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to:

(Large Business & International)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUES

Is Taxpayer required to capitalize excess markup payments paid to purchase auto leases from automobile dealers?

Is Taxpayer required to capitalize participation payments paid to purchase equipment leases from equipment manufacturers?

CONCLUSIONS

Taxpayer is required to capitalize excess markup payments under section 1.263(a)-4(c)(1)(vi) of the Income Tax Regulations paid to purchase auto leases from automobile dealers.

Taxpayer is required to capitalize participation payments under section 1.263(a)-4(c)(1)(vi) of the regulations paid to purchase equipment leases from equipment manufacturers.

FACTS

Taxpayer is a that . Taxpayer engages in .
Through its subsidiaries, Taxpayer purchases automobile and equipment leases from third party dealers in the ordinary course of business.

Automobile Leases

Taxpayer and various dealerships enter into master agreements that provide Taxpayer the opportunity to purchase vehicle lease contracts originated by the dealership if they meet Taxpayer's standards. The dealership enters into master agreements with other financial institutions as well. When a dealership enters into an auto lease with a customer, the dealer collects information about the customer's credit and financial situation and enters it into a third party software program. The software system electronically forwards the information to all banks or financial entities with whom the dealer has entered into master agreements. Taxpayer and other entities bid on the leases on an individual basis; there are no batched bids. The bid does not obligate Taxpayer to purchase the lease, and likewise the dealer is not obligated to choose Taxpayer's bid. The dealer ultimately decides to which bank it will sell the lease.

Taxpayer's master agreement provides that once Taxpayer's offer is accepted by the dealer, delivery of the executed documents to Taxpayer shall constitute a sale and assignment of the entire dealer's right, title, and interest in the lease contract, in the vehicle, and in any guaranty or other document executed in connection with the lease contract. Further, the master agreements acknowledge that the transaction is the purchase of a lease contract and that the dealerships shall not represent that they are an agent of the taxpayer.

There are two components to the fee Taxpayer offers to pay the dealerships to acquire the leases: (1) a lease acquisition flat-fee, and (2) a premium on leases with an excess lease rate. The lease acquisition flat-fee applies to every lease Taxpayer purchases.[1] The premium applies only to leases with excess lease rates. The amount of the premium is based on a formula using variables that the taxpayer distributes to the dealers periodically on a so-called "rate sheet."

[1] The lease acquisition flat-fee is not at issue in this request.

For example, assume Taxpayer has a master agreement with Dealer. Assume Dealer held legal title to the automobile (prior to leasing it in the instant example). Assume Dealer then executes a automobile lease with Individual Lessee. After going through the electronic bidding process described above, assume Dealer decides to transfer legal title to the automobile (and, more to the point, the lessor's position in the negotiated lease with Individual Lessee) to Taxpayer.

More specifically, assume Taxpayer acquires a Tier 1 (based on Individual Lessee's customer's good credit rating) automobile lease from Dealer. Assume the lease has a loan-to-value ratio less than percent of the Manufacturer's Suggested Retail Price (MSRP). Assume, based on the rate sheet in effect at the time,[2] that Taxpayer has agreed to pay a premium if the lease rate the dealer negotiates with the lessee-customer is higher than .[3] Assume that the dealer negotiated a lease rate of (and, therefore, Taxpayer owes Dealer a premium associated with Taxpayer's acquisition of the instant lease from Dealer). Suppose the lease offered for sale contained the following terms:

Adjusted Residual Value[4]
Adjusted Capitalized Cost[5]

Assume, as the result of the lease that Individual Lessee signed, that Individual Lessee will pay a total monthly payment of each month for months. This figure represents the sum of two components. The first component is a monthly depreciation charge to account for the decrease in the FMV of the vehicle during the lease period. The second component is a base monthly lease charge representing the lessor's profit on the lease.

Based on the terms of this lease, the base monthly lease charge is (i.e., the) and over months, the customer would pay a total base charge of . The built-in profit of would be split between the dealer and the taxpayer as follows:

Negotiated lease factor
LTV Pricing Opportunity factor
Excess markup

[2] .

[3] In the example, the lease rate of is the taxpayer's estimate to cover the time value of money and costs, including lease servicing costs.

[4] The "Residual Value" represents expected book value of the vehicle at the end of the lease. At the end of the lease, the customer has the option to purchase the vehicle for an agreed-upon amount.

[5] The "Adjusted Capitalized Cost" represents the agreed upon value of the automobile of plus Sales Tax of plus a lease acquisition fee of .

Taxpayer will keep the minimum of on the lease. The excess markup is then shared between the dealership and taxpayer based on a multi-step formula, as follows:

Step 1: Calculate the dealer reserve percentage by dividing the excess markup rate with a pre-determined base factor.

= dealer reserve

Step 2: Calculate the dealer's and taxpayer's portions of the excess reserve.

