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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer’s Name:

Taxpayer’s Address:

Taxpayer’s TIN:

Tax Years:

Conference was declined.

LEGEND:

Company =

Date A =

Tax Year B =

x =

ISSUES

(1) Are Taxpayer’s transfers of customer notes to Company sales or financings?

(2) If the transfers described in ISSUE (1) are sales, what are the amounts realized?

(3) How is Taxpayer required to treat the nonrefundable enrollment fee paid to Company?

(4) Did Taxpayer make an unauthorized change of accounting method by making an election under § 1.475(c)-(1)(b)(4)(i) of the Income Tax Regulations without consent of the Commissioner and while under examination?

(5) Assuming that Taxpayer could make the election under § 1.475(c)-(1)(b)(4)(i) of the regulations, how should Taxpayer's customer notes, transferred to Company, be valued by Taxpayer?

CONCLUSIONS

(1) Taxpayer's transfers of customer notes to Company are sales.

(2) The amount realized from a sale of the customer notes equals (a) the cash received for the customer notes plus (b) the fair market value of Taxpayer's right to receive the distribution payments created by the sale.

(3) The enrollment fee is a capital expenditure under section 263 of the Internal Revenue Code and is an intangible under section 197 that is amortizable over 15 years.

(4) Since Taxpayer was eligible to make an election under § 1.475(c)-1(b)(4)(i) of the regulations and made such election in a timely manner, such election was effective.

(5) Customer notes should not be marked to market by Taxpayer after having been sold to Company. Taxpayer's right to distribution payments also should not be marked to market.

FACTS

Taxpayer is a corporation that files on the basis of a calendar year using an overall accrual method of accounting. During Tax Years, Taxpayer sold used automobiles. Since many of Taxpayer's customers were unable to arrange third party financing (because of perceived credit risk), Taxpayer accepted installment notes secured by a lien on the automobile (customer notes) as part of the consideration for sales.

To finance its own operations and divest itself of the customer notes, Taxpayer entered into an agreement, dated as of Date A, with Company. Under the agreement, Taxpayer paid Company a one-time, nonrefundable enrollment fee of $x and, was required to pay an annual maintenance fee equal to one-sixth of $x in each subsequent year. As a consequence, Taxpayer had the right to periodically submit customer notes for financing, administration, and collection. If Company accepted a customer note, it made an advance payment to Taxpayer and agreed to make distribution payments which were monthly payments conditioned on Company's collections on all customer notes. The amount of the advance payment was equal to the product of the face amount of the customer note and a percentage that ranged from 100% to 50%,

depending on Company's assessment of the customer's credit rating. During Tax Years, advance payments equalled on average approximately 60% of the face amount of the customer note. Taxpayer was not required to return the advance payment due to a default on the customer note.

Company determined the distribution payments by pooling all of the customer notes transferred by Taxpayer and by applying payments on the pool in the following order: (1) to pay Company's collection costs and insurance premiums for coverage of the financed vehicle; (2) to pay Company a "collection fee" equal to 20% of the monthly receipts; and (3) to repay Company for all advance payments made to Taxpayer by Company plus interest charged at a rate equal to prime less 3%. The remainder, if any, was payable to Taxpayer as distribution payments.

Taxpayer received no distribution payments during the Tax Years in question.

Under the agreement, once Company agreed to service a customer note, it was entitled to receive title to the note and Taxpayer's security interest in the financed automobile. Company was also entitled to endorse Taxpayer's name on any payments made to Taxpayer and any other instruments concerning the customer note and the financed automobile. Company had sole and exclusive discretion to collect upon the customer notes but agreed to use reasonable efforts to collect all payments due including repossession and liquidation of the financed automobile if a default on the customer note had occurred.

The customer note provided on its face that it was assigned to Company and future payments should be made to Company.

Company had the right to terminate the agreement with respect to future acceptance of customer notes at any time on 30 days written notice to Taxpayer; Company would continue to service the customer notes already accepted. Company could also terminate the agreement upon the occurrence of certain events of default (i.e., Taxpayer makes certain misrepresentations, Taxpayer declares bankruptcy, or Taxpayer fails to purchase or return upon request certain vehicles it is selling on behalf of Company). If the agreement were terminated due to the occurrence of an event of default or because Taxpayer chose to terminate the agreement, Taxpayer would be required to repay to Company the outstanding balance on the advance payments, any unreimbursed collection costs, and 20% of the outstanding balance of the customer notes and, in turn, Company would reassign the customer notes to Taxpayer.

