OFFICE OF
CHIEF COUNSEL

SEP 28, 2000

Number: **200103006**
Release Date: 1/19/2001
CC:IT&A:1/TL-N-3216-99
UILC: 61.16-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, MICHIGAN DISTRICT
CC:NER:MIC:DET

Attn: Eric Skinner

FROM: ASSOCIATE CHIEF COUNSEL, INCOME TAX & ACCOUNTING, CC:ITA

SUBJECT: Treatment of Various Advance Payments

This Field Service Advice responds to your memorandum dated June 30, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document <u>only</u> with those persons whose official tax administration duties with respect to the case <u>and</u> the issues discussed in the document require inspection or disclosure of the Field Service Advice.

<u>LEGEND</u>

Taxpayer:
Subsidiary:
merchandise:
Plan 1:
Plan 2:
Plan 3:
Payment A:
Payment B:
Payment C:
a:
b:
Year 1:
Year 2:
Year 3:
Year 4:
First Year:
Introduction Year:

ISSUES

1. Whether advance payments, in the form of Payment A, Payment B, or Payment C, constitute rental income or a reduction in the basis of leased merchandise.

2. Whether such advance payments should be recognized when lease documents are executed or when the documents are processed by Subsidiary.

3. Whether Subsidiary is entitled to change its treatment of Payment C in Year 3 and Year 4, resulting in a reduction of taxable income in both years.

CONCLUSIONS

1. The advance payments constitute rental income.

2. The advance payments should be recognized when paid at the time lease documents are executed.

3. In view of our conclusions on Issues 1 and 2, Subsidiary is not entitled to change its treatment of Payment C in Year 3 and Year 4 and, thereby, reduce its taxable income in both years.

FACTS

We rely on the facts set forth in your memorandum requesting Field Service Advice.

Subsidiary is the wholly-owned subsidiary of Taxpayer, a manufacturer of merchandise. Subsidiary's primary function is to extend credit (for both sales and leasing transactions) to customers of Taxpayer's network of independent dealers. The transactions in question involve leases, rather than direct purchases. During the period in dispute, from Year 1 through Year 4, inclusive, there were three different lease arrangements.

Plan 1 was initiated in First Year. Under Plan 1, in accordance with the lease agreement, Subsidiary was the lessor and the dealer acted as Subsidiary's agent in executing the lease contract with the customer.

In Introduction Year, Plan 2 was introduced. Plan 2 remains the principal leasing arrangement used to lease merchandise manufactured by Taxpayer. Under Plan 2, the dealer is named as lessor. Under the terms of an agreement between the dealer and Subsidiary, Subsidiary may subsequently purchase the lease and the merchandise from the dealer. Plan 2 only applies to merchandise manufactured by Taxpayer. After the introduction of Plan 2, Plan 1 was used only for merchandise manufactured by manufacturers other than Taxpayer.

In Year 3, Plan 3 was introduced. Under this program the customer makes a single up-front payment on the lease. This payment represents the total amount due for the term of the lease, which may range in duration from 12 to 48 months. Beginning in Year 4, Plan 3 was also available for merchandise produced by manufacturers other than Taxpayer.

Under Plans 2 and 3, Subsidiary pre-approves the dealer for lease transactions. An agreement between the dealer and Subsidiary is executed that sets forth the terms under which Subsidiary will purchase leases between the customer and the dealer. The standard agreement between a dealer and Subsidiary has not been revised since Introduction Year. Under all three lease plans, the dealer negotiates the lease with the customer, including the price of the merchandise and, if applicable, the amount of Payment A. Under Plan 1, the dealer acts as Subsidiary's agent under the express terms of the agreement between the dealer and Subsidiary. For Plans 2 and 3, the agreement between the dealer and Subsidiary indicates that the dealer is free to engage in leasing transactions with the financial institution of its choice and is not made Subsidiary's agent.

