INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 28, 2000

Number: **200120001**
Release Date: 5/18/2001
Index (UIL) No.s: 61.03-00 475.00-00 1001.02-00 166.00-00
1011.00-00 1276.00-00 1278.01-01 1278.01-02
CASE MIS No.: TAM-101966-00/CC:FIP:B3

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Tax Years:
Date of Conference:

LEGEND:

a =
b =
c =
d =
e =
tax year f =
g =

ISSUES:

(1) Are automobile dealers' transfers of customer notes to Taxpayer (a) sales of such customer notes or (b) pledges of such customer notes as security for loans made by Taxpayer to the dealers?

And if the transfers described in ISSUE (1) were sales:

(2) What is Taxpayer's basis in the customer notes that it has purchased?

(3) Did the customer notes purchased by Taxpayer have market discount within the meaning of section 1278(a)(2) of the Internal Revenue Code?

(4) Under what circumstances would Taxpayer be entitled to a deduction for wholly or partially worthless debt under section 166 for a customer note that it has purchased?

(5) Are the customer notes that Taxpayer purchased permitted to be marked to market under section 475?

CONCLUSIONS:

(1) Automobile dealers' transfers of customer notes to Taxpayer are sales.

(2) Taxpayer's basis in a customer note upon purchase equals the amount of the advance payment on the customer note. Taxpayer receives additional basis in the customer note for distribution payments. Since final regulations under § 483(f) do not apply to Tax Years, Taxpayer may use a reasonable method to determine when to attribute additional basis to the customer notes.

(3) The facts provided indicate customer notes are subject to the market discount rules of sections 1276 to 1278 of the Code and are typically acquired with market discount. However, it is possible that some customer notes are acquired without market discount or with only "de minimis" market discount. In addition, customer notes with a term of no more than 12 months are not subject to sections 1276 to 1278. Nevertheless, Taxpayer is required to treat discount earned on such notes as ordinary income when a realization event occurs.

(4) Taxpayer is entitled to a deduction for wholly or partially worthless debt on customer notes. The time of such deduction depends on the pertinent facts and circumstances not including the performance of other customer notes originated by the same dealer.

(5) Taxpayer is not permitted to mark customer notes to market under section 475 of the Code during Tax Years.

FACTS:

Taxpayer is a corporation that files on the basis of a calendar taxable year using an overall accrual method of accounting. Taxpayer is a financing company that provides financing and other services to related and unrelated automobile dealers. A significant portion of Taxpayer's business, including the transactions at issue, pertains to sales by dealers of used automobiles to retail customers with poor credit histories.

In the transactions at issue, Taxpayer's arrangement with automobile dealers was governed by a master "servicing agreement" entered into by Taxpayer and the dealer. The servicing agreement was based on a standard form originated by Taxpayer although Taxpayer and the individual dealer might negotiate amendments to the

standard agreement. For the purposes of this memorandum, it is assumed Taxpayer and each dealer used the standard servicing agreement without amendment.

The servicing agreement contemplates that the dealer will sell automobiles to retail customers in return for a cash down payment or a trade-in and a retail installment sales contract (a customer note), secured by a lien on the financed vehicle. Customer notes typically have terms of 6 to 36 months and are issued without Original Isue Discount (OID). The dealer would pay Taxpayer a one-time nonrefundable enrollment fee upon entering into the agreement and had the right to periodically submit customer notes for servicing, administration, and collection. If Taxpayer accepted a customer note, it made an advance payment to the dealer and agreed to make distribution payments, which were monthly payments conditioned on Taxpayer's collections on the customer notes. The amount of the advance payment depended upon the dealer's history with the Taxpayer, the credit profile of the retail customer, and the year, make, model, and mileage of the financed vehicle but was usually equal to between c% and d% of the stated principal amount (the face amount) of the customer note. A customer's default did not obligate the dealer to return the advance payment or to repurchase either the customer note or the financed vehicle.

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

Although not required to do so by the servicing agreement, Taxpayer, as a concession to a particular dealer, might calculate the dealer's right to distribution payments by reference only to the customer notes in a defined pool (of, typically, e or more customer notes) which would not be added to. In theory, creating these "capped" pools accelerated the dealer's receipt of distribution payments because it limited the amount of costs, fees, and advances that must be recovered before distribution payments begin. In practice, the effect of using capped pools was limited by Taxpayer's practice of using money received on one capped pool that was theoretically eligible to be paid as distribution payments to instead reimburse itself for costs, fees, and advances on another capped pools not received due to defaults occurring in the latter pool.