The agreement also placed certain additional restrictions on Taxpayer. Taxpayer could not assign its rights under the Agreement to third parties. Taxpayer made a variety of representations including that it had and would remain duly qualified to carry on its business and had all necessary licenses and that any documents delivered to Company would be free of false or misleading statements and bear genuine signatures. In addition, Taxpayer was obligated to insure that the customer obtained adequate automobile insurance.

Taxpayer effectively treated the transfers of customer notes to Company as sales for federal income tax purposes.

After May 15, 1997, and before September 10, 1997, Taxpayer made an election under § 1.475(c)-(1)(b)(4)(i) for tax year B (an open year for which a tax return had previously been filed but which ended on or before December 24, 1996) and all subsequent tax years by filing the appropriate statement with an amended tax return for tax year B. This election was made while Taxpayer was under examination for that year and without the consent of the District Director. The election was not made during a "window period" as described in sections 6.01(2) or 6.01(3) of Rev. Proc. 97-27, 1997-21 I.R.B. 10. If valid, the election had the effect of changing Taxpayer's accounting method to reflect the application of the mark-to-market accounting method of § 475(a). Taxpayer also filed a Form 3115 with respect to such change of accounting method with the Service by October 31, 1997 but did not provide a copy of the Form 3115 to the examining agent.

OVERVIEW

During Tax Years, Taxpayer sold used automobiles in exchange for cash and customer notes. Taxpayer then sold the customer notes to Company for cash plus the right to receive distribution payments.

On the sale of an automobile, Taxpayer's amount realized was the cash received plus the issue price of any customer note received, which (assuming adequate stated interest) was the face amount of the customer note.

On the sale of a customer note, Taxpayer's amount realized was the cash received from Company (the advance payment) plus the fair market value of Taxpayer's right to receive the distribution payments. Thus, Taxpayer realized a loss on the sale of a customer note equal to the excess of Taxpayer's adjusted basis in the customer note over Taxpayer's amount realized.

Taxpayer's election to apply the mark to market accounting method of § 475 to its securities was effective. However, Taxpayer could not mark to market customer notes once they had been sold. The Taxpayer's right to distribution payments also did not constitute securities that could be marked to market under § 475.

LAW AND ANALYSIS

ISSUE 1

Are Taxpayer's transfers of customer notes to Company sales or financings?

Taxpayer transferred customer notes to Company in exchange for advance payments and contractual rights to distribution payments. The question is whether Taxpayer sold the customer notes or whether Taxpayer borrowed the advance payment from Company using the customer notes as collateral. If the transactions were sales, then Taxpayer must recognize any gain or loss for federal income tax purposes under section 1001 of the Internal Revenue Code. Alternatively, if the transactions were secured financings, then Taxpayer does not include the borrowed amounts in gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30.

In general, federal income tax consequences are governed by the substance of a transaction determined by the intentions of the parties to the transaction, the underlying economics, and all other relevant facts and circumstances. Gregory v. Helvering, 293 U.S. 465, 470 (1935), XIV-1 C.B. 193. The label the parties affix to a transaction does not determine its character. Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939), 1939-2 C.B. 208; Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Ct. Cl. 1977).

The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965), 1965-2 C.B. 282. Whether a transaction is a sale or a financing arrangement is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the surrounding facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). But see Farley Realty Co. v. Commissioner, 279 F.2d 701, 705 (2d Cir. 1960) ("[T]he parties' bona fide intentions may be ignored if the relationship the parties have created does not coincide with their intentions.").

A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). In cases involving transfers of debt instruments, the courts have considered the following factors to be relevant in determining whether the benefits and burdens of ownership passed: (1) whether the transaction was treated as a sale, see United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3; (2) whether the obligors on the notes (the transferor's customers) were notified of the transfer of the notes, id.; (3) which party serviced the notes, id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969), acq., 1969-2 C.B. xxv; (4) whether payments to the transferee corresponded to collections on the notes, United Surgical Steel Co., 54 T.C. at 1229-30, 1231; Town & Country Food Co., 51 T.C. at 1057; (5) whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship, United Surgical Steel Co., 54 T.C. at 1230; Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970); (6) which party had the power of disposition, American Nat'l Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970); Rev. Rul. 82-144, 1982-2 C.B. 34; (7) which party bore the credit risk, Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970); Elmer v. Commissioner, 65 F.2d 568, 569 (2d Cir. 1933) aff'g 22 B.T.A. 224 (1931); Rev. Rul. 82-144; and (8) which party had the potential for gain, United Surgical Steel Co., 54 T.C. at 1229; Town & Country Food Co., 51 T.C. at 1057; Rev. Rul. 82-144. No one factor is dispositive of the issue of whether a sale has taken place. The facts and circumstances determine the importance of each factor. Thus, a factor-by-factor analysis is necessary to determine whether Taxpayer sold the customer notes.