We understand the lease programs were introduced by Subsidiary, not by the dealer. Further, the dealer agreements, lease agreements and worksheets needed to administer the programs are provided to the dealer by Subsidiary and the dealer is required to follow the program guidelines established by Subsidiary and set forth in a dealer's manual. According to the dealer agreement, the dealer agrees to register the merchandise in Subsidiary's name at the time the lease agreement is signed.

Under Plans 2 and 3, the dealer submits the customer's lease application to Subsidiary for review and approval. The dealer receives credit approval from Subsidiary prior to execution of the lease agreement. After receiving credit approval, the lease agreement is executed by the customer as lessee and the dealer as lessor. The dealer records transactions under all three plans as a sale of merchandise at the negotiated sales price. In accounting for the leases, the dealer records gross receipts from the sale of the merchandise at the negotiated sales price regardless of whether the customer makes Payment A.

The lease package, including the lease agreement and a worksheet, may not be submitted to Subsidiary until several days after the lease is executed. If the lease package is acceptable to Subsidiary, the dealer assigns the lease to Subsidiary. Subsidiary has given the following examples of when it will not accept and purchase a lease: 1. a valid dealer agreement has not been executed; 2. the executed lease does not conform to the requirements of the dealer agreement; 3. the terms of the executed lease are different from the representations made with the credit application; and 4. the package is incomplete. If Subsidiary purchases the lease, it records the acquisition on or after the date the lease contract is purchased. Subsidiary purchases the merchandise from the dealer at the same time as the lease. The capitalized cost of the merchandise is recorded by Subsidiary as a depreciable asset. Under the terms of the agreement between the dealer and Subsidiary, the dealer is neither contractually responsible for the customer's performance during the lease period, nor for the value of the merchandise at the time of lease maturity. At the end of a lease contract, Subsidiary takes possession of the related merchandise unless it is purchased by the customer or the dealer at lease-end. At this point, Subsidiary stops calculating depreciation on the merchandise and sells it at auction.

Payment A are down payments that the customer may agree to. The payment of Payment A is negotiated between the customer and the dealer. Payment A may be made in cash, in a allowances, in b, or in any combination thereof. Payment A reduce the net capitalized cost of the leased merchandise. Because the net capitalized cost of the merchandise is the starting point in calculating the customer's monthly lease payment, the customer's payment of Payment A have the effect of reducing the customer's monthly lease payments. For tax purposes, Subsidiary has treated the receipt of Payment A as a reduction in the depreciable tax basis of leased merchandise, rather than as an item of gross income. We understand that Payment A are generally collected and retained by the dealer.

Under Plan 2, in addition to any Payment A that may be applicable, the customer pays the Payment B plus the security deposit to the dealer when the lease is executed. For book purposes, Subsidiary has treated the Payment B as income; however, for tax purposes, the payment has been treated as a reduction in the tax basis of the leased merchandise.

Under Plan 3, for book purposes, the Payment C has been recognized by Subsidiary as income on a straight-line basis over the term of the lease. Income recognition begins in the month that Subsidiary processes the paperwork and notifies the dealer that it has acquired the lease. For tax purposes, for the years in dispute, Subsidiary recognized the Payment C as income in the month of acquisition. As with Payment A, the Payment C are normally collected and retained by the dealer.

We understand Subsidiary is now claiming that it erroneously included the Payment C in taxable income and has filed claims for refund for Year 3 and Year 4 based on its conclusion that the payments should have been treated as a reduction in the tax basis of the leased merchandise.

LAW AND ANALYSIS

Issue 1

> Whether advance payments, in the form of Payment A, Payment B, or Payment C, constitute rental income or a reduction in the basis of leased merchandise.

I.R.C. § 61 provides generally that gross income means all income from whatever source derived. Section 61(a)(5) specifically includes rents within the definition of gross income.

Treas. Reg. § 1.61-8(a) provides that gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property.

Treas. Reg. § 1.61-8(c), includes in rental income any expenses of the lessor paid by the lessee.

