INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB CC:LM:CTM:LN
ATTN J. SCOTT HARGIS

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Tax Treatment of Dealer Participation Fees

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated October 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A = .
B =
Year 1 =
Year 2 =
State C = ________

ISSUES

1. Whether dealer participation in the finance income of retail installment sales contracts (RISC's), paid by B to independent A retail dealers, must be capitalized and amortized over the life of the RISC.

2. If an adjustment is made to amortize the dealer participation fees over the life of the RISC, is the examination division required to make this change in accounting method in the earliest year with the section 481 adjustment in the year of change, or does it have

discretion to enter into an agreement with A for an alternative method of allocating a section 481 adjustment, as proposed by A?

CONCLUSION:

1. Dealer participation in the finance income of RISC's must be capitalized and amortized over the life of the RISC's.

2. The adjustment for amortization of dealer participation fees must be made in the earliest year under examination, and the section 481 adjustment is reported in the year of change.

FACTS:

A is in the business of selling automobiles and sells the automobiles to independent authorized A dealers throughout the country. The dealers negotiate and contract with consumers for the sale of the vehicles. If the consumer needs financing, the dealer will provide a financing package. The loan instrument is an installment contract with a typical term of approximately four years; the dealer sells the loan to either A's wholly owned subsidiary, B, or to a bank.

A Dealer Retail Agreement provides that B will purchase an acceptable contract from an A dealer at the purchase price. The purchase price is defined as the amount financed plus the amount of the dealer participation in the finance income. The amount of the dealer participation is determined upon the sale of the RISC to B and is based on the difference in the interest rate that the dealer obtained from the consumer (write rate) and the yield rate of interest for B (buy rate). For example, a RISC written at a 12% interest rate with a buy rate for B of 9% creates a 3% difference or interest rate spread, which is then used to determine the amount payable to the dealer as the dealer participation fee. Some states impose limitations on the amount of dealer participation that can be paid. For example, in state C, dealers are paid 100% of the APR over the buy rate up to 3%, and the dealer may earn 50% of the next 2% of APR, but receives no portion of the APR more than 5% over the buy rate.

Once a RISC is purchased, B will pay the A dealer the amount financed and the dealer participation according to the type of participation program chosen. Once a program is chosen, the dealer must use the same program for all loans sold to B, though a change in program may be requested. Dealer participation is an industry practice, but the methods used to compute the amount will vary. An A dealer had the choice of three participation programs prior to Year 1, and since Year 1 dealers may chose only the second and third of the following three programs.

Up-Front Participation. A dealers receive 100% of the dealer participation in finance income up-front from B. According to the contract between the parties, the participation fee is deemed to be fully earned by the dealer once the customer's installment contract is fully paid. Thus, if a contract terminates early, dealers must

repay the pro rata portion of the participation fee which is rendered unearned. Also, if the customer loan is charged off due to a customer default and repossession occurs, the dealer must repay participation received up to the amount of the loss sustained by B. Dealer participation is limited by the previously noted limitations effective in State C.

Split Up-Front Participation. The A dealers received 75% of the participation in finance income up-front from B. This participation fee is deemed fully earned once B has timely received the first, second and third scheduled monthly payments from the customer. Once this occurs, the dealers are no longer subject to loss or prepay chargebacks. If the customer either defaults or pays the contract off before the first three scheduled payments, the dealer must repay the pro rata portion of the participation which is rendered unearned.

As Earned Participation. A pays the dealer portion of the interest as the customer makes installment payments. There are no paybacks involved with this program. B nets the participation expense against the interest income, and this method is not in dispute.

For book purposes, B capitalizes the dealer participation and amortizes the amount over the life of the RISC's. For tax purposes, B expenses the dealer participation in the year paid. B has been using this method of deducting dealer participation since beginning operations in Year 2. B was duly notified by the examination division that this method was an issue under consideration in the current audit, and B has not filed a request for a change in method of accounting.

B has requested an alternative method of allocating the proposed section 481 adjustment. Based on the "significant distortion of taxable income by requiring the entire section 481 adjustment to be reported in the year of change", B has requested approval of a three year spread of the section 481 adjustment.

The audit team proposes to deny this request based upon Notice 98-31, 1998-1 C.B. 1165, which requires the section 481 adjustment to be made in the first year of the examination cycle with a one year adjustment period.

LAW:

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. §1.162-1(a) provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. If the expenses in issue meet the threshold requirements for section 162 expenses, it must then be determined whether they are capital expenditures pursuant to section 263(a) and thus excepted from current deductibility under section 162. See section 161 (section 263 provides an exception to section 162).

The term “necessary” imposes only the minimal requirement that the expense be appropriate and helpful for the development of a taxpayer’s business; the function of the term “ordinary” is to clarify the distinction between deductible expenses and capital expenditures. Commissioner v. Tellier, 383 U.S. 687, 689 (1966).