(1) Were the transfers treated as sales?

The agreement states that Taxpayer may submit to Company customer notes for "financing, administration and collection... ." Thus, on its face, the agreement appears to view the transactions as financings rather than sales. However, Taxpayer did report the advance payments as income which is consistent with viewing the transactions as sales for tax purposes.

(2) Were Taxpayer's customers notified of the transfer of the customer notes to Company?

The customer notes indicated on their face that they would be assigned to Company. See, e.g., United Surgical Steel Co., 54 T.C. at 1229-30, 1231 (customers' lack of notice of assignment was a factor supporting financing treatment).

(3) Which party handled collections and serviced the customer notes?

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

(4) Did payments to Company correspond to collections on the customer notes?

The payments Company received were the payments Company collected on the customer notes. Taxpayer had no obligation to make payments to Company. Company received payments only if and when it collected amounts on the customer notes. Compare United Surgical Steel Co., 54 T.C. at 1230, and Town & Country Food Co., 51 T.C. at 1057 (lenders looked to taxpayers for repayment, not payments on pledged installment notes) with Branham v. Commissioner, 51 T.C. 175, 180 (1968) (taxpayer's payments to purported lender were exactly the same in amount and timing as payments on underlying installment notes). Furthermore, an advance payment was based on a percentage of the face amount of a customer note transferred by Taxpayer, which suggests that Taxpayer sold the customer notes. Cf. United Surgical Steel Co., 54 T.C. at 1231 (taxpayer did not borrow maximum amount allowable under agreement); Yancey Bros. Co., 319 F. Supp. at 446 (taxpayer had access to additional funds without providing additional collateral).

(5) Did Company impose restrictions on the operations of Taxpayer that are consistent with a lender-borrower relationship?

The relationship between Taxpayer and Company had none of the characteristics that are common in a lender-borrower relationship. Other than requiring that Taxpayer remain duly qualified to carry on its business and obtain necessary licenses, Company imposed no restrictions on the operations of Taxpayer. For example, Company did not require Taxpayer to maintain a specified ratio of assets to liabilities or current assets to current liabilities. Company did not receive the right to review Taxpayer's books and records. Company received only the right to documents that were necessary for Company to exercise its rights and duties concerning the transferred customer notes. Since Company imposed no restrictions on Taxpayer's operations, Company is less like a lender and more like a purchaser of the customer notes. See, e.g., United Surgical Steel Co., 54 T.C. at 1230 (bank's imposition of restrictions on operations of taxpayer was a factor showing lender-borrower relationship). This conclusion is further supported by Company's failure to require Taxpayer to maintain a minimum amount of collateral. See, e.g., Union Planters Nat'l Bank of Memphis, 426 F.2d at 118, (purported seller required to make margin account payments); Yancey Bros. Co., 319 F. Supp. at 446 (taxpayer obligated to maintain ratio of collateral to debt of not less than 105 percent).

(6) Which party had the power of disposition?

Company had the power of disposition. The agreement contemplates that, following Company's acceptance of a receivable, title to the customer note and the security interest in the financed vehicle would be assigned to Company. The agreement did not restrict Company's right to dispose of the transferred customer notes. Cf. Town & Country Food Co., 51 T.C. at 1057 (finance company could acquire and dispose of installment notes only if the dealer defaulted on its indebtedness).

Taxpayer, on the other hand, no longer had title to the customer notes, and so could not transfer the customer notes. Further, the agreement expressly forbids Taxpayer assigning its rights under the agreement to third parties so Taxpayer could not assign any contractual rights it might have in the customer notes (e.g. its right to distribution payments) to a third party absent Finance Company's waiver of the restriction on assignment. Taxpayer had neither the right to substitute different customer notes for customer notes transferred to Company, nor the right to reacquire customer notes (unless by terminating the agreement and reacquiring all customer notes). If Company were a lender, then it would be reasonable to expect Taxpayer to have the ability to

substitute collateral of equal value to secure the outstanding loan. Cf. American Nat'l Bank of Austin, 421 F.2d at 452 (purported seller could dispose of the securities without prior approval from purported buyer).

(7) Which party bore the credit risk on the customer notes?

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

It may be argued that Company's risk of loss was insubstantial because (1) it advanced Taxpayer an average of about 60 percent of the face amount of each customer note, and (2) the distribution payments were based on the entire pool of customer notes, which meant that Taxpayer's right to payments was subordinated to Company's right.

