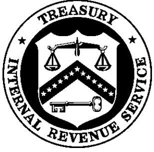

OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

March 12, 2001

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CAM-101676-98/CC:ITA:B7

MEMORANDUM FOR INDUSTRY DIRECTOR, FINANCIAL SERVICES
AND HEALTHCARE

FROM: Chief, CC:ITA:B07

SUBJECT: Denial of Request for Change in Accounting Method

In accordance with section 10.11 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 43, this memorandum advises you that we have denied a request for a change of accounting for a taxpayer within your district.

See the attached letter to the taxpayer.

If you have questions on this matter please call

cc: Changes in Methods of Accounting Industry Specialist

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Index Number:
61.15-01

Person to Contact:

Telephone Number:

Refer Reply To:
CC:ITA:7-CAM-101676-98
Date:
March 12, 2001

EIN:

AttN:

Taxpayer =
Company =
Company 1 =
Company 2 =

Dear Mr. :

This letter refers to a Form 3115, Application for Change in Accounting Method, filed for the above-named taxpayer. In its Form 3115, Taxpayer requested permission to change its method of accounting for capitalized cost reduction (CCR) payments for the taxable year beginning January 1, 1997.

Under its current method of accounting, Taxpayer includes in its gross income a vehicle lessee's CCR payment when it purchases a vehicle subject to a lease. Taxpayer also includes the CCR payment in the purchased vehicle's basis for depreciation purposes.

Under its proposed method of accounting, Taxpayer would not include a CCR payment in its gross income when it purchases a vehicle subject to a lease. Taxpayer also would not include the CCR payment in the purchased vehicle's basis.

After reviewing all of the facts and arguments presented, we conclude that:

1. Taxpayer should include an automobile lessee's CCR payment in its gross income when it purchases a vehicle subject to a lease.

2. Taxpayer should include the CCR payment in the purchased vehicle's basis.

Facts

Taxpayer is engaged in the business of financing automobiles sold by franchised automobile dealers. Taxpayer's business consists of two principal activities -- lending and leasing. With regard to its lending activity, Taxpayer makes secured loans to retail customers for all or some portion of a purchased vehicle's cost. With regard to its leasing activity, Taxpayer purchases vehicles from automobile dealers that are subject to leases with retail customers.

The Automobile Leasing Business

A lease agreement between a retail automobile dealer (hereinafter the dealer) and a retail customer (hereinafter lessee) generally occurs as follows. First, various finance companies provide automobile dealers with their criteria for purchasing a vehicle that is subject to a lease. These criteria include the necessary creditworthiness of the lessee, the finance company's method of estimating the value of the vehicle at the end of the lease term, the finance company's accepted rates of return (the money factor), the maximum amount of the purchase price that the finance company will finance, and the maximum amount of allowed capital cost reduction payments. In fact, on a monthly basis Taxpayer publishes bulletins that outline the required money factor and residual rates that are to be utilized if Taxpayer is to purchase a vehicle that is subject to a lease. Before negotiating and entering into a lease with a retail customer, the dealer takes all of these factors into account.

Prior to entering into a lease with a lessee, the dealer checks the lessee's creditworthiness. Subsequently, the lessee and the dealer negotiate the various lease terms, which include the stated "sales price" of the vehicle and the amount, if any, of a CCR payment that will be paid by the lessee. After the lessee and the dealer have agreed to lease terms, the dealer will review the terms being offered by Taxpayer and

competing finance companies. Ultimately, the dealer utilizes the finance company that provides the greatest opportunity to sell a vehicle while maximizing profit.[1]

