Tax Accounting

BY JAMES E. SALLES

In this month's column:

- The Tax Court takes another stab at the thorny problem of auto dealers' warranty contracts, *Toyota Town, Inc. v. Comm'r*, 79 T.C.M. (CCH) 1457 (2000);
- A teacher's travails illuminate the perils of constructive receipt in legal disputes, *Visco v. Comm'r*, T.C. Memo. 2000-77); and
- The IRS issues yet another ruling in its ongoing attempt to grapple with capitalization issues. Rev. Rul. 2000-7, 2000-9 I.R.B. 712.

AUTO DEALERS' WARRANTY CONTRACTS

A Tax Court decision issued in February upholds the conditions the IRS imposes on auto dealers' use of the "service warranty income method" to report income under warranty agreements. *Toyota Town, Inc. v. Comm'r*, 79 T.C.M. (CCH) 1457 (2000).

Background

Dealers' accounting for automobile warranty contracts, which frequently span several years, has been a sore spot since at least 1992, when the IRS National Office ruled against the taxpayer in Private Letter Ruling 9218004 (Jan. 23, 1992), which involved "extended service plan contracts" sponsored by automobile manufacturers. Dealers sold the contracts to their customers along with the cars, were paid up front, and immediately turned over most of their receipts to a special-purpose subsidiary of the manufacturer. That subsidiary operated the actual "insurance program," paying the dealers (or others) as they made repairs under the warranties.

For tax purposes, the dealers generally treated themselves as if they were sales agents for the policies, and reported as income only the "commission" left in their hands after they made the payment to the insurance subsidiary. In Private Letter Ruling 9218004, however, the IRS concluded that under the common form contracts, the car owners were not contracting with the insurance subsidiary. Instead the dealers were obligating themselves to their customers as principals and then paying the insurance company to assume what was now *their* risk. This meant the dealers were immediately taxable on the whole receipt under *Schlude v. Commissioner*, 372 U.S. 128 (1963), although under normal capitalization principles they could only deduct their payments to the insurance company over the lifetime of the contracts, generally several years.

Revenue Procedure 92-98

Widespread criticism of the whipsaw imposed by Private Letter Ruling 9218004 prompted administrative concessions. Revenue Procedure 92-98, 1992-2 C.B. 512, since superseded by Revenue Procedure 97-38, 1997-2 C.B. 479, permitted dealers in automobiles and other durable consumer goods to elect the service warranty income method of accounting. Taxpayers electing under the procedure could recognize the "nonprofit" portion of their customers' up-front payments over the life of the contract rather than take the whole amount into account all at once. In exchange, electing taxpayers had to agree to include "phantom" income to compensate the IRS for the time value of money. For example, if the "applicable interest rate" (based on the applicable federal rate) was 6 percent, a dealer deferring $1,000 under a five-year contract would report $224 per year for five years. Taxpayers also had to amortize their corresponding payments to the insurer over the lifetime of the contracts.[1]

Thus, taxpayers could in effect pay—by accepting the inclusion of phantom income—to eliminate the whipsaw otherwise imposed by *Schlude*. More accurately, they could eliminate most of the whipsaw, but not quite all of it. For simplicity, Revenue Procedure 92-98 required that payments received at any time during the

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taxable year be treated as having been received on the first day of the year, so that in each year of the contract term there was a full year's inclusion; however, Revenue Ruling 92-97, 1992-2 C.B. 510, permits amortization of the *deduction* only over the actual contract term.

> **Example.** Dealer A, a calendar-year taxpayer, defers $1,000 under a five-year contract beginning July 1, 2000. The applicable interest rate is 6 percent. Dealer A must include $224 in warranty income in each of 2000, 2001, 2002, 2003, and 2004. On the other hand, it is only permitted to deduct insurance expense of $100 in 2000, $200 in each of the years 2001 through 2004, and a final $100 in 2005.

It was this disparity that produced the issue in *Toyota Town*.

Toyota Town

The taxpayers in *Toyota Town* were several related auto dealerships that sought to use the same convention on the deduction side as Revenue Ruling 92-98 imposed on the income side. That is, they calculated their deductions as if all the policies had been issued on the first day of the taxable year rather than by using the actual policy term.

> **Example.** The facts are the same as those in the preceding example. Under the method used by the *Toyota Town* taxpayers, in each of the years 2000 through 2004 Dealer A would report $224 in warranty income and deduct $200 of insurance expense.

79 T.C.M. (CCH) at 1460. In the notice of deficiency, the IRS imposed adjustments calculated to conform the taxpayers' accounting to the terms of the revenue procedures.

The IRS cannot change a taxpayer's accounting method unless it does not "clearly reflect income." See I.R.C. § 446(b). Even then, the new method the IRS imposes must clearly reflect income itself.[2] The taxpayers argued that their method clearly reflected income and that the method in the revenue procedures did not. The court, however, reasoned that had the taxpayers not elected under Revenue Procedure 92-98, they would have had to include the full receipt up front under *Schlude*, and the deduction would have had to be amortized over the contract term anyway. 79 T.C.M. (CCH) at 1463. Nobody forced the taxpayers to elect. The issue was whether the conditions the revenue procedures imposed on the taxpayers' election were reasonable, and the court held that they were.

Lessons from *Johnson*?