Deductions are matters of legislative grace and are exceptions to the norm of capitalization. Accordingly, deductions are strictly construed, and the burden of clearly showing the right to the claimed deduction is on the taxpayer. Commissioner v. Idaho Power, 418 U.S. 1 (1974).

Section 263(a) provides that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. The taxpayer must capitalize and amortize over the life of the property any expenditure which restores, adds to the value of, or substantially prolongs the useful life of that property. Treas. Reg. § 1.263(a)-2(a) gives examples of capital expenditures and provides that the cost of acquisition of property having a useful life “substantially beyond the taxable year” is a capital expenditure.

Section 446(b) vests the Commissioner with broad powers of determining whether accounting methods used by a taxpayer clearly reflect income. Commissioner v. Hansen, 360 U.S. 446, 467 (1959). This authority is not limited to overall methods of accounting, but extends to a taxpayer’s method of accounting for specific items of income and expense. Treas. Reg. § 1.446-1(a).

Both Treas. Reg. § 1.461-1(a)(1) (applying to cash basis taxpayers) and Treas. Reg. § 1.461-1(a)(2)(i) (applying to accrual basis taxpayers) require that an expenditure be capitalized if it “results in the creation of an asset having a useful life extending substantially beyond the close of the taxable year.” Treas. Reg. § 1.461-1(a)(2) provides that under section 263 and 263A a liability that relates to the creation of an asset having a useful life extending substantially beyond the taxable year is taken into account in the taxable year incurred through capitalization.

In Commissioner v. Lincoln Savings & Loan Assoc., 403 U.S. 345 (1971), the taxpayer was insured by the Federal Savings and Loan Insurance Corporation (FSLIC), and the annual premium was measured by the amount of its accounts and creditor obligations. By 1962, Congress added a secondary reserve to the primary or general reserve, and the secondary reserve required an additional premium. Each insured institution had a pro rata share in the secondary reserve and could obtain a cash refund of its share if its status as an insured terminated. Lincoln was not permitted to deduct the premium for the secondary reserve because the payment “serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under §162....” 403 U.S. at 354. The secondary reserve provided a fund available for losses both in the current year and in the future.

INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) clarified that a separate and distinct asset is not a prerequisite to classification as a capital expenditure. The Court stated that although the creation of a separate and distinct asset may be sufficient in and of itself to classify an expenditure as capital in nature, it is not an exclusive or controlling test for identifying a capital expenditure. Also undeniably important in determining the appropriate tax treatment is a taxpayer's realization of benefits beyond the year in which the expenditure is incurred.

In INDOPCO, the Court considered whether certain investment banking and legal fees incurred by a target corporation incident to a friendly takeover produced significant long-term benefits for the taxpayer. The Court identified two significant long-term benefits, namely, potential synergistic benefits to be derived from being associated with the acquirer's business and the avoidance of shareholder relation expenses and complications shouldered by a publicly-held corporation. Though the presence of a future benefit is not controlling, taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. In making this determination, it is important to consider the duration and extent of the benefits realized by the taxpayer. A capital expenditure is usually amortized and depreciated over the life of the relevant asset, or if useful life cannot be ascertained, is deducted upon dissolution of the enterprise. Id.

Treas. Reg. § 1.167(a)-3 permits a depreciation deduction for amortization of the cost of intangible assets if the life of the intangible can be estimated with reasonable accuracy. In Seaboard Finance Co. v. Commissioner, T.C. Memo. 1964-253, petitioners presented evidence that the estimated lives of the secured loan contracts was three years and that of the unsecured loan contracts was five years. See also Richmond Television Corp. v. United States, 354 F.2d 411-12, n.3. (intangible assets may only be depreciated if the useful life of the asset is of limited duration, capable from experience of being estimated with reasonable accuracy).

Treas. Reg. § 1.481-1(c)(5) provides that a change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer.

Treas. Reg. § 1.481-4(a) provides that in addition to the terms and conditions prescribed by the Commissioner under Treas. Reg. § 1.446-1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under section 481. See section 481(c).

Treas. Reg. § 1.481-4(b) provides that an agreement to the terms and conditions of a change in method of accounting under Treas. Reg.§ 1.446-1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an

alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

Treas. Reg. § 1.481-1(c)(3) provides that if the change in method of accounting is involuntary (not initiated by the taxpayer), the amount of the adjustment is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income.

Rev. Proc. 97-27, 1997-1 C.B. 680, provides the general procedures under section 446(e) and Treas. Reg. § 1.446-1(c) for obtaining the consent of the Commissioner to change a method of accounting. Section 4.02(2) states that the revenue procedure does not apply if the taxpayer is under examination unless the taxpayer files a Form 3115 during an open window or with the district director's consent.