Section 1012 provides that, generally, the basis of property shall be the cost of such property.

Treas. Reg. § 1.1012-1 defines cost as the amount paid for such property in cash or other property.

When an obligation of a taxpayer is paid by a third party, the effect is the same as if the third party had paid the money to the taxpayer who in turn paid his creditor. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929); Sachs v. Commissioner, 32 T.C. 815, 819 (1959), aff'd, 277 F.2d 879 (8th Cir. 1960). The amounts paid on behalf of the taxpayer are included in the taxpayer's income. O'Malley v. Commissioner, 91 T.C. 352 (1988).

In this case, the Payment A collected from the customer are credited by the dealer to the purchase price of the merchandise. When Subsidiary accepts the lease, it is obligated to pay the dealer the remainder of the purchase price. Thus, the dealer receives the full negotiated purchase price for the merchandise and accounts for the transaction as a sale. Although the lease agreement purports to be between the dealer and the customer, when the lease agreement is signed, the merchandise is titled in the name of Subsidiary. The customer makes the remaining lease payments to Subsidiary as lessor.

We believe these facts support a finding that this transaction is, in substance, a sale of the merchandise by the dealer to Subsidiary, with a concurrent lease agreement between the customer and Subsidiary. The customer owes Subsidiary certain amounts as lessor and Subsidiary owes the dealer for the remainder of the purchase price. Under these circumstances, it is appropriate to treat the Payment A as paid by the customer to Subsidiary and, in turn, by Subsidiary to the dealer as part of the purchase price of the merchandise. It follows that the Payment A should be included in Subsidiary's income based on Old Colony Trust and its progeny. Moreover, because the Payment A are included in the purchase price paid for the merchandise, they do not reduce the basis of the merchandise; rather, they should be included in Subsidiary's cost basis of the property.

With respect to the Payments B and C, we understand they are expressly referenced as lease payments in the lease agreements. As lease payments made by the customer, they should not reduce Subsidiary's cost basis in the property. Like the Payment A, they should be treated as a payment to the dealer by Subsidiary to the extent the amounts are credited to the purchase price of the merchandise.

As to the character of the income, the customers' payment of Payment A has the effect of reducing the customer's future rental payments by reducing the net capitalized cost of the leased merchandise on which the monthly rent payments are based. Accordingly, there is a basis for regarding the Payment A as advance payments of rent or payments in lieu of future rent.

With respect to the Payments B and C, we see no compelling reason to characterize the payments as anything other than rent payments. In Hyde Park Realty, Inc. v. Commissioner, 20 T.C. 43 (1953), aff'd, 211 F.2d 462 (2d Cir. 1954), the Tax Court addressed the issue of the treatment of rents in a situation similar to the instant one. In Hyde Park Realty, the taxpayer purchased real property subject to an existing lease. The contract provided that rents collected by the seller should be apportioned between the parties as of the closing date. In accordance with the contract, the taxpayer received a credit toward the purchase price of the property equal to the amount of rent received by the seller before the closing date that was allocable to the period after the closing date. The taxpayer also received prepaid rent in the same year relating to amounts due in the following year.

The taxpayer treated the rents collected by the seller as rental income on its return, but did not report the prepaid rent for the next year. The Commissioner adjusted the taxpayer's income to reflect the rent received in the current year that was due in the following year. The Commissioner argued that the rent was reportable on receipt.

The taxpayer contended that the Commissioner's position was inconsistent. If rent is income when received, then, according to the taxpayer, the prepaid rent received by the seller should have been income to the seller, not to the taxpayer. The taxpayer also argued that the prepaid rent collected by the seller should be treated as a reduction to the sales price of the purchased property.

Both the Tax Court and the Second Circuit disagreed, indicating that reclassification of the prepaid rent as a reduction to purchase price was not appropriate. Both courts considered that the amounts were intended as rent when paid and concluded that the fact that the prepaid rent was ultimately used to pay for property did not alter the nature of the income when received. In addition, both courts agreed that it was axiomatic that the rent was taxable when received.

