxpayer is relieved. Treas. Reg. § 1.1001-2(a)(1).

In Hyde Park Realty v. Commissioner, 20 T.C. 43 (1953), aff'd, 211 F.2d 462 (2nd Cir. 1954), the Tax Court and Second Circuit addressed the issue of the treatment of rents received before the purchase of leased property but pertaining to the period after the date of purchase. There, the taxpayer purchased leased real property. The contract of purchase provided that rents collected by the seller should be apportioned between the parties as of the closing of title date, which was February 14, 1947. In accordance with the purchase contract, taxpayer received as credit toward the purchase of the leased property the sum of $8,724 for rents received by the seller before the closing date of sale and relating to the taxable period subsequent to the closing date. The taxpayer on its tax return for its first fiscal year ended January 31, 1948, treated the rents collected by the seller as rental income. In the Tax Court and before the Second Circuit, taxpayer contended that if rents are income when received, the prepaid rent of $8,724 received by the seller constitute income not to the taxpayer but to the seller, taxpayer's predecessor, and a reduction to the sale price of the leased property purchased.

In disagreeing that the credit represented an adjustment or reduction of the sale price, the Tax Court found that the credit represented rents paid over to taxpayer to cover taxpayer's period of ownership of the leased property beginning with February 14, 1947. The Tax Court also observed that if the seller had remained the owner of the property, it would have had to include the entire amount of prepaid rent in its taxable income in the year when it was collected. The Tax Court noted that the seller did not remain the owner of the property but sold it to taxpayer and agreed to apportion the rents with taxpayer, the purchaser. The Tax Court concluded therefrom that the $8,724 represented rents which taxpayer received in its fiscal year ended January 31, 1948, and did not represent a reduction in the purchase price.

In affirming the Tax Court, the Second Circuit pointed out that rents are taxable when received and that taxpayer received the $8,724 sum on February 14, 1947. The circuit court also stated that it did not view as material the fact that the $8,724 constituted rents paid by tenants to the seller of the leased property on earlier dates. The circuit court added that while a taxpayer cannot evade his responsibility by assigning what are really his earnings, the receipts in issue were not yet earned. Further, the circuit court observed that when taxpayer received the later due rents of $8,724 it simultaneously undertook an obligation to perform the services contemplated by the lease on which they were paid.

Similarly, in Pokusa v. Commissioner, T.C. Memo. 1978-93, taxpayers were the owners of rental property and reported income on a calendar year basis. During 1972, taxpayers owned and operated the rental property in issue from January 1, 1972 to May 1, 1972. Also during that time, taxpayers collected space rental income in the amount of $58,190 with respect to such rental property. On May 1, 1972, taxpayers sold the rental property, and, at closing, the $ 58,190 of space rental income for 1972 was credited to the buyer.

The Tax Court found that taxpayers possessed the attributes of ownership until May 1, 1972. Thus, it held that the portion of the annual space rental collected by taxpayers, which is attributable to the period prior to May 1, 1972, is includable in taxpayers' taxable income for 1972. The court noted that the 1972 space rentals attributable to the period after May 1, 1972, are not includable in taxpayers' income and that the $58,190 amount credited to the purchasers at closing was intended by the parties to represent space rentals and was not an adjustment to the purchase price.

In reaching its holding, the court rejected respondent's reliance on Treas. Reg. § 1.61-8(b) in arguing that the entire amount of 1972 space rentals collected by taxpayers should be included in their 1972 taxable income because such amount was collected when taxpayers where the owners of the rental property and taxpayers had complete dominion and control over such amount when collected.

The court noted that Treas. Reg. § 1.61-8(b) provides when rental income is reportable but not who must report it.

It should be noted that the issue of whether and to what extent a CCR payment is advance rental income to a dealer in an arrangement where a lease and the underlying vehicles are sold by the dealer after execution of the lease by the customer is factual. Thus, resolution of the issue as well as the issue of the basis of the underlying vehicle depends on the facts and circumstances.

Section 446(e) requires a taxpayer to obtain the Service's consent before making an accounting method change. A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, as well as a change in the treatment of any material item used in the plan. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1. 446-1(e)(2)(ii)(a). Thus, if the practice does not permanently affect the taxpayer's lifetime income, but does change the tax year in which the income is reported, then, the item involves timing and is considered a method of accounting.

A change in accounting method for an item occurs whenever the taxpayer deviates from its established treatment of the item. Section 446(e) requires a taxpayer to obtain the Service's consent before making an accounting method change.

