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Taxpayer's Name:

Taxpayer's Address:

Taxpayer's TIN:

Tax Year:

LEGEND

Company =

ISSUES

(1) Is Taxpayer required to use the accrual method to account for the purchase and sale of used automobiles?

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

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

CONCLUSIONS

(1) Taxpayer is required to use the accrual method to account for the purchase and sale of used automobiles.

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

(3) The amounts realized from sales of the customer notes equal (a) the cash received for the customer note, plus (b) the fair market value of Taxpayer's right to receive the distribution payments created by the sale.

FACTS

Taxpayer is an individual who files on the basis of a calendar year using the cash receipts and disbursements method of accounting. During Tax Year, Taxpayer sold used automobiles. Since most of Taxpayer’s customers were unable to arrange third-party financing (because of perceived credit risk), Taxpayer accepted installment notes (customer notes), secured by a lien on the automobile, as part of the consideration for sales.

To finance its own operations and avoid the difficulties of servicing the customer notes, Taxpayer entered into a "servicing agreement" with Company. Under the agreement, Taxpayer paid Company a one-time, nonrefundable enrollment fee and agreed to periodically submit customer notes for servicing, 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 the customer notes. The advance payment was the lesser of 50 percent of the outstanding principal balance of the customer note or 150 percent of the net down payment made on the purchase of the financed automobile. A customer’s default did not obligate Taxpayer to return the advance payment or to repurchase either the customer note or the financed automobile.

Company determined the distribution payments by pooling the customer notes transferred by Taxpayer and by applying payments on the pool in the following order: (1) to pay Company’s collection costs (all of Company’s out-of-pocket costs incurred in the administration, servicing and collection of the customer notes), (2) to pay Company’s fee of 20 percent of the total payment (net of any collection costs), and (3) to repay Company for all advance payments made to Taxpayer. The reminder, if any, was payable to Taxpayer as distribution payments.

Taxpayer has stated that he never received and does not expect to receive any distribution payments.

Once Company agreed to service a customer note, Taxpayer transferred the customer note, all files relating to the customer note, and Taxpayer’s security interest in the financed automobile. Company was entitled to endorse Taxpayer’s name on any payments made to Taxpayer and any other instruments concerning the customer note and the financed automobile. Taxpayer was obligated to ensure that the customer obtained and maintained adequate automobile insurance.

Company, in its discretion, could determine whether there was a default on a customer note and could waive any late payment, charge, or any other fee it was entitled to collect in

the ordinary course of servicing the customer note. Company agreed to use reasonable efforts to collect all payments due under a customer note and to repossess and sell or otherwise liquidate the financed automobile if a default on the customer note occurred. Taxpayer agreed to indemnify Company for any expenses and claims arising out of Company’s administration, servicing, and collection on the customer notes.

Company had the right to terminate the servicing agreement on 30 days written notice to Taxpayer. Company could terminate immediately if for any two calendar quarters Taxpayer failed to place with Company at least 15 qualifying customer notes or if Taxpayer "defaulted." Taxpayer also had the right to terminate the servicing agreement on 30 days written notice. If Company terminated the agreement because of default or if Taxpayer terminated the agreement, Taxpayer was obligated to pay Company its unreimbursed collection costs, any outstanding advances, and a termination fee equal to 20 percent of the outstanding amounts of the customer notes. If Company terminated the agreement (other than for default) or if Taxpayer terminated the agreement, Company would continue servicing and administering the customer notes unless Taxpayer asked Company to stop.

At the time they signed a customer note, Taxpayer’s customers were told that the customer note would be assigned (without recourse) to Company. The assignment was stated on the face of the customer notes.

Taxpayer effectively treated the transfers of customer notes to Company as sales for federal income tax purposes. Taxpayer’s treatment was consistent with a letter received from Company. The letter was prepared for Company’s use, including distribution to dealers participating in Company’s programs, and acknowledged that sale treatment was a permissible characterization of the transfers.

OVERVIEW

During Tax Year, 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.

As a dealer in used automobiles, Taxpayer was required to be on an accrual method of accounting. 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 difference between Taxpayer's adjusted basis in the customer note and Taxpayer's amount realized.

LAW AND ANALYSIS

ISSUE 1

Is Taxpayer required to use an accrual method to account for the purchase and sale of used automobiles?