Although Taxpayer made significant distribution payments, they were substantially less than the amount that might have been paid absent defaults on the customer notes and were a relatively small fraction of the outstanding principal balance of the customer notes. Some dealers received no distribution payments at all.

Once Taxpayer agreed to service a customer note, the dealer transferred to Taxpayer the customer note, all files relating to the customer note, and dealer's security

interest in the financed vehicle. Taxpayer was entitled to endorse the dealer's name on any payments made to dealer and any other instruments concerning the customer note and the financed vehicle. Taxpayer could require the dealer to ensure that the customer obtained and maintained adequate automobile insurance.

Taxpayer, in its discretion, could waive any late payment, charge, or any other fee it was entitled to collect in the ordinary course of servicing the customer note. Taxpayer agreed to use reasonable efforts to collect all payments due under a customer note and to repossess and sell or otherwise liquidate the financed vehicle if a default on the customer note occurred. The dealer agreed to indemnify Taxpayer for any expenses and claims arising out of Taxpayer's administration, servicing, and collection on the customer notes other than such claims as might arise out of Taxpayer's gross negligence or willful misconduct.

Taxpayer had the right to terminate the servicing agreement on 30 days written notice to the dealer. Taxpayer could terminate immediately if for any two calendar quarters the dealer failed to place with Taxpayer at least 15 qualifying customer notes or upon the occurrence of certain events of default (e.g. dealer failed to perform any covenant set forth within the servicing agreement, dealer made certain misrepresentations, or dealer declared bankruptcy). The dealer also had the right to terminate the servicing agreement on 30 days written notice. If Taxpayer terminated the servicing agreement because of the occurrence of an event of default or if the dealer terminated the servicing agreement, the dealer was obligated to pay Taxpayer its unreimbursed collection costs, any outstanding advances, and a termination fee equal to 20 percent of the outstanding amounts of the customer notes. If Taxpayer terminated the agreement (other than for the occurrence of an event of default), Taxpayer would continue servicing and administering the customer notes unless the dealer asked Taxpayer to stop. Also, although seemingly inconsistent with the substantial payments to be made by a dealer that terminates the agreement, the servicing agreement provides that Taxpayer will continue to service customer notes upon termination by a dealer absent the occurrence of an event of default, unless the dealer asks Taxpayer to stop.

The assignment (without recourse) of a customer note to Taxpayer was typically stated on the face of the customer note. The retail customers were informed at the time that their customer note was transferred to Taxpayer that future payments should be made to Taxpayer.

The servicing agreement also placed certain obligations on the dealer. The dealer could not assign its rights under the servicing agreement to third parties. The dealer was obligated, upon Taxpayer's request, to ensure that the customer obtained adequate automobile insurance. The dealer also made a variety of representations including that it had and would remain duly qualified to carry on its business, that it had all necessary licenses and permits to carry on its business, and that each customer note delivered to Taxpayer was originated in the ordinary course of the dealer's business, was properly executed, and contained customary and enforceable provisions.

Taxpayer treated the transfer of the customer notes as a pledge of the notes to secure a loan made to the dealer in the form of the advance payment. Taxpayer did not recognize interest income on the loan but treated the service fees as income when received. In tax year f, Taxpayer took a bad debt deduction of $g million with respect to unrecoverable advances on the customer notes.

Taxpayer asserts that it did not sell customer notes or other securities during the years in question and this assertion is accepted for the purposes of this memorandum. Taxpayer's tax returns for the Tax Years did not reflect the application of the mark to market accounting method of section 475.

OVERVIEW

During Tax Years, certain automobile dealers sold used cars to retail customers in return for a cash payment and a customer note secured by the financed vehicle. Taxpayer, in turn, purchased these customer notes pursuant to the terms of the servicing agreement.

Final regulations governing the purchase of assets for a price that included deferred contingent payments do not apply to Tax years. If they applied, Taxpayer's basis in a customer note upon purchase would be equal to the advance payment on the customer note. In the event that Taxpayer later made a distribution payment on the customer note, Taxpayer would receive additional basis in the customer note. The additional basis would equal the amount of the distribution payment characterized as principal. In the absence of final regulations, Taxpayer may use any reasonable method, including the method of the proposed regulations which are generally similar to the method described above, to determine when additional basis is attributed to the customer notes .