Turning to the five situations described above, we conclude as follows:

Situation (1)

The facts reveal that Bank was the owner of the leased vehicle at the time the vehicle was leased and throughout the period of the lease. The facts also reveal that Customer leased the vehicle from Bank, and Dealer acted as the agent of Bank in receiving the $2,000 CCR payment at lease inception. Therefore, it is our position that Bank is the lessor of the leased vehicle because Bank is the owner of the leased property. It is also our position that the $2,000 down payment which Customer paid to Dealer should be treated as an advance rental income to Bank. This is because the amount represents payments in lieu of future rental payments to Bank during the period the Bank is or will be the owner and lessor of the vehicle. In this regard, Bank should be treated as having received the advance payment at the point in time Dealer as agent for Bank received the $2,000 from Customer. See Hyde Park Realty, 211 F.2d at 462 and Treas. Reg. § 1.61-8(c).

Bank's cost basis in the leased vehicle should be $24,000, the negotiated price or cost of the vehicle to Bank. The $2,000 advance but unearned rental payment did not reduce the consideration paid by Bank and, as noted, should be treated as income of Bank.

Situation (2)

Subfin should treat the entire $2,000 payment made by Customer to the Dealer as advance rental income. This is because as discussed above, with respect to Situation (1), the amount represents the portion of the rent collected that is in lieu of rent that is otherwise payable for the period in which Subfin is and will be the owner of the vehicle. Further, Subfin should be treated as having received the $2,000 advance payment at the point in time the Dealer received and credited the $2,000 toward the purchase price of the vehicle. See Hyde Park Realty, 211 F.2d at 462 and Treas. Reg.§ 1.61-8(c). Subfin's cost basis in the vehicle is the $24,000, the cost or negotiated price of the vehicle.

Subfin's request to change its method of accounting from its present method of currently including the CCR payments in income to its proposed method of reducing its basis in the underlying vehicles by the amount of the CCR payment should be rejected. This is because Subfin would be switching from a method that clearly reflects income to an improper method that fails to recognize advance rental income and understates the basis in the vehicle leased.

Situation (3)

The legal reasoning underlying situation (2) also applies here. Thus, Subfin should treat the $9,400 Customer paid Dealer as advance rental income. This amount represent payment in lieu of rental payments due during the period of time Subfin is the owner or will be the owner of the leased vehicle. The $9,400 should be treated as received by Subfin at the time Dealer received and credited the payment toward the purchase price of the leased vehicle acquired by Subfin from Dealer. Subfin's cost basis in the leased vehicle is $24,000. As noted the advance rental or CCR payment is in lieu of future rental payments; as a result, the payment does not affect Subfin‘s cost basis in the leased vehicle.

Subfin should not be allowed to change its method of accounting. The method to which it wants to change is improper because it fails to recognize advance rental income and understates Subfin's cost basis in the vehicle acquired from Dealer.

Situation (4)

The reasoning is the same as with regard to Situation (2). Thus, Subfin should treat the $2,000 received from Dealer as advance rental income because it represents payment in lieu of future rental payments to Subfin during the period Subfin is or will be the owner of the vehicle. Further, Subfin should be treated as having received the $2,000 advance rental payment at the point in time it received the $2,000 remittance from Dealer. Subfin's cost basis in the vehicle is $24,000, the cost of the vehicle. Applying the $2,400 advance payment as a credit toward the purchase price of the vehicle acquired by Subfin from Dealer is the same as

remitting the advance payment to Subfin. See Treas. Reg. § 1.61-8(c). Therefore, the fact that the CCR or advance rental payment is remitted to Subfin rather than being applied as a credit toward the purchase price of a vehicle is immaterial.

Situation (5)

On these facts, Subfin should treat as advance rental income the amount of the CCR or advance rental payment made by Customer that is in lieu of rental payments due during the period Subfin is the owner or will be the owner of the leased vehicle. Further, Subfin's cost basis in the leased vehicle is the negotiated price or arm's length price.

The facts reveal that Subfin does not maintain records supporting the amount of the CCR or advance rental payment received for a specific leased vehicle, but only maintains the records reflecting the average CCR or advance rental payment per lease. Thus, Subfin's records may not be sufficient to properly determine Subfin's cost basis in each leased vehicle and the advance rental income received by Subfin for a particular tax year. Accordingly, the Service should attempt to use a method of reconstruction that will allow it from the records available to reasonably determine the cost basis of leased vehicles and the CCR or advance rental payment applicable thereto. The Service has broad authority to reconstruct a taxpayer's income if the taxpayer's method of accounting does not clearly reflect income or if the taxpayer's books and records are inadequate to determine income. See e.g., I.R.C. § 446(b) and Holland v. United States, 348 U.S. 121 (1954).

Please note that proper analysis of leasing transactions requires careful and complete factual development. If you have further questions, please call Willie E. Armstrong, Jr., at (202) 622-7920.

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