This argument assumes that the fair market value of the customer notes equaled their face amounts. The evidence, however, is to the contrary. Between a customer's down payment and the advance payment from Company, Taxpayer generally profited on the sale of an automobile. Given the value of the automobiles sold, the credit quality of the customers, and statutory limits on interest charged in consumer credit sales, it is reasonable to conclude that the face amounts of the customer notes exceeded their fair market values. See, e.g., Hercules Motor Corp. v. Commissioner, 40 B.T.A. 999, 1000 (1939) (taxpayer inflated sales price to account for buyer's uncertain credit status). Taxpayer transferred customer notes to Company for cash payments averaging about 60 percent of their face amounts and permitted Company to retain substantial fees on all collections. Taxpayer would not have agreed to these conditions unless the fair market value of the customer notes was less than their face amounts. Accordingly, we are unwilling to conclude that Company's risk of loss was insubstantial.

(8) The potential for gain on the customer notes.

Company's potential for gain on the customer notes was greater than Taxpayer's. Company gave Taxpayer cash, namely, the

advance payments when Taxpayer transferred customer notes to Company. Company's right to recover those advance payments plus a small "interest charge" and payment for its collection costs and fees was limited to its collections on the customer notes. Company's profits, therefore, depended on the timing and amount of the collections rather than on any interest charged to Taxpayer while the advance payments were outstanding. Consequently, the greater the collections on the customer notes, the greater Company's rate of return on the advance payments made to Taxpayer.[1] In addition, Company stood to gain more than Taxpayer if customers defaulted at a rate lower than expected.

In cases addressing transfers of debt instruments or other rights to future payments, courts have pointed to a fixed rate of return on the loaned amount as evidence that the transactions were financings. E.g., Mapco, 556 F.2d at 1111-12; Union Planters Nat'l Bank of Memphis, 426 F.2d at 118; American Nat'l Bank of Austin, 421 F.2d at 452; United Surgical Steel Co., 54

[1]An example may help illustrate why Company's rate of return on its investment (the advance payments) depended solely on the performance of the customer notes. Assume Taxpayer transferred to Company a customer note with a face amount of $3,600, a term of 22 months, an interest rate of 21.82 percent per annum, and monthly payments of approximately $200. Also assume that Company had no collection costs, Taxpayer transferred only the one customer note and that Company did not receive interest on the advance payment. Company would be entitled to receive its fee of 20 percent of each payment (approximately $40). Company would also be entitled to the remaining $160 of any payment ($200 - $40 fee) until it recovered the advance payment of $1,800. Thus, Company would be entitled to eleven payments of $200, one payment of $80, and ten payments of $40. Taxpayer would be entitled to receive, starting in month twelve, one payment of $120 and ten payments of $160.

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

T.C. at 1229. A debt instrument can provide for a variable rate of return and even contingent payments. E.g., §§ 1.1275-4 and 1.1275-5 of the Income Tax Regulations; Rev. Rul. 83-51, 1983-1 C.B. 48. Nevertheless, to be a financing there must be a debtor-creditor relationship between Company and Taxpayer. Since Company's economic return was based solely on the performance of the customer notes rather than on its relationship with Taxpayer, Company was more like an owner of the customer notes than a creditor of Taxpayer.

After transferring the customer notes, Taxpayer had little potential to realize gain on the customer notes. Only after Company recouped its out-of-pocket costs, its fees, and all of the advance payments would Taxpayer receive any distribution payments. While Taxpayer had the potential for some benefit if the pool of customer notes had a low default rate, that potential benefit does not in itself make Taxpayer the owner of the customer notes. See Commissioner v. Brown, 380 U.S. 573 (1965); Rev. Rul. 83-51, 1983-1 C.B. 48. Further, Taxpayer could not realize any economic benefit of changes in market interest rates by disposing of the customer notes.

For the foregoing reasons, we conclude that Taxpayer sold the customer notes to Company.

ISSUE 2

What are the amounts realized on the sale of the customer notes?

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

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

Under the dealer agreement, Taxpayer's receipt of distribution payments depended on Company's ability to collect on the customer notes and Company's cost of making those collections. Distribution payments were determined under a complex formula. No amount or time of payment was specified for any particular customer note or any group of customer notes.

Payment, if any, was deferred until an indefinite time in the future. Moreover, there was no provision for interest regardless of when Taxpayer might receive any distribution payments.