If the dealer decides to sell the vehicle to Taxpayer, the dealer completes a preprinted lease worksheet that has been provided by Taxpayer.[2] The dealer then submits the completed lease worksheet to Taxpayer for review and approval. If Taxpayer decides to approve the transaction, Taxpayer issues a contract approval number to the dealer. When the dealer obtains the contract approval number, the dealer and the lessee are free to execute a lease agreement. The lease agreement is a preprinted form that has been prepared and provided by Taxpayer. This lease agreement specifically provides that when the dealer negotiates with a lessee, the dealer is not acting as Taxpayer's agent.[3] However, the lease agreement also includes a lease assignment provision that provides that the dealer, as lessor, will assign all rights, title, and interest in the vehicle and the lease to Taxpayer. When the dealer sells a vehicle that is subject to a lease to Taxpayer, it must provide Taxpayer with a signed and executed vehicle lease agreement, a completed lease worksheet, title to the vehicle and other miscellaneous information. If Taxpayer receives this information within sixty days of the issuance of a contract approval number, Taxpayer purchases the vehicle subject to the lease. At the inception of the lease, the vehicle is titled (registered for ownership with a state motor vehicle agency) to Taxpayer. After Taxpayer purchases the vehicle, legal ownership of the vehicle passes to it.

The Lease Worksheet

In order to determine the required monthly lease payments for a specific vehicle, the dealer utilizes a preprinted worksheet that has been provided by Taxpayer. The worksheet is divided into four segments: (1) Capitalized Cost; (2) Residual Value; (3) Monthly Payment; and (4) Amount Due Dealer.

The Capitalized Cost segment begins with the “Selling Price” of the vehicle. To the selling price is added state and federal excise taxes, the price of any warranty or

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[1]Taxpayer estimates that it finances approximately 55% of all new Company purchases and leases. Taxpayer also estimates that it has a 70% share of the new leased Company market.

[2]Dealers do not generally use their own or generic forms.

[3]Company dealerships are independently owned and operated businesses that conduct their business relationship with Company 1 pursuant to the Dealer Agreement. The Dealer Agreement also specifically states that a “[d]ealer will conduct its Company operations on its own behalf and for its own account” and that the “[d]ealer has no power or authority to act for or to bind Company 2 and/or Company 1.”

maintenance contract, and an assignment fee charged by Taxpayer. The sum of these amounts is an amount called the “Gross Capitalized Cost.” From the gross capitalized cost is subtracted the CCR payment. The CCR payment can be the net value of any vehicle that the lessee is trading in and/or any cash payment that the lessee makes. The resulting amount is called the “Adjusted Capitalized Cost”.

In the Residual Value segment, the dealer estimates the value of the vehicle at the end of the lease term by multiplying the “Manufacturer’s Suggested Retail Price” (which may or may not be identical to the Selling Price) of the vehicle by a residual percentage, which has been predetermined by Taxpayer.

In the Monthly Payment segment, the dealer computes the total monthly lease payment. The total monthly lease payment consists of three components: (1) the Monthly Lease Charge; (2) the Monthly Depreciation; and (3) any applicable sales and use taxes and any other monthly charges. To compute the Monthly Lease Charge, the dealer adds together the Adjusted Capitalized Cost and the Residual Value and then multiplies the sum by a “money factor” that has been established by Taxpayer. The dealer then computes Monthly Depreciation by subtracting the Residual Value from the Adjusted Capitalized Cost and then dividing the difference by the number of months in the lease term. The dealer then adds any applicable sales or use taxes and any other monthly charges to the Monthly Lease Charge and Monthly Depreciation to determine the Total Monthly Payment. The last figure in the Monthly Payment segment is the Total of All Monthly Payments. The Total of All Monthly Payments is the product of the Total Monthly Payment multiplied by the number of months in the Lease Term

In the Amount Due Dealer segment, the Adjusted Capitalized Cost is reduced by the first monthly lease payment, the Security Deposit/Last Monthly Payment, any Tax on Capitalized Cost Reduction, Taxpayer’s Assignment Fee, and any Federal Luxury Tax. The Adjusted Capitalized Cost may be increased by other charges and sometimes a Dealer Reserve. The resulting figure is the Net Amount Due to Dealer. If Taxpayer decides to purchase the vehicle from a dealer, it will transfer funds to the dealer in an amount equal to the Net Amount Due to Dealer.

