Tax Accounting

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"CLEAR REFLECTION" PRINCIPLES MAY WORK FOR TAXPAYERS TOO

The Eighth Circuit has partially reversed the Tax Court's decision in *Johnson v. Comm'r*.[1] The decision addressed a variety of issues concerning automobile dealers' treatment of advance payments under vehicle service contracts (VSCs), which are sold along with new automobiles.

The *Johnson* Facts

The automobile dealers sold VSCs along with both new and used motor vehicles. VSCs were similar to insurance policies: In return for payment in advance, the dealer contracted to make any necessary repairs to the vehicle (over and above a deductible) for the contract term, or to pay third parties to make any of these repairs.

The dealers kept part of the sales price of the VSCs, which they reported as current income. The remaining amounts, which were placed in escrow, had three objectives:

1. To secure the dealers' obligations to perform under the contracts;
2. To pay sales commissions and the administrators' fees; and
3. To buy excess loss insurance through an unrelated insurer (Travelers).

The controversy concerned the proper time for reporting the portion of the receipts placed in escrow and the proper time for the deduction of the associated expenses.

Reporting of Income

The parties disputed numerous issues relating to the "income side," but the courts' holdings broke no new ground. The Supreme Court's decision in *Schlude v. Comm'r*, 372 U.S. 128 (1963), required current reporting of advance payments for dance lessons received by an Arthur Murray dance studio. *Schulde* is generally read to require accrual-basis taxpayers to report income in three situations:

1. When cash or other property is received;
2. When the taxpayer becomes entitled to immediate payment; or
3. As performance occurs under the contract, whichever occurs first, e.g., Revenue Ruling 74-607, 1974-2 C.B. 149.

Economic Benefit

Comm'r v. Hansen, 360 U.S. 446 (1959), involved so-called dealer reserves withheld from automobile dealers when they factored sales receivables. The Tax Court and the Eighth Circuit in *Johnson* held, in keeping with a line of cases beginning with *Hansen*, that the amounts were in effect "received" by the dealer. Here the amounts in escrow were fated ultimately either to be released to the dealer or applied to the obligations the dealer assumed under the VSC, so that either way the escrow amounts could be used to the dealer's benefit.

This *Johnson* decision is consistent with the broader doctrine of "economic benefit." Even a cash-basis taxpayer that possesses vested rights to the ultimate receipt of an amount held or secured by a trust or other segregated fund is taxable as in receipt of "property." The economic benefit rule applies even though the taxpayer may not be able to realize those rights immediately. E.g., Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd*.,194 F.2d 541 (6th Cir. 1952), and Pulsifer v. Commissioner, 64 T.C. 245 (1975). Similarly, the *Johnson* court treated the establishment of an income amount as a receipt under *Schlude*.

Inclusion of Income

The Schlude rule assumes that the receipt is in fact income to the taxpayer in the first place. The taxpayers disputed this result on two grounds:

1. The Tax Court rejected the dealers' argument that their receipt of cash, subject to an obligation to turn the cash

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over to the escrow agent, was a receipt in the capacity of agent or fiduciary for their customers, and thus not taxable to them. The court analyzed the documents and concluded that the escrow agents' duties ran to the dealers, not to the customers. If a customer canceled a VSC, it was the dealer, not the escrow agent, who became liable to make a pro rata refund. See 108 T.C. at 466. Any release of escrowed funds for that purpose was in fact a payment for benefit of the dealer.

2. A deposit is not income even if received up front in cash with no strings attached. Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). A merchant is ordinarily obliged to return a deposit unimpaired unless the deposit is later applied to the customer's account because of a default. The obligation to pay the customer back is a sufficient "string" to prevent taxation, in the same way that the receipt of a loan does not produce income to the borrower. However, the touchstone of a deposit is precisely the fact that the amount remains a credit in favor of the customer until, because of some subsequent event (e.g., the customer's direction or a default), the default is applied as a payment.