Similarly, in Pokusa v. Commissioner, T.C. Memo. 1978-93, one of the issues in dispute was the treatment of prepaid rent collected by the taxpayers prior to their sale of rental property. The rent was credited to the purchaser at closing. The Commissioner took the position that the entire amount collected should be included in the taxpayer's taxable income because at the time the rent was collected, the taxpayers owned the property. The taxpayers argued that the bulk of the rent had not been earned at the closing date and that, because the amount was credited to the purchaser, they should not be required to report the rent as income.

The court rejected the taxpayers' argument that the rent should not be reported because it constituted an adjustment to the purchase price of the property. The court noted that at the time the payments were made, they were intended to represent rent. The court refused to change the character of the payments based solely on the fact that they were credited to the purchaser and used to reduce the purchase price of the property. The court, however, also rejected the Commissioner's argument that the entire amount collected should be taxable to the taxpayers. Consistent with the outcome in Hyde Park Realty, the court required the taxpayers to report only the income earned as of the closing date. The remaining portion of the collected rent was allocable to the new owners of the property.

In this case, the customer makes Payments B and C in exchange for the possession and use of the merchandise. Just as in Hyde Park Realty and Pokusa, there is little doubt that, when paid, the Payments B and C are intended by the parties to represent rent. Under these circumstances, treatment of the payments as rent is fully justified.

On the issue of who must report the income from these payments, we have already indicated that the Payment A represent income to Subsidiary because Subsidiary benefits from the payments made by the customer through a reduction in the amount it is obligated to pay the dealer for the merchandise. As a general matter, Payments B and C should be taxed to the owner of the rented property. Helvering v. Horst, 311 U.S. 112 (1940).

We understand, particularly with reference to Payments B, that Subsidiary argues it is not the owner of the rented property until it accepts the lease packages and the leases are assigned. We agree, however, with your conclusion that the facts of this case will support an argument that, in substance, Subsidiary is the owner/lessor of the merchandise under Plans 2 and 3, as well as under Plan 1, as of the date the lease is executed.

The substance, rather than the form of a transaction, determines its tax consequences. Gregory v. Helvering, 293 U.S. 465 (1935). Thus, despite the fact that the dealer is the named lessor in the lease agreements, we believe a persuasive argument can be made that the form in which these transactions are cast is inconsistent with their true nature. Packard v. Commissioner, 85 T.C. 397, 419 (1985); see also Commissioner v. Court Holding Co., 324 U.S. 331, 334

(1945). Further, we agree that reliance on the step-transaction doctrine is appropriate in this case.

Under the step-transaction doctrine, an interrelated series of steps is examined as an integrated whole in determining the tax consequences of the result. Packard, 85 T.C. at 420. Courts have applied three alternative tests in deciding whether to invoke the step-transaction doctrine. The "mutual interdependence test" inquires whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949). The "end result test" links actions together if they are component parts of a single transaction intended from the outset to be executed for the purpose of reaching the ultimate result. Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987). The "binding commitment" test, first articulated by the Supreme Court in Commissioner v. Gordon, treats a series of actions as a single, integrated transaction if, at the time the actor took the first step, he was under a binding commitment to take the later steps. Commissioner v. Gordon, 391 U.S. 83, 96 (1968); Security Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983).

The facts of this case will support arguments under at least two of these tests. Here, the dealer must be pre-approved by Subsidiary to engage in lease transactions under Plans 2 and 3. Guidelines setting parameters on the terms of the lease agreements and specific instructions for managing the transactions are provided by Subsidiary to the dealer. The lease agreements are then negotiated pursuant to the guidelines established by Subsidiary. The customer’s credit is approved by Subsidiary prior to execution of the lease and title to the merchandise is immediately registered in Subsidiary’s name after the lease is executed.