Section 446(a) of the Internal Revenue Code provides that taxable income is computed under the method on the basis of which the taxpayer regularly computes his income in keeping his books.

Section 446(b) of the Code provides that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 446(c) of the Code provides, in part, that subject to section 446(a) and (b), a taxpayer may compute taxable income under the cash method of accounting or an accrual method of accounting.

Section 1.446-1(a)(4)(i) of the Income Tax Regulations provides that in all cases in which the production, purchase, or sale of merchandise of any kind is an income producing factor, merchandise on hand (including finished goods, work in progress, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 263A and 471 and the regulations thereunder.)

Section 1.446-1(c)(2)(i) of the regulations provides that in any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under § 1.446-1(c)(2)(ii).

Section 1.446-1(c)(2)(ii) of the regulations provides that the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.

Section 471 of the Code provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-1 of the regulations provides that in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those that have been acquired for sale or that will physically become a part of merchandise intended for sale.

Under § 1.471-1 of the regulations, inventories are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor. See also § 1.446-1(a)(4)(i). "Merchandise" for purposes of § 1.471-1 is property transferred to a customer.

Taxpayer transferred used automobiles to its customers, and the purchase and sale of such merchandise (used automobiles) were income producing factors in Taxpayer's business. This means that Taxpayer was required to maintain an inventory. Thus, Taxpayer is required to use the accrual method to account for the purchase and sale of used automobiles.

A change from Taxpayer's current method of accounting to the accrual method of accounting requires computing an adjustment under section 481(a) of the Code. The entire section 481(a) adjustment should be taken into account in the earliest year under examination. Section 481(b) may limit the amount of tax arising from the section 481(a) adjustment.

ISSUE 2

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 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 (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 attending 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 have 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 form of the agreement between Taxpayer and Company is that of a servicing agreement and not a sales contract. Taxpayer nevertheless treated the transfers of the customer notes as sales for tax purposes. Further, in the letter sent to Taxpayer, Company acknowledged that sale treatment was a permissible characterization of the transfers.

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

Customers were told at the time they signed a customer note that it would be assigned without recourse to Company. The assignment was also stated on the note itself. 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. Although the servicing agreement states that Company was Taxpayer's nominee for administrating, servicing and collecting on the customer notes, in fact, 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 sole discretion to determine whether a default had occurred and to elect to pursue remedies. 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 that 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 fixed amount of a customer note, not on Taxpayer's creditworthiness. This implies 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. 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). That 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 to dispose of the customer notes?

The servicing agreement is silent about the power of disposition. Taxpayer could dispose of the customer notes only by reacquiring all of them from Company. To reacquire the

customer notes, Taxpayer had to terminate the servicing agreement and pay Company its unreimbursed collection costs, any outstanding advances, and a termination fee equal to 20 percent of the outstanding amounts of the customer notes. If, however, 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). At the same time, Company's power to dispose of the customer notes must have been restricted, since Taxpayer had the right to reacquire them.

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

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

It may be argued that Company's risk of loss was insubstantial because (1) it advanced Taxpayer no more than 50 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 of no more than 50 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 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

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[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 $5,900, a term of 36 months, an interest rate of 18 percent per annum, and monthly payments of approximately $213. Also assume that Company had no collection costs and Taxpayer transferred only the one customer note. Company would be entitled to receive its fee of 20 percent of each payment (approximately $43). Company would also be entitled to the remaining $170 of any payment ($213 - $43 fee) until it recovered the advance payment of $2,950. Thus, Company would be entitled to seventeen payments of $213, one payment of $103, and eighteen payments of $43. Taxpayer would be entitled to receive, starting in month eighteen, one payment of $110 and eighteen payments of $170.

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 46 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 still would be approximately 32 percent. As the example shows, the more payments Company collects, the greater Company's rate of return on its advance payment to Taxpayer.

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 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 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, the cost of reacquiring the customer notes from Company effectively prevented Taxpayer from profiting from any changes in market interest rates.

For the foregoing reasons, we conclude that the transfers of customer notes to Company are sales.

ISSUE 3

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 servicing 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 in

the servicing agreement 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 servicing 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 servicing 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 servicing 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.

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

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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.

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 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.

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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).

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. 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 amount realized by Taxpayer from the sale 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 future distribution payments.

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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