The deferred nature of the distribution payments and the absence of any stated interest implicates section 483 of the Code.[2] Section 483 generally applies to payments under a contract for the sale of property if the contract provides for one or more payments due more than 1 year after the date of sale, and the contract does not provide for adequate stated interest. For purposes of section 483, a sale is any transaction treated as a sale for tax purposes (such as Taxpayer's transaction with Company) and property includes debt instruments (such as the customer notes). § 1.483-1(a)(2) of the regulations.

Section 483 of the Code is intended to ensure that a minimum portion of the payments under a sales contract is treated as interest. H. Conf. Rep No. 215, 97th. Cong. 1st Sess. 281 (1981), 1981-2 C.B. 525. In other words, if a sales contract provides for deferred payments but not adequate stated interest, section 483 recharacterizes a portion of the deferred payments as interest for tax purposes. Thus, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange. § 1.483-1(a)(2) of the regulations. See §§ 1.1001-1(g) and 1.1012-1(g).

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

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[2]The deferred receipt of the distribution payments superficially resembles the deferred receipt of payment in Commissioner v. Hansen, 360 U.S. 446 (1959), 1959-2 C.B. 460. Nevertheless, as discussed later, under the facts and circumstances, Taxpayer had no fixed right to receive the distribution payments at the time Taxpayer sold the customer notes.

Section 483(f) of the Code authorizes the Secretary to issue regulations applying section 483 to any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment cannot be determined at the time of the sale or exchange. Section 1.483-4 of the regulations,[3] which was issued under the authority of section 483(f), contains rules applying section 483 in the case of a sales contract that calls for one or more "contingent payments".

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

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

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

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[3]Section 1.483-4 applies to sales or exchanges that occur on or after August 13, 1996. For a sale or exchange that occurred before August 13, 1996, a taxpayer may use any reasonable method to account for the contingent payments, including a method that would have been required under the proposed regulations when the sale or exchange occurred. See T.D. 8674, 1996-2 C.B. 84, 89.

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

Because the distribution payments are contingent payments under § 1.483-4 of the regulations, each payment must be accounted for using rules similar to those contained in § 1.1275-4(c)(4).

Under § 1.1275-4(c)(4) of the regulations, the portion of a contingent payment treated as interest is includible in gross income by the holder and deductible from gross income by the issuer in the year in which the payment is made. A contingent payment is characterized by § 1.1275-4(c)(4)(ii) as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date.

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

Section 1.1001-1(g)(2)(ii) of the regulations provides the rule for determining the amount realized attributable to a debt instrument subject to § 1.1275-4(c)(4) or § 1.483-4. Under § 1.1001-1(g)(2)(ii), the amount realized attributable to contingent payments is their fair market value. Since the distribution payments are contingent payments for purposes of section 483 of the Code, the amount realized attributable to the distribution payments is the fair market value of the distribution payments. Thus, the amounts realized from the sales

of the customer notes equal (a) the cash received plus (b) the fair market value of Taxpayer's right to receive the distribution payments.

The conclusions reached on this issue are consistent with section 451 of the Code. Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Section 1.451-1(a) of the regulations provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. See also § 1.446-1(c)(1)(ii)(A). Thus, it is the right to receive and not the actual receipt that determines inclusion. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-85, 1934-1 C.B. 281.

In Commissioner v. Hansen, 360 U.S. 446 (1959), 1959-2 C.B. 460,[4] the Supreme Court addressed the issue of whether accrual method taxpayers have a fixed right to receive income even though payment is withheld. The taxpayers were two automobile dealers and a trailer dealer who accepted installment notes from their customers. Each dealer sold their notes to a finance company for a price determined by a fixed formula. The finance company paid 95 to 97 percent of the formula price in cash and held the remainder in reserve. The reserve served as security for payment of the dealers' obligation to repurchase a note that went into default. If the accumulated reserve exceeded a designated percentage of the unpaid principal balances of the notes, the finance companies paid the excess to the dealer.

The Supreme Court held that the dealers had to currently include in income the amounts withheld in reserve. Even though the dealers' actual receipt of the reserve amounts was subject to their contingent liabilities to the finance companies, the Court concluded that the dealers had received a fixed right to the reserve amounts. Id. at 463. Only one of two things could happen to the reserve amounts -- either the amounts would be paid to the dealers or would be used to satisfy the dealers' guaranty

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[4]Section 483 was not applicable in Hansen. Section 483 was added to the Code by the Revenue Act of 1964, Pub. L. No. 88-272, § 224, 78 Stat. 19, 77-79 (1964), and applies to sellers of ordinary income property as a result of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 678, 98th Cong. 2d Sess. (1984).

obligations to the finance companies. Id. at 465-66. As the dealers effectively received the entire amount of the reserves in all events, the right to the receive the reserves was not conditional but absolute at the time they were withheld and the dealers had to include the reserves in income at that time. Id.