Advance Payments

A receipt that is designated from the outset as to be applied to the future purchase of goods or services is not a deposit, but an advance payment. As is common in advance-payment situations, the dealers' customers would be entitled to a pro rata refund if they cancelled the VSCs, but the Tax Court rejected the dealers' arguments that process would somehow convert the advance payments into deposits until the amounts became nonrefundable.

The dealers had a receipt of an advance payment that was presumed to be taxable under *Schlude*. Administrative exceptions apply to the *Schlude* doctrine, but these transactions do not apply to warranty contracts like VSCs.[2] Some courts have recognized a narrowly drawn exception that applies if there is certainty of performance on a particular date or dates (e.g., Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968)), but such circumstances clearly did not exist in *Johnson*. 108 T.C. at 491-93. Thus, the dealers had to report the up-front payments for the VSCs in full. The court held that the income earned on the escrowed amounts was taxable to the dealers under the grantor trust provisions.

Timing of Deductions

It is the courts' much shorter discussions of the issues concerning when the dealers became entitled to deductions that present the most food for thought. Accrual-basis taxpayers generally are entitled to take expenditures into account, for tax purposes, when the taxpayer meets the "all-events" test and "economic performance" is assured. This all-events test is met when all events have occurred that determine both the fact of liability and the amount of such liability with reasonable accuracy.[3] "Economic performance" means the goods or services for which payment is being made. An expenditure is "taken into account" through capitalization rather than a deduction if the expenditure produces an asset "having a useful life extending substantially beyond the close of the taxable year."[4]

The IRS and both courts agreed that the insurance premiums were capital expenditures and should be amortized over the policies' term. As to the administration fees, the IRS argued that these fees should be capitalized and written off only as each VSC expires. The Tax Court agreed that the administration fees should be capitalized, but allowed an amortization over the term of the VSC based on the refund schedule that applied between the automobile dealer and its customer. For example, at the point at which the dealer would only be required to refund 50 percent of the customer's original payment in the event of cancellation, it could take a deduction for 50 percent of the administration fees relating to that contract. The Eighth Circuit, however, rejected both approaches, and allowed an immediate deduction. Its reasoning was based on broad grounds:

> If taxpayers are going to be required to take into income the entire amount paid into the escrow fund in the year of receipt and payment, we think, as a matter of fairness, that they should also be allowed to deduct, in that year, the entire amount of the fee paid to the Administrator. . . .

The Commissioner argues that economic performance has not yet occurred with respect to the liability. . . . While this is certainly true in the abstract, the question in this case is whether the method of accounting proposed by the Commissioner clearly reflects income. To answer that question both income and deductions must be considered. If the income is to be recognized, and we have upheld the Commissioner's decision on that point, the deduction directly associated with it should also be recognized.

The taxpayers in *Johnson* probably derived only marginal comfort from this consolation prize, which involved only a fraction of the total amount at stake. However, the appellate holding may have far-reaching implications both for automobile dealers and taxpayers at large.

Extended Service Plan Contracts

In 1992, the IRS issued a technical advice memorandum involving automobile dealers' "extended service plan contracts" (ESPs). P.L.R. 9218004 (Jan. 23, 1992). Unlike the VSCs in *Johnson*, the ESPs in the ruling were sponsored by the automobile manufacturers. The dealers selling them immediately paid over the great bulk of the proceeds to a special-purpose subsidiary of the manufacturer for "insurance." The subsidiary assumed the dealers' obligations under the contract. The repair services were provided through the manufacturers' network of dealerships, and if the particular dealership that sold the contract wound up performing any of the services, the dealership would get paid like anyone else.

The critical issue in the technical advice memorandum was whether the dealers were acting as agents for the manufacturer (or its subsidiary), and therefore could ignore both receipts and payments relating to the ESPs, except for their commission, or whether they were acting as principals. Analyzing the contracts, the National Office concluded that the dealers were obligating themselves as principals to their customers, and then assigning their liabilities under the "insurance" contract with the subsidiary. This meant that the dealers had to take the full amount of their receipts into income immediately (under *Schlude*), and the dealers were whipsawed because they could only amortize the deduction for the payments to the subsidiary over the lifetime (generally three to six years) of the warranty contracts.