Taxpayer’s Present and Proposed Methods of Accounting for CCR Payments

Currently, when Taxpayer purchases a vehicle that is subject to a lease, it includes the CCR payment, if any, in its gross income as prepaid or advanced rent and in the purchased vehicle’s basis (i.e., the basis of the vehicle is equal to the Gross Capitalized Cost figure reflected in the Capitalized Cost segment of the lease worksheet) for depreciation purposes. Taxpayer is now seeking the Commissioner’s consent to change its method of accounting. Under Taxpayer’s proposed method of accounting, Taxpayer would not include the CCR payment in gross income and would not include the CCR payment in the purchased vehicle’s basis (i.e., the basis of the vehicle would

be equal to the Adjusted Capitalized Cost figure reflected in the Capitalized Cost segment of the lease worksheet) for depreciation purposes.

Although Taxpayer proposes to change the accounting treatment of CCR payments, Taxpayer will continue to report the difference between the Adjusted Capitalized Cost figure and the Amount Due to Dealer as gross income upon acquisition of a leased vehicle. As explained above, the difference in these figures is attributable to the first and last month's rental payment, any security deposit, any applicable taxes on the CCR payment or the vehicle, and Taxpayer's assignment fee. All of these amounts are paid by the lessee to the dealer; nonetheless, Taxpayer agrees that they are properly includible in Taxpayer's gross income.

Taxpayer's Arguments

Taxpayer believes that its proposed method of accounting for the CCR payments is appropriate for several reasons. First, Taxpayer argues that it should not have to include a CCR payment in its gross income because it never actually or constructively receives the CCR payment. According to Taxpayer, the leasing transaction can be broken down into two distinct transactions, the first transaction being a leasing transaction between the dealer and the lessee and the second transaction being a sales transaction between it and the dealer. The dealer is an independent franchisee that is acting on its own behalf when it negotiates certain lease terms, such as the Selling Price, the amount of the CCR payment, and the value assigned to any vehicle traded-in to the dealer. Therefore, Taxpayer argues that the dealer is the initial lessor of the vehicle and that the dealer, and not it, should include the CCR payment in gross income as advanced rent.

Second, Taxpayer argues that it should not have to include a CCR payment in its gross income because it receives no economic benefit from the CCR payment. Taxpayer explains that the price it pays for a vehicle that is subject to a lease is a function of the underlying cash flow and income stream that is generated by the lease and the residual value of the vehicle.[4] Taxpayer asserts that it pays a reduced amount for a vehicle that is subject to a lease with a CCR payment because the CCR payment

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[4]Presumably, the rate of return on the transaction can be derived from the figures on the lease worksheet. The present value of the Total of All Monthly Payments and the Residual Value should equal the Adjusted Capitalized Cost of the vehicle when discounted at the expected rate of return (based on an annuity due rather than an annuity in arrears). However, Taxpayer may actually earn a rate of return that is more or less than expected because the residual value of the vehicle may be different from the anticipated amount.

reduces the underlying cash flow and income stream that is generated by the lease. In other words, Taxpayer contends that a vehicle that is subject to a lease with a CCR payment is worth less; therefore, Taxpayer pays less. Taxpayer contends that the purchase price of the leased vehicles is the Adjusted Capitalized Cost amount, rather than the Selling Price. Thus, according to Taxpayer, the proposed method of accounting more accurately reflects the economic substance of the leasing transaction.

Finally, Taxpayer argues that the Service would not respect the form of the leasing transaction if the Service were to hold that the CCR payment is included in its gross income. Taxpayer further argues that the Service has previously respected the form of the leasing transaction in the luxury tax area. See LTR 9639003.

Law and Analysis

Section 451 of the Internal Revenue Code provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is properly accounted for as of a different period. Section 1.451-1(a) of the Income Tax Regulations further provides that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer, unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. See §§1.446-1(c)(1)(ii) and 1.451-1(a). Generally, all the events that fix the right to receive income have occurred at the earliest of: (1) when the item of income has been actually or constructively received; (2) when the item of income has become due; or (3) when the item of income has been earned by performance. See Schlude v. Commissioner, 372 U.S. 128 (1963); Union Mut. Life Ins. Co. v. United States, 570 F.2d 382, 385 (1st Cir. 1978); Automobile Club of New York, Inc. v. Commissioner, 32 T.C. 906, 911-913 (1959), affd. 304 F.2d 781 (2d Cir. 1962). Consequently, it is well established that advanced payments of income, over which the taxpayer has a present right and complete and unrestricted control, are includible in gross income in the year the advance payments are received. See id.