Under the particular facts and circumstances of the instant case, Taxpayer does not have a fixed right to distribution payments at the time Taxpayer sells a customer note. Taxpayer's case is distinguishable from Hansen. Taxpayer's customers had poor credit and the customer notes were of poor quality. Because of the poor creditworthiness of the customers, Company's collection costs were uncertain and sometimes significant. Company was obligated to pay distribution payments to Taxpayer only if it collected enough from the customers to recover (1) all its collection costs on the transferred customer notes; (2) its 20% servicing fee on the customer notes; and (3) any outstanding advances on the customer notes plus an interest charge. Under these circumstances, there was reasonable doubt that any future distribution payments would be made to Taxpayer. In light of these facts and circumstances, which were not present in Hansen, Taxpayer's right to distribution payments were contingent upon future events that were uncertain at the time the notes were sold to Company.

Accordingly, the amounts realized by Taxpayer from the sales of the customer notes does not necessarily include the full amount of future distribution payments. Rather, the amount realized is equal to (a) the cash received plus (b) the fair market value of Taxpayer's right to receive the distribution payments.

ISSUE 3

How is Taxpayer required to treat the nonrefundable enrollment fee paid to Company? Is the fee a capital expenditure under section 263 of the Code or currently deductible under section 162? If the fee is a capital expenditure, is it a section 197 intangible?

Section 161 of the Code provides that, in computing taxable income there are allowed as deductions the items specified in part VI (which contains section 162), subject to the exceptions provided in part IX (which contains section 263).

Section 162(a) of the Code allows a deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) of the Code prohibits a deduction for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

The determination of whether an expenditure is capital or ordinary must be based on a careful examination of the particular facts and circumstances of each situation. Deputy v. du Pont, 308 U.S. 488, 496 (1940), 1940-1 C.B. 118, 121. An expenditure incurred in a taxpayer's business may qualify as ordinary and necessary under section 162 of the Code if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure under section 263. Commissioner v. Tellier, 383 U.S, 687, 689 (1966), 1966-1 C.B. 32, 33; Deputy v. du Pont, 308 U.S. at 495, 1940-1 C.B. at 121; Welch v. Helvering, 290 U.S. 111, 113 (1933), 1933-2 C.B. 112, 113. Under section 161, if a cost is a capital expenditure, the capitalization rules of section 263 take precedence over the deduction rules of section 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974), 1974-2 C.B. 85, 90. Thus, a capital expenditure cannot be deducted under section 162, regardless of whether it is ordinary and necessary in carrying on a trade or business.

In determining whether a cost is a capital expenditure, the Supreme Court in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), noted that a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is a current deduction or a capital expenditure. 503 U.S. at 87, citing United States v. Mississippi Chemical Corp., 405 U.S. 298, 310 (1972), 1972-1 C.B. 229, 232-33 (expense that "is of value in more than one taxable year" is a nondeductible capital expenditure). Initiation fees payable to an organization, the services of which benefit the taxpayer's business beyond the taxable year, are nondeductible capital expenditures. Harmon v. Commissioner, 72 T.C. 362, 367-68 (1979); Wells-Lee v. Commissioner, 360 F.2d 665 (8th Cir. 1966); Iowa-Des Moines Nat'l Bank v. Commissioner, 68 T.C. 872 (1977), aff'd on other grounds, 592 F.2d 433 (8th Cir. 1979); Webb v. Commissioner, 55 T.C. 743 (1971); Rev. Rul. 77-534, 1977-2 C.B. 50.

Another factor that is considered is whether the fee is nonrecurring. The distinction between recurring and nonrecurring expenditures provides a crude but serviceable demarcation between deductible expenses and capital expenditures. Encyclopedia Britannica Inc. v. Commissioner, 685 F.2d 212, 216-17 (7th Cir. 1982); Central Texas Savings & Loan Assoc. v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984); Rev. Rul. 80-3, 1980-1 C.B. 145;

Rev. Rul. 70-171, 1970-1 C.B. 55. In Central Texas Savings & Loan, the court held that fees paid to obtain permits to open new branch offices were capital expenditures:

> [T]he permit was a one-time payment that gave the taxpayer the right to operate for an indefinite period of time. The benefit secured by the permit clearly extended beyond the year in which the fee payment was made. Furthermore, the fact that the fee payment was made only once supports the proposition that the outlay was a capital asset, rather than an annual expense.