The ruling position was controversial, and the IRS wound up issuing a revenue procedure[5] providing a special elective method of accounting (the service warranty income method) under which the dealerships could amortize the ESP receipts into income. The price extracted was that taxpayers electing this special method had to include, in total, more income than the amount actually received, the difference being designed to roughly compensate the IRS for the use of the time value of money in the meantime. Thus, for example, if the "applicable interest rate" (based on the AFR) were 6 percent, a dealer receiving $1000 for a five-year contract could choose to report either the $1000 in advance or $224 per year for five years.

If the Eighth Circuit's logic were applied to the "insurance" payments to the subsidiary, the dealers could obtain the benefits of deferral—or what is much the same thing, an immediate deduction for the payment—without the price of having to recognize this phantom income. The payment to the manufacturer's subsidiary is unquestionably "directly associated" with the dealer's proceeds from the corresponding ESP. Nor would this necessarily be an unfair result: The phantom income is merely the price the IRS extracts for forgoing the benefits of the whipsaw—immediate inclusion of income plus amortization of the corresponding deduction—produced by the interaction of the *Schlude* doctrine and the capitalization principle. Allowing an immediate deduction would produce a result equivalent to the dealers' original practice of reporting only their net commissions.

Clear Reflection of Income

More broadly, the appellate opinion in *Johnson* reminds us that the overarching principle in tax accounting is the "clear reflection of income." The primary Code section addressing accounting methods is Code Section 446. Code Section 446(a) provides that, in general, "[t]axable income shall be computed . . . on the basis of which the taxpayer regularly computes his income in keeping his books." Code Section 446(b) adds that if the taxpayer's method of accounting fails to clearly reflect income, the IRS has the authority to substitute one that does.

In a series of old cases beginning with Ohmer *Register Co. v. Comm'r*, 131 F.2d 682 (6th Cir. 1942), courts held that merchants could accrue deductions for sales commissions payable only when and if the merchants collected from their own customers. This sales commission accrual took place even though, standing on their own, the commissions represented "contingent liabilities" that would not meet the all-events test. The courts' reasoning was similar to that of the Eighth Circuit in Johnson. It would not clearly reflect income to require a taxpayer to accrue a receipt in full, while denying it a deduction for a commission. The merchant could not collect on its receivable without becoming unconditionally liable for the commission. However, these cases did not implicate the economic performance requirement, which was not added until 1984, nor was there a capitalization issue.

IMPACT OF THE *JOHNSON* CASE

Johnson demonstrates that at least one circuit is willing to look at an income item and a related deduction together. Johnson allowed broad "clear reflection" principles to trump not only the technical requirements of the all-events test, but also the economic performance requirement and capitalization principles that would ordinarily apply if the deduction were considered in isolation. This clear reflection result makes sense. As the Supreme Court has pointed out, the capitalization requirement is itself a reflection of the matching principle. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

The court's holding in *Johnson* points the way to a possible solution to the thorny problem of accounting for automobile warranty contracts. Johnson confirms that the basic principle of matching related income with deductions has survived the advent of the economic performance rules and other developments in tax accounting in the nearly 60 years since *Ohmer Register* was decided.

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1. ___ F.3d ___ (8th Cir. July 21, 1999), *aff'g in part, rev'g in part*, 108 T.C. 448 (1997).
2. See Rev. Proc. 71-21 § 3.08, 1971-2 C.B. 549, 550.
3. I.R.C. § 461(h)(4); Treas. Reg. § 1.461-1(a)(2).
4. Treas. Reg. § 1.461-1(a)(2).
5. Rev. Proc. 92-98, 1992-2 C.B. 512, *superseded by* Rev. Proc. 97-38, 1997-2 C.B. 479.