The *Toyota Town* court was notably unreceptive to the taxpayers' argument that their method *more* clearly reflected income because it provided a superior matching of income to deductions, remarking that "matching of income and related expense does not necessarily result in a clear reflection of income for tax purposes." 79 T.C.M. (CCH) at 1463, citing Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979). With some luck, however, the taxpayers may find a more hospitable reception to their matching argument on appeal. *Toyota Town* bears more than a passing resemblance to *Johnson v. Commissioner*, 184 F.3d 786 (8th Cir. 1999), *aff'g in part and rev'g in part,* 108 T.C. 448 (1997), discussed in this column in the November 1999 issue.

Johnson involved vehicle service contracts that were similar to the warranty contracts in *Toyota Town* except that the dealerships retained primary responsibility for vehicle repairs, and most of the proceeds were transferred to an escrow account rather than paid over to the insurer. Notwithstanding the escrow account, the IRS and both courts agreed that the dealers had a receipt, that what was received was an advance payment, and therefore the dealers were immediately taxable under *Schlude*. The Eighth Circuit, however, reversing the Tax Court on this point, held that the expenses associated with the escrow account should be immediately deducted. The court stated that "both income and deduction must be considered" in determining whether a method of accounting "clearly reflects income," and basically held that it was unreasonable to require amortization of a deduction when *Schlude* required all the associated income to be reported "up front." 184 F.3d at 789.

Toyota Town is complicated by the fact that the taxpayers made an express election and then tried to wiggle out of its terms. Purely on matching grounds, however, the taxpayers in *Toyota Town* would seem to have a stronger case than *Johnson*, because they paid *all* the amounts that they sought to defer over to the insurance company, whereas the escrow administration expenses in *Johnson* accounted for only a small fraction of the receipts at issue. An appeals court might shortcut the election issue by holding that, regardless of whether it complied with the conditions of the revenue procedure, the taxpayers' method, taken as a whole, clearly reflected income.

TEACHER TAXED ON SETTLEMENT CHECK

A teacher learned an expensive lesson on an obscure point of constructive receipt in a Tax Court memorandum decision issued in March, *Visco v. Commissioner*, T.C. Memo. 2000-77.

Background

The doctrine of constructive receipt requires a cash-basis taxpayer to report income when an amount is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time," and his potential receipt is not "subject to substantial limitations or restrictions." Treas. Reg. § 1.451-2(a). A problem sometimes arises in the context of disputed accounts, where the issue is whether some condition is attached to the taxpayer's receipt that amounts to a substantial limitation or restriction. A taxpayer will not be in constructive receipt of a check in a lesser sum that is proffered "in full payment" of a disputed balance or otherwise on condition that the taxpayer waive some valuable rights.

On the other hand, taxpayers who can cash checks without prejudice to their rights cannot avoid constructive receipt by returning the checks. For example, in Revenue Ruling 73-486, 1973-2 C.B. 153, a taxpayer who received two checks from the Bureau of Public Debt, one in a larger amount than was due, and one in a smaller amount, was told to return the larger and keep the smaller. Instead, the taxpayer returned both. The IRS ruled the taxpayer was in constructive receipt of the smaller check, having both a right to it and the power to cash it.

The Schoolteacher's Dilemma

The taxpayer in *Visco* was a teacher who was awarded back pay and interest for wrongful dismissal. The school district messengered her checks in purported full payment on December 28, 1992. She refused delivery for reasons that are not wholly clear from the opinion but that seem to have stemmed from her view that part of the proceeds belonged in her retirement plan and the school district had miscomputed interest on the rest. The disputed checks were paid into court in 1993, and deposited into a bank account in her name in 1995. As of the time of trial, she had not requested access to the funds.

The district included the back pay on the taxpayer's Form W-2 for 1992, the year of attempted delivery. The taxpayer contacted the IRS both by telephone and in writing requesting advice; she never filed a return for 1992. A notice of deficiency ultimately resulted, and the sole disputed issue was whether, and when, the disputed back pay was includible. The taxpayer argued that the checks represented a settlement offer that she had rejected. The court disagreed, because "the Commonwealth Court [in the original dispute] established the exact amount due petitioner for backpay, interest on backpay, and benefits. The district was not negotiating; it was complying with the . . . order. Consequently, when the courier delivered the checks to petitioner on December 28, 1992, she had the right to a specific amount of money and the power to receive that money." Thus, she was taxable in full in 1992. The court did, however, excuse her from penalties for failure to file, citing her good faith as evidenced by her having left the funds undisturbed for more than six years and her repeated attempts to contact the IRS for advice.

RULING ON REMOVAL COSTS

In Revenue Ruling 2000-7, 2000-9 I.R.B. 712, the IRS addressed whether the costs of removing telephone poles to replace them had to be capitalized under either general capitalization principles or the uniform capitalization rules.

The IRS noted that historically, the costs of removal have been treated as allocable to the removed asset, not the replacement asset. Since deductions are generally permitted for the unrecovered basis of an abandoned asset, the taxpayer was permitted an immediate deduction for the costs of removal. The ruling confirmed that the fact that the retirements took place in the context of a replacement project did not make the removal costs part of the costs of the replacement poles or otherwise capitalizable.

Changes to comply with this revenue ruling will be permitted under the automatic consent procedure. Rev. Proc. 99-49, 1999-52 I.R.B. 725.

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1. A companion procedure granted automatic consent to change to this treatment. Rev. Proc. 92-97, 1992-2 C.B. 510.

2. See, e.g., Artnell Co. v. Comm'r, 29 T.C.M. (CCH) 403, 406 (1970).

This article first appeared in the May 2000 issue of *Corporate Business Taxation Monthly.*