Generally, Taxpayer's advance payment on a customer note equaled between c% and d% of the face amount of the customer note. This amount was significantly less than the stated redemption price of the customer note at maturity. Therefore, customer notes were typically purchased with market discount. Although customer notes with a term of 12 months or less would not be subject to the market discount rules of sections 1276 to 1278, Taxpayer would be required to treat earned discount on such notes as ordinary income.

Since Taxpayer purchased the customer notes, Taxpayer would be entitled to a deduction should a customer note become wholly or partially worthless. The time of such deduction depended on the pertinent facts and circumstances including the value of the financed vehicle and the financial condition of the obligor. However, the performance of other customer notes originated by the same dealer would not be pertinent to such determination.

Since, during Tax Years, Taxpayer regularly purchased securities (that is, customer notes) from customers (that is, automobile dealers) in the ordinary course of a

trade or business, Taxpayer met the statutory definition of a dealer in securities for the purposes of section 475 of the Code. Section 475 requires a dealer in securities to mark its securities (subject to certain exceptions) to market. However, § 1.475(c)-1(c) excludes a taxpayer from the definition of a dealer in securities if the taxpayer makes only negligible sales of securities unless the taxpayer takes certain steps to waive such exclusion. Taxpayer made only negligible sales of securities during Tax Years and took no steps to waive the exclusion afforded by § 1.475(c)-1(c). Therefore, Taxpayer was not a dealer in securities during Tax Years and could not mark securities such as customer notes to market.

LAW AND ANALYSIS

ISSUE 1

Were automobile dealers' transfers of customer notes to Taxpayer (a) sales of such customer notes or (b) pledges of such customer notes as security for loans made by Taxpayer to the dealers?

Dealers transferred customer notes to Taxpayer in exchange for advance payments and contractual rights to distribution payments. The question is whether the dealers sold the customer notes or whether the dealers borrowed the advance payment from Taxpayer using the customer notes as collateral. If the transactions were sales, then Taxpayer must recognize income on the customer notes as the obligee. Alternatively, if the transactions were secured borrowings, it is the dealers rather than the Taxpayers who are the obligees who must recognize income on the customer notes.

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 some other 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 form of the agreement between Taxpayer and automobile dealers is that of a servicing agreement and not a sales contract. Further, Taxpayer treated the transfers of the customer notes as pledges of security rather than sales for tax purposes. However, in a letter sent by Taxpayer to most, if not all, dealers, Taxpayer acknowledged that sale treatment was an available characterization of the transfers.

(2) Were automobile dealers' customers notified of the transfer of the customer notes to Taxpayer?

The assignment without recourse of the customer note to Taxpayer was typically reported 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?

Taxpayer collected payments, serviced the customer notes, and repossessed the financed vehicle if a customer defaulted. Although the servicing agreement states that Taxpayer is the automobile dealer's nominee for administrating, servicing and collecting on the customer notes, in fact, Taxpayer does not act as the dealer's agent. The dealer did not exercise any control over Taxpayer. Aside from agreeing to use reasonable efforts, Taxpayer 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 Taxpayer correspond to collections on the customer notes?

The payments Taxpayer received were the payments that Taxpayer collected on the customer notes. Automobile dealers had no obligation to make payments to Taxpayer. Taxpayer 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 the face amount of a customer note rather than the dealer's creditworthiness. This implies that the dealers 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 Taxpayer impose restrictions on the operations of automobile dealers that are consistent with a lender-borrower relationship?

The relationship between Taxpayer and dealers had none of the characteristics that are common in a lender-borrower relationship. Taxpayer imposed no restrictions on the operations of dealers. For example, Taxpayer did not require dealers to maintain a specified ratio of assets to liabilities or current assets to current liabilities. Taxpayer did not receive the right to review dealers' books and records. Taxpayer received only the right to documents that were necessary for Taxpayer to exercise its rights and duties concerning the transferred customer notes. Since Taxpayer imposed no restrictions on dealers' operations, Taxpayer 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 Taxpayer 's failure to require dealers 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. Dealers could dispose of the customer notes only by reacquiring all of them from Taxpayer. To reacquire the customer notes, dealers had to terminate the servicing agreement and pay Taxpayer 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, Taxpayer were a lender, then it would be reasonable to expect dealers 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, Taxpayer's power to dispose of the customer notes must have been restricted, since dealers had the right to reacquire them.