Section 61(a) provides generally that gross income means all income from whatever source derived. Section 1.61-8(a) provides that, except as provided in § 467 and the regulations thereunder, gross income includes advance rentals. Section 1.61-8(b) specifically provides that advanced rental payments are included in income in the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer.

Payments that are made by a lessee on behalf of a lessor constitute rental income to the lessor even when the lessee makes such payments directly to a third party. See Ethel S. Amey v. Commissioner, 22 T.C. 756 (1954). In Amey, a lessee of real estate made mortgage payments to the bank that held the property's mortgage, even though the lessor and not the lessee was liable for such payments. The lessor argued that the mortgage payments that were attributable to amortization that was paid to the bank by the lessee should be reflected as adjustments to the lessor's basis, rather than treated as ordinary income. The court rejected the lessor's argument and noted that the lessee's payments to the bank were "actually nothing more than a form of rental payments." See Amey v. Commissioner, supra at 763. In doing so, the court also stated that the "proposition that payments by a lessee may be taxed as rental income to the lessor even though paid directly to a third party is by no means novel." Id. at 765.

Similarly, in Hyde Park Realty v. Commissioner, 20 T.C. 43 (1953), affd. 211 F.2d 462 (2d. Cir. 1954), the Tax Court addressed the tax treatment of rents that were received prior to the purchase date of property, and which pertained to periods after the date of purchase. In Hyde Park Realty, the taxpayer purchased real estate that was subject to a lease agreement. The purchase contract provided that rents collected by the seller should be apportioned between the parties as of the closing date. Pursuant to the sales contract, the purchaser received a credit from the seller toward the purchase of the property for the advanced rents that were received by the seller before the closing date of sale and which related to the taxable period subsequent to the closing date. The buyer argued that the advanced rents that were paid to the seller should not be included in its income, but instead should be included in the seller's income. The buyer further argued that the credit of the advanced rent against the purchase price constituted an adjustment to the sales price, which resulted in the purchased property having a reduced basis.

In Hyde Park Realty, the Tax Court disagreed with the taxpayer's argument and held that the advanced rents paid to the seller should be included in the buyer's income. In so holding, the court observed that if the seller had remained the owner of the property, the seller would have included the entire amount of advanced rent in income in the year when the rent was collected. The court then noted that the seller sold the property before the rent was earned. Therefore, the court concluded that the advanced rents that were unearned as of the date of sale, were received by the buyer during the sale and did not represent a reduction in the purchase price.

In affirming the Tax Court, the Court of Appeals noted that advanced rents are taxable when received. The Court of Appeals also held that the purchaser in effect

received the advanced rents when it purchased the property and received a credit against the sale price in an amount equal to advanced rents that related to periods that were subsequent to the sales date. The Court of Appeals also noted that in deciding whether advanced receipts are taxed as income to the buyer or constitute an adjustment in purchase price depends on the commercial intent of the parties. In Hyde Park, the Court of Appeals held that when the taxpayer purchased the property it undertook an obligation to perform leasing services and that it had been paid for such services in the form of advanced rent.

The Tax Court in Pokusa v. Commissioner, T.C. Memo. 1978-93, again addressed the situation where real property was sold subject to a lease and advanced rents were paid and related to periods subsequent to the sales date. In Pokusa, the taxpayers operated rental property from January 1, 1972 to May 1, 1972. On May 1, 1972, the taxpayers sold the property and credited to the buyers advanced rental payments that were collected prior to the sales date, but which related to periods subsequent to the sales date. In Pokusa, the court again held that the advanced rent payments that were credited to the buyer were not an adjustment of the purchase price and should be included in the buyer's and not the seller's income.