These facts indicate that the ultimate result -- Subsidiary’s purchase of the merchandise and assumption of the lease -- is a virtual certainty at the time the lease is executed. Certainly, this result comports with Subsidiary’s function as a financing institution for taxpayer and with the initial leasing arrangements (Plan 1 transactions) instituted by Subsidiary. In addition, the steps of the lease transactions, as established by Subsidiary, appear to be interdependent. Although Subsidiary argues it is not bound to accept a lease and the dealer is free to find other financing, Subsidiary admits that leases are only rejected in the unlikely event that the dealer has not been preapproved, the dealer has failed to comply with the terms of the agreement with Subsidiary, or the dealer has misrepresented material facts concerning the terms of the lease. Thus, the dealer can control whether the lease will be acceptable to Subsidiary. Given the dealer’s motivation to sell merchandise, rather than finance such sales, it seems evident that the steps of these transactions are designed to lead to Subsidiary's purchase of the merchandise and assumption of the lease.

As to the dealer, it is questionable whether the provision allowing the dealer to obtain other financing is meaningful in view of the fact that the terms of these agreements are established by Subsidiary. Further, we can see no obvious reason why the dealer would expend the effort in trying to obtain alternative financing when the dealer has an assurance of adequate financing by simply complying with the terms of its agreement with Subsidiary.

In sum, we believe there are sufficient grounds for invoking the step-transaction doctrine under either the "mutual interdependence," or the "end result" test. If the steps involving the execution of the lease by the dealer and the assignment of the lease to Subsidiary are collapsed, Subsidiary would be considered the lessor at the inception of the lease and any lease income would properly be taxable to it.

Issue 2

> Whether such advance payments should be recognized when lease documents are executed or when the documents are processed by Subsidiary.

Treas. Reg. § 1.61-8(b) provides that, except as provided in section 467 and the regulations thereunder, gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer.

As we have indicated above, the facts of this case support the argument that Subsidiary is the true owner/lessor of the merchandise on the date the lease agreement is executed. At this time, the customer's credit has been approved by Subsidiary and possession of the merchandise has been turned over to the customer. Also, in accordance with the terms of the agreement with Subsidiary, the dealer is obligated to immediately title and register the merchandise in Subsidiary's name. Although there may be some delay in processing paperwork, the operative actions needed to consummate the transfer of ownership of the merchandise from the dealer to Subsidiary are complete as of the date the lease is executed. Based on these facts, we conclude that Subsidiary should be considered the owner of the merchandise as of the date the lease is executed. As the owner of the property, rent payments, or payments made in lieu of rent, should be taxed to Subsidiary, the owner of the merchandise, as of the date of payment. Hyde Park Realty, Inc. v. Commissioner, 20 T.C. 43.

Issue 3

Whether Subsidiary is entitled to change its treatment of Payment C in Year 3 and Year 4, resulting in a reduction of taxable income in both years.

In view of our conclusions on Issues 1 and 2, Subsidiary is not entitled to change its treatment of Payment C in Year 3 and Year 4 and, thereby, reduce its taxable income in both years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Although we believe our arguments are sound, we recognize that there are always hazards in presenting a substance over form argument. The determinations as to the character of the income and the ownership of the property are factual. Accordingly, detailed factual development of the issues will be crucial to the outcome of the case.

[redacted]

Although we do not foreclose the possibility of arguing that the transactions between the dealer and Subsidiary should be considered a sham, we point out that in order to treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction and that the transaction has no economic substance because no reasonable possibility of a profit exists. Packard v. Commissioner, 85 T.C. at 417, (quoting Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985)). These tests are factual and, to some extent, subjective. Moreover, both tests must be met before a transaction will be disregarded as a sham. Packard at 417.

HEATHER C. MALOY
Associate Chief Counsel
Income Tax & Accounting
By: GERALD M. HORAN
Senior Technician Reviewer
(CC:ITA:1)