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

By transferring the customer notes to Taxpayer, dealers eliminated almost all of their exposure to credit risk on the customer notes. Unless a dealer canceled or permitted the occurrence of an event of default under the servicing agreement, the dealer, in the event of a customer's default, had no obligation to repurchase either the customer note or the financed vehicle, or return the advance payment. Further, dealers fixed their economic loss in the customer notes. After transferring a customer note, a dealer's only risk of loss was a diminution in value of its right to receive distribution payments. Taxpayer, on the other hand, was at risk for recouping the advance payments it made to the dealer.

It may be argued that Taxpayer's risk of loss was insubstantial because (1) it advanced the dealer no more than c% to d% 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 the dealer's right to payments was subordinated to Taxpayer'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 Taxpayer, a dealer 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). Dealers transferred customer notes to Taxpayer for cash payments of no more than d percent of their face amounts and permitted Taxpayer to retain substantial fees on all collections. Dealers would not have agreed to these conditions unless the fair market value of the customer notes was less than their face amounts.

Furthermore, in tax year f, Taxpayer had to take a bad debt deduction of $g million with respect to unrecoverable advances on the customer notes. This further indicates that Taxpayer's risk of loss was anything but insubstantial.

Accordingly, we are unwilling to conclude that Taxpayer's risk of loss was insubstantial.

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

Both Taxpayer and dealers had potential for gain on the customer notes. Dealers had the right to distribution payments if there were sufficient payments on the customer notes to first make all the payments due to Taxpayer. Taxpayer gave dealers cash, namely the advance payments, when dealers transferred customer notes to Taxpayer. Taxpayer's right to recover those advance payments plus payment for its collection costs and fees was limited to its collections on the customer notes. Taxpayer's profits, therefore, depended on the timing and amount of the collections rather than on any interest charged to dealers while the advance payments were outstanding. Consequently, the greater the collections on the customer notes, the greater Taxpayer's rate of return on the advance payments made to dealers.[1]

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 secured loans. E.g., Mapco, 556 F.2d at 1111-12;

---

[1]An example may help illustrate why Taxpayer had the potential for a significant return on its investment (the advance payments) provided that the default rate on the customer notes is not too high. Assume that a dealer transferred to Taxpayer 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 in return for an advance payment equal to 50% of face or $2,950. Also assume that Taxpayer had no collection costs and that dealer transferred only the one customer note. Taxpayer would be entitled to receive its fee of 20 percent of each payment (approximately $43). Taxpayer would also be entitled to the remaining $170 of any payment ($213 - $43 fee) until it recovered the advance payment of $2,950. Thus, Taxpayer would be entitled to seventeen payments of $213, one payment of $103, and eighteen payments of $43. The dealer would be entitled to receive, starting in month eighteen, one payment of $110 and eighteen payments of $170.

Taxpayer’s rate of return on the advance payment made to the dealer increases as more payments are collected on the customer note. If Taxpayer were to collect all payments, then Taxpayer’s yield to maturity would be approximately 46 percent per annum, compounded annually. If Taxpayer were to collect enough payments for it to recoup its collection costs, its 20 percent fee, and its advance payment, then Taxpayer’s yield to maturity still would be approximately 32 percent. And, of course, the Taxpayer also runs the risk of not being able to recoup its advance payment and any collection costs. As the example shows, the more payments Taxpayer collects, the greater Taxpayer’s rate of return on its advance payment to the dealer. Indeed, the Taxpayer’s rate of return on its investment depended solely on the performance of the customer notes.

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 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, for there to be a secured loan, there must be a debtor-creditor relationship between dealers and Taxpayer. Since Taxpayer's economic return was based solely on the performance of the customer notes rather than on its relationship with dealers, Taxpayer was more like an owner of the customer notes than a creditor of the dealers.

After transferring the customer notes, dealers had little potential to realize gain on the customer notes. Only after Taxpayer recouped its out-of-pocket costs, its fees, and all of the advance payments would dealers receive any distribution payments. In practice, the amount of distribution payments made were only a small percentage of the outstanding principal balance of the customer notes transferred to Taxpayer. While dealers 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 the dealers 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 Taxpayer effectively prevented dealers from profiting from any changes in market interest rates.

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

ISSUE 2

What is the Taxpayer's basis in the customer notes that it has purchased?

As a general matter, a taxpayer's basis in property is the cost of the property subject to adjustments at the time and in the manner required by the Code or . regulations. Section 1012 of the Code.