731 F.2d at 1183. Accord Grace Nat'l Bank of New York v. Commissioner, 15 T.C. 563, 565 (1950) (holding that admission fee was capital expenditure because not recurring and benefits of fee not limited to taxable year in which paid or incurred).

The enrollment fee at issue is similar to an initiation or admission fee. By making a one-time payment, Taxpayer was able to sell customer notes indefinitely to Company. Company's purchase of the customer notes provided long-term benefits to Taxpayer's business by eliminating the need to carry and service high-risk customer notes. This in turn freed up Taxpayer's cash flow, enhanced its ability to maintain a greater automobile inventory, and increased turnover. The benefits to Taxpayer were significant and extended substantially beyond the taxable year. Accordingly, the enrollment fee is a capital expenditure under section 263 of the Code and may not be currently deducted under section 162.

Section 197(a) of the Code provides that a taxpayer is entitled to an amortization deduction for any amortizable section 197 intangible. The amortization is ratable over a 15-year period.

Under section 197(c)(1) of the Code, an "amortizable section 197 intangible" is any section 197 intangible acquired by the taxpayer after August 10, 1993 and held in connection with the conduct of a trade or business.

Under section 197(d)(1) of the Code, a "section 197 intangible" includes any supplier-based intangible. The term "supplier-based intangible" (defined in section 197(d)(3)) means any value resulting from the future acquisition of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

Section 197(e)(4)(D)(i) of the Code allows, to the extent provided in regulations, for an exception from inclusion as a section 197 intangible any interest under a contract if such right has a fixed duration of less than 15 years.

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

The dealer agreement does not have a fixed duration of less than 15 years, therefore the exception from inclusion under section 197 of the Code does not apply. Taxpayer entered into the dealer agreement after the August 10, 1993, effective date of section 197. Therefore, the dealer agreement meets the requirements of section 197(c) and the nonrefundable enrollment fee is amortizable as a section 197 intangible.

The adjusted basis of the dealer agreement is amortizable ratably over a 15-year period beginning with the month in which the contract was entered into. As Taxpayer deducted the fee in the year paid rather than capitalizing, an adjustment under section 481 of the Code is necessary to recover the improper deduction.

ISSUE 4

Did Taxpayer make an unauthorized change of accounting method by making an election under § 1.475(c)-1(b)(4)(i) of the regulations without consent of the Commissioner and while under examination?

Section 1.475(c)-1(b)(4) of the regulations exempts a taxpayer from the application of section 475 of the Code if the taxpayer would not be a "dealer in securities" within the meaning of section 475 but for its purchases of "customer paper." Customer paper with respect to a person is defined to mean a debt instrument if —

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) At all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person. Section 1.475(c)-1(b)(2).

Under § 1.475(c)-1(b)(4)(i) of the regulations, a taxpayer may elect to waive the "customer paper" exemption. Although § 1.475(c)-1(b) became effective on December 24, 1996, the waiver may be elected for a year ending on or before December 24, 1996, by attaching a statement to an amended tax return filed prior to October 31, 1997. An election under § 1.475(c)-1(b)(4)(i) is deemed also to be an election to waive the exemption from application of section 475(a) provided by § 1.475(c)-1(c) for taxpayers with negligible sales of securities. See Rev. Rul. 97-39, 1997-39 I.R.B. 4, Holding 18.

In general, making the election under § 1.475(c)-1(b)(4)(i) of the regulations requires a taxpayer to change its method of accounting. Ordinarily, a taxpayer cannot change its method of accounting absent the Commissioner's permission. Section 446(e). Rev. Proc. 97-27, 1997-1 C.B. 680, governs changes of accounting methods applied for after May 15, 1997. Rev. Proc. 97-27, at sections 4.01, 13.01. Rev. Proc. 97-27, however, does not apply to taxpayers under examination other than those that request a change of accounting method with the consent of the district director or in certain "window periods". Id. at section 6.01. In addition, Rev. Proc. 97-27 does not apply to changes of accounting method subject to automatic consent procedures such as Rev. Proc 97-43. Id. at section 4.02(1).