Section 2.10 of Rev. Proc. 97-27 describes a change made as part of an examination. Section 446(b) and Treas. Reg. § 1.446-1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. If a taxpayer under examination is not eligible to change an accounting method under the revenue procedure, the change may be made by the district director. A change resulting in a positive section 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with a one year section 481(a) adjustment period.

Notice 98-31, 1998-1 C.B. 1165, generally sets forth rules for appeals and district counsel to resolve timing issues including allowing the taxpayer to have longer spread periods. Taxpayers that are required to make a method change while under examination, normally receive a shorter spread period than taxpayers requesting method changes prior to being contacted for examination. Id. § 1.02. Notice 98-31 published a proposed Revenue Procedure that would require the examination division to resolve any timing issues as an accounting method change and to make the change in the earliest taxable year under examination with a one year section 481(a) adjustment period.

ANALYSIS:

Issue One:

The Commissioner has published revenue rulings providing that expenditures incurred in connection with the acquisition of intangible assets are capital expenditures. For example, Rev. Rul. 69-331, 1969-1 C. B. 87, holds that bonuses and commissions

paid by gas distributors to secure long-term leases for hot water heaters are capital expenditures. In Rev. Rul. 57-400, 1957-2 C.B. 520, commissions paid by a bank to brokers and other third parties for introduction of acceptable applicants for mortgage loans are capital expenditures. Yet, recognizing that the courts have not always agreed with the Commissioner's view of capitalized costs, we need to consider cases involving intangible assets.

With respect to the specific facts at issue here, cases have been litigated involving participation fees or interest, but usually in the context of when the participation fee was accrued income for the taxpayer selling the consumer paper to finance companies. The finance companies include participation interest as part of their payment for the consumer paper. For example, in Resale Mobile Homes, Inc. v. Commissioner, 91 T.C. 1085 (1988), aff'd, 965 F.2d 818 (10th Cir. 1992), the court held that the taxpayer was required to report anticipated participation interest from consumer installment sales contracts it sold to finance companies in the tax year those contracts were sold. See also Commissioner v. Hansen, 360 U.S. 446 (1959) (sale of commercial installment paper by retail vehicle dealers to finance companies; percentages of the purchase price of the installment paper withheld by finance companies was accrued income for dealers at the time the amounts were entered on the books of the finance companies as liabilities to the dealers.).

Courts have held that amounts of money paid in various contexts are capital investments. In Hampton Pontiac, Inc. v. United States, 294 F. Supp. 1073 (USDC, S.C, 1969), plaintiff entered into an agreement with an automobile franchise holder in order to "procure the termination of the existing franchise." Plaintiff agreed to pay a fixed sum over three years and a percentage of profits for five years. The court held that the payments were capital investments because the agreement was premised on the voluntary cancellation of the other party's franchise and the expectation that a new franchise would then be awarded to plaintiff. Thus, the payment enhanced or created the taxpayer's acquisition of a franchise.

At issue in Hibler v. Commissioner, 46 T.C. 663 (1966), aff'd per curiam, 67-2 U.S.T.C. ¶9711 (5th Cir. 1967), were insurance expirations purchased by the taxpayer, and the seller reserved the right to a commission of 50% of the renewals. Taxpayer deducted the commissions paid. The court agreed with the Commissioner that the commission paid expenses were a capital expenditure for the purchase of intangible assets. Again, costs related to the acquisition of an intangible asset are capital costs.

There are several recent cases which have considered the capitalization of costs which are directly related to and which create or enhance a separate and distinct asset. In Wells Fargo v. Commissioner, 224 F.3d 874 (8th Cir. 2000), the Service had disallowed deductions for salaries paid to officers of a subsidiary attributable to services performed in merging several companies and disallowed legal and investigatory expenses. The court determined that the salaries were deductible as they were directly related to the employment relationship and only indirectly related to the capital transaction. The salaries existed and were paid irrespective of the capital

transaction. The legal and investigatory expenses which were incurred after the final decision regarding the acquisition had to be capitalized. Accordingly, expenses directly related to a capital transaction (and thus a long-term benefit) should be capitalized. Wells Fargo, 224 F.3d at 888-89. See also Lychuk v. Commissioner, 116 T.C. No. 27 (May 31, 2001) (capitalization issues for a taxpayer whose business is acquiring and servicing RISC's).

In Lychuk, the basic facts are similar to your case except that participation interest is not involved. Taxpayer provides alternative financing to purchasers of vehicles who have marginal credit. It acquires the RISC's from dealers and services the contracts. Taxpayer and the dealers have an agreement under which the dealers sell some of the installment contracts (and the right to the principal and interest) to taxpayer at a price equal to 65% of each contract's principal amount. Those costs which were directly related to the loan acquisitions were capital expenditures. The loan contracts are separate and distinct assets as well as providing a future benefit of long-term income. INDOPCO, supra. Thus in Lychuk salaries and benefits are capital expenses as they are directly related to the acquisition of RISC's, but overhead expenses are deductible as they are not directly related to the contracts. Also costs related to installment contracts which were never acquired are deductible.