In the instant case, Taxpayer purchases a customer note from a dealer in return for two types of payments: (1) an initial advance payment that is not (absent default or termination of the servicing agreement by the dealer) refundable; (2) distribution payments that, as developed above, may or may not be paid depending on the performance of the customer notes purchased from that dealer.

The advance payment made on a customer note is a cost of purchasing the customer note and should be included in Taxpayer's basis for such note. The treatment of the distribution payments requires some discussion.

Under the servicing agreement, Taxpayer's payment of distribution payments depended on its ability to collect on the customer notes and its 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 make any distribution payments.

The deferred nature of the distribution payments and the absence of any stated interest implicates section 483 of the Code. 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 dealers' sales of the customer notes to Taxpayer) and property includes debt instruments (such as the customer notes). § 1.483-1(a)(2) of the regulations. However, section 483 would not apply to any payments if it can be established that, at the time of sale of a customer note, total payments under the contract of sale cannot exceed $3,000. Section 483(c)(3).

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. The distribution payments called for in the servicing agreement are contingent payments under section 483 of the Code. At the time Taxpayer bought a customer note, its liability for, and the amount and timing of any distribution payments could not be reasonably determined. Taxpayer'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 a sale, both Taxpayer and the dealer understood that customers' defaults and Taxpayer's collection costs would reduce the amounts left for distributions to the dealer. As discussed above, the face of the customer notes generally exceeded the value of the underlying collateral. Given that fact, together with the generally high credit risk of the dealer's customers, Taxpayer would fail to collect the entire principal amount of a significant but uncertain number of customer notes. Taxpayer 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 many dealers with minimal or no distribution payments. For these reasons, and in light of other unique circumstances, Taxpayer's liability for, and the amount and timing of those payments to the dealer could not be determined at the time of the sale of the customer notes.

Section 1.483-4 of the regulations, 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". However, § 1.483-4 applies only to sales or exchanges that occur on or after August 13, 1996 and, thus, would not apply to sales or exchanges occurring during Tax Years. If the final regulations did apply, Taxpayer's tax basis in the customer notes would be calculated as follows.

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. Neither § 1.483-4 nor § 1.1275-4 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). As developed previously, the distribution payments are contingent payments for the purposes of section 483(f) and so should also be treated as contingent payments for the purposes of § 1.483-4 and § 1.1275-4.

Because the distribution payments are contingent payments under § 1.483-4 of the regulations, these payment must be accounted for using the rules of § 1.483-4 and rules similar to those contained in § 1.1275-4(c)(4). Generally, § 1.1275-4(c) provides that each contingent payment under the contract is characterized as principal and interest. 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. The remainder of the contingent payment is characterized as a payment of interest.

The fact that a purchaser may make contingent payments in the future does not give the purchaser a corresponding increase in its basis in the asset at the time of sale. Rather, the purchaser receives additional basis in the purchased asset at the time that the purchaser makes a contingent payment. The additional basis equals the amount of the contingent payment characterized as principal. Section 1.483-4(b), *Example (1)*, (iii).

Thus, if the final regulations were to apply, Taxpayer would receive basis in a customer note equal to the advance payment for the customer note. In addition, the Taxpayer would receive additional basis in the customer note at the time Taxpayer made a distribution payment on the customer note. The amount of the additional basis would equal the amount of the distribution payment characterized as principal under § 1.1275-4(c)(4)(ii) of the regulations.

However, the final regulations do not apply. The preamble to the final regulations provide that for a sale or exchange that occurred before August 13, 1996, a taxpayer may use any reasonable method to account for the contingent payments. The preamble specifically provides that a reasonable method would include the 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. The proposed regulations generally give the same result as the final regulations.[2]

The preamble to the final regulations does not give other guidance as to what might constitute a reasonable method for accounting for contingent payments. However, any method of tax accounting is subject to the general requirement that it "clearly reflect income." Section 1.446-1(c)(1)(ii)(C) of the regulations. Presumably, issues of administrability may also be considered in determining what is reasonable.