I. CCR payments are advance rental payments constructively received by *Taxpayer*.

The facts in this case are identical to the facts in Hyde Park and Pokusa. Taxpayer purchases a leased vehicle from a dealer and the dealer credits Taxpayer with the payments made by the lessee with respect to the vehicle. In fact, Taxpayer apparently agrees with the analysis in those cases to the extent that the lease worksheet denominates the lessee's advance payments as first month's rent, last month's rent or administrative fees. Taxpayer attempts to distinguish these payments from CCR payments by stating that CCR payments "reduce the capitalized cost of the vehicle, whereas the other payments are amounts that come due under the lease." We believe that this is a distinction without a difference.

At the inception of the lease, the lessee can make a CCR payment that will result in a reduced monthly rental payment. Rent is payment of an amount set by a contract, made by a tenant at designated intervals in return for the right to occupy or use another's property. See Webster's II New Riverside University Dictionary 995 (1994). Advance payments of rent reduce the amount of rent to be paid in the future. Taxpayer admits that "[the CCR payment] affects the amount of the payments under the lease." Clearly, the lessee makes a CCR payment to reduce its monthly payments for the use of a vehicle. Since both parties understand that the CCR payment is a substitute for higher monthly payments during the lease term, the parties must regard the CCR

payment as advanced rent.[5] Therefore, we believe that the CCR payments, like the first and last months' rental payments, are advance rentals constructively received by Taxpayer.

Moreover, all of the payments contemplated in the lease worksheet "become due under the lease." The lease simply will not be consummated unless the lessee either agrees to pay market lease payments or an adequate CCR payment in conjunction with below-market lease payments. Similarly, the lease will not be consummated unless the lessee agrees to pay the first and last month's rental payment at the inception. The fact that these payments are made prior to the period covered by the lease does not change their fundamental purpose and character; they are advance payments of rent.

II. *Taxpayer* receives an economic benefit equal to the amount of the CCR payment and its cost basis in the leased vehicle is equal to the amount actually paid for the vehicle plus the amount of any liability assumed.

Taxpayer asserts that its cost basis in the vehicle is equal to the Adjusted Capitalized Cost of the vehicle. Taxpayer also argues that the amount it pays the dealer is equal to the fair market value of the vehicle that is subject to a lease with a CCR payment. Taxpayer further argues that the fair market value of a vehicle that is

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[5]The following example demonstrates that a lessee makes a CCR payment at the beginning of the lease in lieu of making future lease payments over the lease term. As a result of making a CCR payment at the beginning of the lease, a lessee also avoids the finance charges associated with the lease payments that will not be paid over the lease term.

The "Monthly Payment" amount was calculated using the leasing formula contained in Taxpayer's Lease Worksheet. The example assumes a "Selling Price" of $20,000, a money factor of .00345, a residual factor of 60%, a lease term of 30 months, sales tax of 5%, and an assignment fee of $500.

	No CCR Payment	With CCR Payment of $3,000
Monthly Payment	$432.25	$321.90
Lease Terms (A)	30 months	30 months
Total Lease Income Collected (B)	$12,967.50	$9,657.00
Capital Cost Reduction Payment (C)		$3,000
Money Factor Used		.00345
CCR*Money Factor*Lease Term(D)		$310.50
B+C+D		$12,967.50

subject to a lease with a CCR payment is less than the fair market value of a vehicle that is not subject to a lease or that is subject to a lease without a CCR payment because of the reduced cash flow that results from a CCR payment. We disagree.

When Taxpayer purchases a vehicle subject to a lease with a CCR payment, it receives an undeniable accession to wealth. Taxpayer is willing to accept the lower lease payments over the term of the lease because it has received something of value when it purchases the vehicle - the lessee's CCR payment constitutes part of the purchase price of the vehicle. Dealers consistently treat the CCR payment as part of the sales price of the vehicle.[6] Thus, dealers clearly regard the CCR payment as a payment made on behalf of Taxpayer.[7] When the dealer sells the vehicle subject to the lease, it credits Taxpayer with the CCR payment that it has received. Accordingly, "[t]he taxpayer was the 'beneficiary' of the [CCR] payment in 'as real and substantial [a sense] as if the money had been paid it and then paid over by it to [the dealer].'" See Crane v. Commissioner, 331 U.S. 1, 13 (1947)(quoting United States v. Hendler, 303 U.S. 564, 566 (1938).