The Tax Court in Lychuk specifically noted that capitalizable expenditures are not limited to the actual price that the buyer pays to the seller for the asset but include, for example, the payment of legal, brokerage, accounting, appraisal and other "ancillary" expenses related to the asset's acquisition. Lychuk, slip op. at 24. In your case, the participation interest is more than ancillary, it is part of the price paid by B for the RISC's. Furthermore, the court stated that "payments made with a sufficiently direct connection to the acquisition, creation, or enhancement of a capital asset must be capitalized even when those payments are made in the course of the payee's regular business operations." Id. at 57.

In Falstaff Beer, Inc. v. Commissioner, 37 T.C. 451 (1961), the taxpayer agreed to make payments to a predecessor beer distributor for all goodwill and other intangible assets owned by the predecessor. The court held that the payments were investments in the acquisition of a new business and as such were capital outlays.

Somewhat analogous to your case is Seaboard Finance Co. v. Commissioner, T.C. Memo. 1964-253. Taxpayer's business was making small loans, and it also serviced retail installment sales contracts (RISC's) acquired from dealers. Taxpayer purchased several small loan companies for a price higher than the aggregate value of the outstanding loan contracts. The court determined the portion of the excess consideration which was attributable to the intangible asset loan contracts. The amounts paid for the loan contracts were subject to amortization; the secured loan contracts had useful lives of three years, and the unsecured loan contracts had useful lives of five years.

In summary, we believe that there is strong support in caselaw for the

capitalization of the participation fees. Lastly, amortization over the life of the RISC is clear. Under Treas. Reg. § 1.167(a)-3, capitalized costs (other than goodwill) associated with a contract (intangible asset) may be amortized if the contract is of use in the business or in the production of income for a limited period that can be ascertained with reasonable accuracy. [1]

Issue Two:

Although Rev. Proc. 97-27, § 2.10, states that a positive section 481 adjustment will ordinarily be made in the earliest taxable year under examination with a one year spread, the word "ordinarily" was not meant to create a notable exception to the general rule. Rather it was used to cover situations where, for example, there were no records for the earliest year under exam, and there are records for some later year. The examiner is then permitted to make the year of change in a later year.

The basic rule is that for an examiner initiated method change, the change is made in the earliest year under examination, and the entire section 481(a) adjustment is reported in the year of change. Any deviation from these terms is made based on a "hazard of litigation" determination, which may only be made by the appeals division. See Rev. Proc. 97-27, § 2.10. Notice 98-31 similarly provides that the examination division must make an accounting method change in the earliest taxable year under examination and make a one year section 481(a) adjustment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

One possible hazard for your case is PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3d Cir. 2000), rev'g 110 T.C. 349 (1998). At issue in PNC was whether certain costs incurred by banks for marketing, researching, and originating loans were deductible as ordinary and necessary business expenses. The Tax Court agreed with the Commissioner that the origination costs created a separate and distinct asset, namely, the loans, and the costs must be capitalized over the life of the loans. In reversing, the Third Circuit held that because loan operations were the primary method of income production for the banks and expenses incurred in loan origination were normal and routine in the banking business, the costs at issue were deductible business expenses.

The court was highly critical of the Tax Court's "broad reading of Lincoln Savings [which] essentially treats the term 'separate and distinct asset' as if it extends to cover any identifiable asset. We do not subscribe to this broad read of Lincoln Savings." PNC Bancorp, 212 F.3d at 830. "...[B]oth the Tax Court and the government effectively have transformed [the Lincoln Savings test] by subtle and significant degrees, from a test based on whether a cost 'creates' a separate and distinct asset, into a much more

[1] Although the issue is not raised by the Field, we note that a similar outcome results from the application of section 171 to these fees as amortizable bond premiums.

sweeping test that would mandate capitalization of costs incurred 'in connection with' or 'with respect to' the acquisition of an asset." Id. Yet, so far the Third Circuit is alone in this view, and the Tax Court does not agree.

We recommend distinguishing PNC by pointing out that the participation fees are clearly a part of the overall cost of the assets, the loans. The costs in PNC were ancillary to the loans, not a direct part of the amount loaned to the consumer.

For your information, the Service sent an advance notice of proposed rulemaking to the Federal Register on January 17, 2002 concerning capitalization of intangibles. Although an advance notice of proposed rulemaking may not be relied upon by a taxpayer, the taxpayer may try to apply rules contained therein to receive a deduction.

If you have any further questions, please contact the attorney assigned to this case at 202-622-4950.

HEATHER MALOY
By: ROBERT M. CASEY
Senior Technician Reviewer
Branch 3
Income Tax & Accounting