Although such a standard gives taxpayers some discretion, Revenue Ruling 82-224, 1982-2 C.B. 5, provides some indication of what would be a reasonable method for Taxpayer. This revenue ruling, which relied in part on section 483[3], addressed the issue of a purchaser's basis in a purchased asset attributable to contingent payments for the purposes of determining depreciation and the amount of the allowable tax credit. In this revenue ruling, the taxpayer acquired property for cash plus a part recourse, part non-recourse note. The note was payable in full in 20 years but prepayments were required in the amount of profits derived from the use of the property. The revenue ruling concluded that the taxpayer's basis in the property was equal to the cash paid plus the present value of the recourse portion of the note, assuming that it was paid in 20 years. In other words, the taxpayer was given basis in the property equal to cash paid plus the present value of those payments on the contingent payment debt instrument for which purchaser would be personally liable if not made. The taxpayer was permitted an adjustment to basis for earlier or additional payments although the nature of the adjustment was not described. Applying the

---

[2] Regulations for section 483 were first proposed in 1986. LR-189-84, 1986-1 C.B. 820 (the 1986 proposed regulations). The 1986 proposed regulations were amended in 1992. FI-189-84, 1993-1 C.B. 734 (the 1992 amendments). The 1992 amendments, among other things, rescinded the portion of the 1986 proposed regulations that dealt with contingent payments. Thus, there were no proposed regulations under section 483 dealing with contingent payments during Tax Years until proposed regulations under section 483 dealing with contingent payments were published in 1994. FI-59-91, 1995-1 C.B. 894 (the 1994 proposed regulations).

Applying the 1986 or 1994 proposed regulations gives a result similar to that of the final regulations and Rev. Rul. 82-224. The purchaser receives no basis in the property purchased for a contingent payment. The adjusted basis in the purchased property is increased on the date a contingent payment becomes fixed by the portion of the payment which is treated as principal. Section 1.483-5(b)(3)(iv) of the 1986 proposed regulations. Section 1.483-4(b), *Example 1(iii)* of the 1994 proposed regulations.

[3] Due to the fact that current section 483(f) was added in 1984 (as section 483(g)), at which time section 483 was substantially amended, this revenue ruling cannot be considered dispositive. See Tax Reform Act of 1984 § 41, 1984-3 (Vol.1) C.B. 1, 61.

reasoning of the revenue ruling to the instant case, Taxpayer would receive a basis in a customer note equal to cash paid at purchase plus additional basis for any contingent purchase payments it is obligated to make . Since there are no such contingent payments, Taxpayer's basis in a customer note upon purchase will be limited to the advance payment. However, Taxpayer will be permitted an adjustment for later distribution payments.

Revenue Ruling 82-224 indicates that a method of accounting that treated various dealers' transfers of customer notes to Taxpayer as a pledge of collateral for a loan made by Taxpayer to the dealers would probably not be a reasonable method.

ISSUE 3

Did the customer notes purchased by Taxpayer have market discount within the meaning of section 1278(a)(2) of the Internal Revenue Code?

Sections 1276 to 1278 of the Code govern the treatment of market discount. As a general matter, accrued market discount on a debt instrument is treated as ordinary income when sold or upon receipt of a partial principal payment. Sections 1276(a)(1), (a)(3). A market discount bond is a debt instrument with "market discount" defined as "the excess (if any) of — (i) the stated redemption price of the bond at maturity, over (ii) the basis of such bond immediately after its acquisition by the taxpayer." Sections 1278(a)(1)(A), (a)(2)(A)[4]. Notwithstanding the foregoing, market discount bonds are not: (1) obligations with terms of no more than 1 year; (2) U.S. savings bonds; or (3) installment obligations. Section 1278(a)(1)(B). In addition, the market discount rules are subject to a "de minimis" exception. In general, a debt instrument is deemed to have no market discount if the market discount is less than 1/4 of 1 percent of the stated redemption price at maturity times the number of complete years remaining to maturity at the time of acquisition.

As developed previously, the customer notes are debt instruments. Taxpayer's basis in a customer note immediately after acquisition will be the amount of the advance payment for the customer note. In general, the customer notes are not the type of debt instrument excluded from the definition of market discount bond. Thus, customer notes may generally be subject to section 1276 to 1278 of the Code provided that they are acquired with more than "de minimis" market discount.

Notwithstanding the foregoing, customer notes that have a term of no more than 12 months are not market discount bonds. Section 1278(a)(1)(B)(i) of the Code. The treatment of such customer notes will be further discussed below.

---

[4] For debt instruments issued with OID, the stated redemption price at maturity is equal to "revised issue price". Section 1278(a)(2)(B). However, customer notes, like other retail installment obligations, are typically issued without OID.