Taxpayer essentially argues that it derives no economic benefit from the CCR payment because the vehicle is laden with a below-market lease. In other words, Taxpayer might be willing to pay the Selling Price of a given vehicle if the vehicle were subject to a lease that called for market lease payments. But when that vehicle is subject to a lease with below market lease payments, the vehicle is worth less.

The basis of property acquired by purchase is generally equal to the property's cost. See Treas. Reg. §1.1012-1. Generally, cost is the amount paid for such property in cash or other property. See id. However, cost basis of property acquired by purchase also includes obligations incurred or assumed by the purchaser in acquiring the property and liabilities to which the property is subject at the time of purchase, whether or not the purchaser assumes personal liability for the obligation. See Crane v. Commissioner, supra; Mayerson v. Commissioner, 47 T.C. 340 (1966).

In Crane, the taxpayer (Mrs. Crane) inherited a building from her deceased husband. At the time of her husband's death in 1932, the building was subject to a mortgage debt that was in the same amount as the fair market value of the building.

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[6]Although the sales price was initially negotiated by the lessee, Taxpayer ratifies the terms of the lease agreement when it issues a contract approval number. As stated above, Taxpayer purchases a vehicle subject to a lease when the dealer within sixty days of the issuance of a contract approval number submits a signed and executed lease agreement, a completed lease worksheet, and title to the vehicle.

[7]Although Taxpayer is not required to know and is not bound by the dealers' treatment, the dealers' treatment evidence of the commercial intent of the parties.

Mrs. Crane was not personally liable on the mortgage. After inheriting the building, Mrs. Crane attempted to operate the building for several years hoping to make the building profitable. During this period, she claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make any payments toward the mortgage's principal. However, in computing her basis for depreciation deductions, Mrs. Crane included the full amount of the mortgage debt.

After operating the building unsuccessfully for a number of years, Mrs. Crane sold the building in 1938. The purchaser took the property subject to the mortgage and paid Mrs. Crane $3,000 in cash. As part of this transaction, Mrs. Crane paid $500 in sales expenses.

In Crane, Mrs. Crane reported a gain on the transaction in the amount of $2,500. In reporting the gain, Mrs. Crane asserted that her basis in the property was zero (even though she had earlier taken depreciation deductions that were based on an amount that included the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received less the selling expenses she had paid. In other words, Mrs. Crane argued that her basis in the building was equal to her equity in the building.

In Crane, the Supreme Court rejected Mrs. Crane's argument and held that her basis in the property was the property's fair market value at the time of her husband's death undiminished by the mortgage. In reaching this holding, the Supreme Court observed that if it were to merely regard the taxpayer's equity in the property as her basis the resulting depreciation deductions would be less than the actual physical deterioration of the property. The Court also held that the amount that the taxpayer realized from the sale also included the outstanding value of the mortgage. Accordingly, the Court held that the amount realized from the sale includes the amount of liability from which the transferor was discharged as a result of the sale. See also Treas. Reg. §1.1001-2(a)(1).

In this case, the sales price of a vehicle is provided by the lease agreement. The first line item of the Capitalized Cost segment of the leasing agreement begins with the "Selling Price" of the vehicle. Subsequently, when the dealer sells a vehicle that is subject to a lease with a CCR payment to Taxpayer, the dealer credits the CCR payment towards the purchase price of the vehicle. As discussed above, when a lessee pays a CCR payment he or she intends the CCR payment to be advanced rent. When Taxpayer purchases a vehicle that is subject to a lease, it undertakes an obligation to perform the services that have been contemplated by the lease. Accordingly, when the taxpayer purchases a vehicle subject to a lease with a CCR payment, it undertakes the obligations that have been contemplated by the lease and also receives a credit for the lease obligations that have already been paid for by the lessee. Consequently, Taxpayer's basis in the vehicle is equal to the full sales price of

the vehicle undiminished by its liability to perform services that relate to the advanced rent.