Rev. Proc. 97-43, 1997-39 I.R.B. 12, provides a method by which a taxpayer can secure the automatic consent of the Commissioner to change its method of accounting to reflect the application of section 475 of the Code as a result of making the election provided by § 1.475(c)-1(b)(4)(i) of the regulations. To secure automatic consent, the taxpayer must make the election by attaching the statement required by § 1.475-1(b)(4)(i) to a tax return or amended tax return, as applicable. Rev. Proc. 97-43 at section 4.02. In addition, the taxpayer must file a Form 3115 (and certain supplemental material) with the main office of the Service and, subject to certain limited exceptions, with the tax return or amended tax return that makes the election. Id. at sections 4.05, 4.07. If the taxpayer is under examination with respect to the year of change, a copy of the Form 3115 must also be provided to the examining agent. Id. at section 4.06(1). The effective date for Rev. Proc. 97-43 is September 10, 1997, although the effective date for § 1.475(c)-1(b) is December 24, 1996. T.D. 8700, 1997-1 C.B. 108; Rev. Proc. 97-43 at section 6.

Taxpayer's primary activity is the sale of used cars. The customer notes are issued by the purchasers of the used cars in order to finance their purchase. The customer notes are held by Taxpayer upon issuance. Therefore, the customer notes are

customer paper with respect to Taxpayer. Taxpayer was therefore subject to the "customer paper" exemption and could waive the exemption by making an election under § 1.475(c)-1(b)(4)(i). If an election out of the negligible sales exemption of § 1.475(c)-1(c) had been necessary for Taxpayer to have become subject to the application of the mark-to-market accounting method of section 475(a) of the Code, the election under § 1.475(c)-1(b)(4)(i) would be deemed also to be an election out of the application of § 1.475(c)-1(c).

Electing the waiver provided by § 1.475(c)-1(b)(4)(i) of the regulations may require changing an accounting method. However, the section is, on its face, comprehensive and does not refer to an obligation to obtain consent of the Commissioner in order to elect the waiver. This suggests that automatic consent to a resultant change in accounting method was contemplated. This is consistent with Rev. Proc. 97-43 which imposed certain requirements for taxpayers to obtain such automatic consent.

Taxpayer did not file a copy of the Form 3115 with the Taxpayer's examining agent and, therefore, failed to comply with the requirements of section 4.06(1) of Rev. Proc. 97-43. However, since Taxpayer's election predated the effective date of Rev. Proc. 97-43, Rev. Proc. 97-43 should not be read to impose requirements on Taxpayer additional to those imposed by § 1.475(c)-1(b)(4)(i).

Rev. Proc. 97-27 does not apply to changes of accounting method subject to automatic consent procedures. Therefore, Rev. Proc. 97-27 does not apply in this case.

Taxpayer was eligible to make an election under § 1.475(c)-1(b)(4)(i) of the regulations. Taxpayer made such election in conformity with the regulation prior to October 31, 1997, so such election could apply to tax year B, which was an open tax year ending on or before December 24, 1996. Taxpayer's election predated the effective date of Rev. Proc. 97-43. Taxpayer's election is an automatic change of accounting method, and is therefore not subject to Rev. Proc. 97-27.

ISSUE 5

Assuming that Taxpayer could make the election under § 1.475(c)-1(b)(4)(i) of the regulations, how would Taxpayer's customer notes, transferred to the Company, be valued by Taxpayer?

A taxpayer that is subject to section 475 of the Code (whether by election or otherwise) is required to apply the mark-

to-market accounting method of section 475(a) to any "security" held by the taxpayer other than one described in section 475(b)(1) that is timely identified as provided by section 475(b)(2) or that is deemed identified as described in Holding 15 of Revenue Ruling 97-39. A security is defined to include stock, partnership or beneficial interests in widely held or publicly traded partnerships or trusts, notes, bonds, debentures, or other evidence of indebtedness, swaps, an interest in or any derivative financial instrument in any of the above-described securities, and a position which is a hedge with respect to an instrument described above. Section 475(c)(2).

Because the customer notes received by Taxpayer are "customer paper" as defined by § 1.475(c)-1(b)(2) of the regulations, they are securities for the purposes of section 475 of the Code. Therefore, customer notes held by Taxpayer, other than those identified or deemed identified as described in section 475(b)(1), would be marked to market by Taxpayer in accordance with section 475(a). Of course, customer notes not held by Taxpayer because of a sale to a third party would not be marked to market by Taxpayer. The customer notes sold to Company, therefore, could not be marked to market by Taxpayer after their sale.

When Taxpayer transfers a customer note to Company, it receives a right to distribution payments. Such rights could be marked to market by Taxpayer if they constituted a "security" for the purposes of section 475 of the Code. However, the right to distribution payments does not fit within any of the definitions of a security under section 475(c)(2). Therefore, the right to distribution payments can not be marked to market by Taxpayer.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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