The phrase “stated redemption price of the bond at maturity” is not defined for the purposes of section 1276 or the other sections dealing with market discount in Subpart V.B of Subchapter P of the Code. A similar phrase (“Stated redemption price at maturity”) is defined for the purposes of Subpart V.A (sections1271 to 1275) and is used to define original issue discount (OID) but such definition does not apply to Subpart V.B. Sections 1273(a)(1), (a)(2). Nevertheless, the legislative history of subpart V.B demonstrates that Congress was aware that market discount and OID are economically indistinguishable from the viewpoint of the obligee. S. Rept. No. 98-169, Vol.1 98th Cong. 2d. Sess., 155 (Senate Report). Accordingly, the two phrases should be interpreted consistently.

Section 1273(a)(2) of the Code defines stated redemption price at maturity to mean the amount fixed by the most recent modification of the purchase agreement other than payments of interest that are “payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument.” This has been interpreted by regulation to mean all payments on a debt instrument other than payments of “qualified stated interest”. Section 1.1273-1(b) of the regulations. Qualified stated interest, in turn, is defined as all payments of stated interest that are unconditionally payable at least annually at a single fixed rate or, in the case of variable rate debt instruments, calculated with respect to certain permitted types of indices. Sections 1.1273-1(c), 1275-5(e).

In the instant case, the stated redemption price at maturity of the customer notes is equal at least to the face amount, assuming all interest payable on the customer note is qualified stated interest. If not all interest is qualified stated interest, the stated redemption price at maturity will be increased by the amount of interest on the customer note that is not qualified stated interest. In any event, as developed previously, Taxpayer’s basis in a customer note immediately after acquisition was equal to the amount of the advance payment for the customer note which was usually between c% and d% of the face amount.

Therefore, the stated redemption price at maturity typically significantly exceeded the basis of such bond immediately after its acquisition by Taxpayer and the customer notes were acquired with market discount. It is possible that, in some cases, Taxpayer may acquire a customer note with only “de minimis” market discount or no market discount but that is a factual issue to be addressed with respect to particular customer notes.

As developed previously, those customer notes that have a term of no more than 12 months are not market discount bonds. Debt instruments that have a term of 12 months or less are “short-term obligations”. Section 1283(a)(1) of the Code. Sections 1281 to 1283 provide rules for the treatment of discount on short-term obligations. However, for nongovernmental obligations such as the customer notes, sections 1281 to 1283 of the Code govern only the treatment of OID unless the taxpayer makes an election under section 1283(c)(2). Section 1283(c). To the best of our knowledge, Taxpayer has not made an election under 1283(c)(2).

Although there is no statutory guidance on the treatment of discount (other than OID) on customer notes with a term of 12 months or less, it is well-established that the portion of the amount realized as a result of a realization event on a debt instrument that is attributable to earned discount is ordinary income rather than capital gain since it is economically equivalent to interest. See United States v. Midland-Ross Corp. 381 U.S. 54, 57 (1965) (discussing treatment of OID on debt instruments sold in year of purchase). Although the Supreme Court's opinion in Midland-Ross dealt with OID rather than market discount, the two types of discount are economically equivalent for an obligee. See S. Rep. No. 169, 98th Cong., 2d Sess. 155 (1984) (legislative history of sections 1276 to 1278 of the Code). Therefore, Midland-Ross, unless superseded by statute, should apply to an obligee that holds a debt instrument with market discount. Thus, it should apply to Taxpayer in the instant case and the amount of principal payments received on a customer note that are attributable to earned market discount should be treated as ordinary income.

However, the opinion in Midland-Ross does not address the issue of how to determine the amount of market discount earned at a particular point in time. A later tax court case assumed that discount would accrue "ratably" over time. Bolnick v. CIR 44 T.C. 245, 257(1965) (accruing OID). Thus, the market discount could be treated as accruing in an equal amount on each day a customer note with a term of 12 months or less is outstanding. However, other methods would also be acceptable provided they meet the general requirement applicable to any method of accounting that it "clearly reflect income." Section 1.446-1(a)(2).

ISSUE 4

Under what circumstances would Taxpayer be entitled to a deduction for wholly or partially worthless debt under section 166 of the Code for a customer note that it has purchased?

Section 166(a)(1) of the Code provides that taxpayers are allowed a deduction for a debt which became worthless within the taxable year. Section 166(a)(2) further authorizes the Secretary of the Treasury to promulgate regulations permitting a partial deduction for debt that is determined to be recoverable only in part during the taxable year. Section 166(d) limits the applicability of section 166(a) but does not apply to corporate taxpayers such as Taxpayer.