III. The income tax consequences of a leasing transaction differ from those of a financing arrangement.

Taxpayer argues that it purchases a vehicle subject to a lease for the Adjusted Capitalized Cost amount. Taxpayer further argues that this amount, rather than the selling price, more accurately reflects the economic substance of the leasing transaction because as a financing company it intends to enter into financing arrangements, rather than agreements to purchase. Taxpayer further argues that a leasing transaction is akin to a financing arrangement because in substance it purchases the present value of the income stream generated by the lease and the vehicle's residual value. Furthermore, Taxpayer contends that the lessee's capitalized cost reduction reduces the capitalized cost of the vehicle, which in turn determines the Monthly Lease Charge and Monthly Depreciation. Therefore, a CCR payment results in lower Monthly Lease Charges and Monthly Depreciation and thus a reduced income stream. Accordingly, Taxpayer contends that it "pays less for the vehicle to reflect the diminished value."[8]

Taxpayer structured the transactions at issue as leasing transactions rather than financing arrangements. Moreover, Taxpayer does not argue that the transaction is a financing arrangement for federal income tax purposes. Instead, Taxpayer argues that its leasing transactions should be analyzed as if they were financing arrangements. We do not dispute Taxpayer's argument insofar as it relates to financial analysis and valuation. However, the federal income tax consequences of a leasing transaction differ from the federal income tax consequences of a financing arrangement and Taxpayer agrees that the transactions at issue are leases for federal income tax purposes.

IV. *Taxpayer*'s reliance on LTR 9639003 is misplaced.

Taxpayer argues that the CCR payment is only includible in the gross income of the initial lessor, i.e., the dealer. In the instant case, the dealer receives the CCR payment as a result of negotiating a lease with the retail customer and then sells the vehicle subject to the lease to Taxpayer. Taxpayer argues that the Service is recasting the form of the transaction to treat Taxpayer as purchasing the vehicle from the dealer first and then leasing it to the retail customer. Taxpayer argues that the Service's recast of the transaction for income tax purposes is inconsistent with the approach taken for luxury tax purposes. See LTR 9639003.

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[8]Taxpayer offers no explanation for why its economic substance argument does not apply equally to the first and last months' lease payments and the Taxpayer Administrative Fee. Like the CCR payment, those payments are received by the dealer and are taken into account in determining the Net Amount Due to Dealer.

Under former section 4001(a), a luxury tax of 10% was imposed on the amount by which the sales price of a passenger vehicle exceeded a base amount. The tax was only imposed on the first retail sale. Former section 4002(c)(1) provided that, in general, "the lease of a vehicle . . . by any person shall be considered a sale of such vehicle at rental." In LTR 9639003, the Service determined that in the case of a leasing transaction, the dealer, not the financing company, was liable for the tax imposed by section 4001. The Service's determination that the dealer was liable for the tax was based on the ground that the dealer is the initial lessor even though the leasing agreement provided that the leased vehicle would be sold to the leasing company.

Under LTR 9639003, liability for the luxury tax depended upon a determination that the dealer was the initial lessor. With respect to the income tax, however, Hyde Park Realty makes clear that advanced rent received by a seller of property is includible in the buyer's gross income to the extent that the parties agree to reduce the sales price of the property thereby. The determination of who is the initial lessor is irrelevant to the income tax consequences of the transaction at issue. Thus, Taxpayer's reliance on LTR 9639003 is misplaced.

Based upon the foregoing, permission to change to the proposed method of accounting is denied.

In accordance with the provisions of a power of attorney on file with this office, we are sending a copy of this ruling letter to the taxpayer's authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Associate Chief Counsel
(Income Tax & Accounting)
By_____________________
Thomas A. Luxner
Chief, Branch 7

cc: Industry Director, Financial Services
and Healthcare