Adjusted capitalized cost
Dealer reserve percentage ____
Dealer's portion of excess markup

Taxpayer's portion of excess markup ____
Total excess markup

Taxpayer pays the dealer reserve up-front to the dealer when the taxpayer purchases the lease agreement. For book purposes, Taxpayer capitalizes and amortizes the excess markup owed to the dealership. For tax purposes, Taxpayer deducts this amount under its current method of accounting. This amount must be capitalized for tax purposes as a direct cost of acquiring the lease.

<u>Equipment Leases</u>

In addition to vehicle leases, Taxpayer also acquires leases from equipment manufacturers and vendors. The acquisition process is similar to the process for vehicle leases in that: (1) Taxpayer enters into a master agreement with the manufacturers or vendors, (2) the manufacturers or vendors enter into lease agreements with customers, (3) the manufacturers or vendors decide to sell the lease, (4) Taxpayer identifies leases it wishes to purchase from the manufacturer or vendor, and (5) the parties agree to the sale/purchase. Upon the purchase, Taxpayer receives all payments due or that will become due to the vendor under the lease agreement, including any security deposits paid to the vendor.

The pricing structure for the equipment leases is simpler than for the vehicle leases. For equipment leases, Taxpayer offers the vendors a set percentage applied to the equipment cost ("participation payment"). For example, suppose a piece of equipment cost and Taxpayer agreed to pay the manufacturer or vendor a participation amount of percent of the cost of the equipment. Taxpayer would then owe the vendor for the cost of acquiring the lease.

For book purposes, Taxpayer capitalizes the participation payments and amortizes them over the term of the lease agreement. For tax purposes, Taxpayer capitalizes and amortizes any participation payments exceeding $, and deducts any participation payments below $ under its current method of accounting.[6] The participation payments must be capitalized by Taxpayer for tax purposes as a direct cost of acquiring the leases.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 161 of the Code provides that the deductions under section 162 are subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible).

Section 263 of the Code provides generally that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the U.S. Supreme Court held that section 263(a) of the Code requires taxpayers to capitalize expenditures to acquire, create, or enhance separate and distinct assets and certain significant future benefits. See also, Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345 (1971). The Court also held that capitalization is required not only for costs of the asset itself, but also for ancillary transaction costs incurred in the process of acquisition. See, Woodward v. Commissioner, 397 U.S. 572 (1970); Helvering v. Winmill, 305 U.S. 79 (1938).

Following the decision in INDOPCO, taxpayer and the IRS often disputed whether particular costs were sufficiently related to the acquisition, creation, or enhancement of an intangible asset or benefit as to require capitalization. In 2003, to resolve these disputes, the IRS issued regulations under sections 1.263(a)-4 and 1.263(a)-5.

Section 1.263(a)-4 deals specifically with amounts paid to acquire or create an intangible. Section 1.263(a)-4(c) deals with acquired intangibles. Section 1.263(a)-4(c)(1) provides that a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Section 1.263(a)-4(c) then lists various examples of intangibles within the scope of this rule. Section 1.263(a)-4(c)(1)(vi) specifically lists “a lease.”

Here, the excess markup payments made by Taxpayer for the automobile leases and the participation payments made by Taxpayer for the equipment leases fit squarely

[6] The application of a $ threshold reveals that the taxpayer may be treating the participation payments as facilitative costs under Treas. Reg. § 1.263(a)-4(e).

into the amounts paid under section 1.263(a)-4(c) of the regulations as costs to acquire an intangible. The payments at issue are part of (or in the case of equipment leases the entire amount of) the purchase price of the lease agreement. This is a direct cost of acquiring the leases. These payments represent what the Taxpayer, as the buyer, is willing to pay the seller for a valuable intangible asset. For the auto leases, the price of the leases is directly tied to the expected profit and the lease rate negotiated with the customer. For the equipment leases, the purchase price is tied to the equipment being financed through the lease.

Taxpayer argues that the dealer is acting as an intermediary to assign the leases to Taxpayer, and as such, there is no sale of an intangible asset for tax purposes. This argument is contrary to Taxpayer's master agreements, which specifically state that there is no agency relationship between Taxpayer and the dealer. The master agreements with the auto dealers clearly describe the transaction as a purchase of a lease contract; the master agreements with the equipment manufacturers state that the manufacturer assigns and transfers the lease for consideration. Both of these transactions qualify as a "purchase or similar transaction" under section 1.263(a)-4(c)(1). Even if Taxpayer were to successfully argue that the transaction did not constitute the acquisition of an intangible, the amount would then be considered paid to create an intangible under section 1.263(a)-4(d)(6) and would nevertheless have to be capitalized.

Taxpayer also argues that since the payments do not comprise or equate to the principal value of the lease contracts, they represent compensation to the dealer for services. Taxpayer has provided no evidence to support that these payments may be treated other than as the acquisition of a lease.

Therefore, Taxpayer's situation is clearly covered by section 1.263(a)-4(c)(1)(vi), and the excess markup payments and the participation payments must be capitalized.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-7011 if you have any further questions.