In general, in determining whether a debt is worthless in whole or in part, all pertinent evidence, including the value of any collateral and the financial condition of the obligor is considered. Section 1.166-2(a) of the regulations. Thus, deductions for worthlessness are determined with respect to specific debts. See also § 1.166-3(a)(1) (applying to partial worthlessness). A deduction for partial worthlessness is permitted

only to the extent that the debt has been charged off by the obligee for financial accounting purposes[5]. Section 1.166-3(a)(2).

Since Taxpayer acquires the customer notes from various dealers, Taxpayer is permitted a deduction for wholly or partially worthless customer notes under section 166 of the Code. The time at which such deduction is permitted will depend on the pertinent facts and circumstances including the value of the financed vehicle securing the customer note and the credit of the obligor.

In assessing the time at which a deduction is permitted on a particular customer note under section 166, the performance of other customer notes originated by the same dealer should not be considered. As developed above, Taxpayer's obligation to make distribution payments is calculated by reference to a complicated formula that takes into account, among other things, the aggregate amount of the advance payments made and the payments received on either (1) all the customer notes purchased from a particular dealer, or (2) a "capped" pool of such customer notes. Nevertheless, the customer notes cannot be considered to collateralize each other. Since the customer notes are owned by Taxpayer, they cannot have been pledged by a dealer to secure payments on the other customer notes the dealer sold to Taxpayer.

ISSUE 5

Were the customer notes that Taxpayer purchased required to be marked to market under section 475?

A dealer in securities is required to mark its securities to market at the end of its taxable year. Section 475(a). For the purposes of section 475, a taxpayer that "regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business" is a dealer in securities and securities include debt instruments. Sections 475(c)(1),(c)(2)(C). Notwithstanding the foregoing, securities does not include debt instruments that are "nonfinancial customer paper." Id. at (c)(4). Nonfinancial customer paper means a receivable that "arises out of the sale of non-financial goods or services by a person the principal activity of which is the selling or providing of non-financial goods and services" provided such receivable continues to be held by such person or a person that bears a relationship to such person described in sections 267(b) or 707(b). Section 475(c)(4)(B).

In addition, a taxpayer that regularly purchases securities from customers but "engages in no more than negligible sales of the securities so acquired" is not a dealer in securities for the purposes of section 475. Section 1.475(c)-1(c)(1) of the regulations. For the purposes of the regulation, a taxpayer makes negligible sales of

---

[5] As a general matter, a debt instrument that has been pledged as security by the obligee for a loan may not be charged off by the obligee for financial accounting purposes.

debt instruments purchased from customers if, in the taxable year, it sells fewer than 60 debt instruments or sells debt instruments with an adjusted basis of less than 5 percent of its aggregate basis, immediately after acquisition, of all debt instruments acquired in the year. Id. at -1(c)(2). A taxpayer may elect to waive the exemption afforded by § 1.475(c)-1(c) by filing a federal tax return reflecting the application of section 475 and meeting certain other requirements that may be necessary to receive the Commissioner's consent to a change of accounting method. Id. at -1(c)(1)(ii); Rev. Proc. 97-43, 1997-39 I.R.B.12.

A dealer in securities does not mark to market securities that are held for investment or as a hedge and are identified as such on the taxpayer's records before the close of the day when acquired. Sections 475(b)(1), (b)(2).

As developed previously, Taxpayer certainly purchases debt instruments (the customer notes) from its customers in the ordinary course of business. The customer notes are generally not "nonfinancial customer paper" when held by Taxpayer since Taxpayer did not originate the customer notes and does not bear a relationship to the dealers that originated the customer notes that is described in sections 267(b) or 707(b)[6]. These facts suggest Taxpayer might be a dealer in securities for the purposes of section 475.

However, Taxpayer did not sell securities during the years in question. Consequently, Taxpayer would not be a dealer in securities subject to section 475 unless Taxpayer waived the exemption afforded by § 1.475(c)-1(c) by filing a federal tax return reflecting the application of section 475 and meeting any other requirements imposed by Rev. Proc. 97-43. Since Taxpayer's tax returns did not reflect the application of section 475 during the applicable taxable years, Taxpayer was not a dealer in securities for the purposes of section 475 and could not mark securities, such as the customer notes, to market.

CAVEAT

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

- END -

[6]However, customer notes would be nonfinancial customer paper if purchased from an automobile dealer whose relationship to Taxpayer at all times since issue was described in sections 267(b) or 707(b). Such customer notes could not be marked to market.