



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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel, Income Tax and Accounting

SUBJECT: Year of Inclusion for Lessor Administration Fees

This Chief Counsel Advice responds to your memorandum dated January 19, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer	=
Year A	=
X#	=

ISSUE

Whether fees associated with automobile leases should be recognized by an accrual method taxpayer in the year of the lease inception or ratably over the life of the lease.

CONCLUSION

Because Taxpayer receives the capitalized cost reduction payment in the year of the lease inception, and such payment is equal to or greater than the amount of the fees, the fees should be included in income in that year and not over the term of the lease.

FACTS

Taxpayer is a full service bank. For Year A and later years, Taxpayer offered the usual variety of banking services, including automobile leases. Although the facts of your incoming are not clear, generally a lease agreement between a retail automobile dealer and a retail customer occur as follows:

First, various financing companies or banks provide the automobile dealer with their criteria for purchasing a vehicle that is subject to a lease. These criteria include the necessary creditworthiness of the lessee (customer), the bank's method of estimating the value of the vehicle at the end of the lease term, the bank's accepted rates of return (profit factor), the maximum amount of allowed capital cost reduction payments. Before negotiating and entering into a lease with a customer, the automobile dealer takes all of these factors into account. Usually, automobile dealers chose the lessor banking institution which provided the most attractive lease for the prospective customer.

Generally, customers wishing to lease an automobile enter into negotiations with the automobile dealer, indicating the amount of monthly payment desired. Adjustments could be made in the make of the vehicle, the options, the lease term, down payments and/or trade-in allowance, in order to reach a figure affordable to a customer. If a deal could be structured, the automobile dealer completes a preprinted lease form from one of several banks for which it has authority to prepare lease proposals.

The capitalized cost of the lease is an important concept in the vehicle leasing business. Rental income is a return on the investment in the leased asset. The amount of the monthly lease charge is a function of the capitalized cost of the lease and the residual value of the vehicle. Thus, the monthly lease payment depends upon the gross capitalized costs of the lease, the finance company's money factor requirement, and the amount that the vehicle will depreciate during the term of the lease. Generally, a lessee makes an up-front payment that reduces the gross capitalized cost of the lease and reduces the monthly lease payments. This up-front payment is generally called a capital cost reduction ("CCR"). A CCR may be either paid in cash or property. Typically, a CCR in the form of property is the agreed upon value of a used vehicle that is being traded in by the customer/lessee.

For leases written for Taxpayer, a calculation of the customer's monthly lease payment is contained in the Lease Agreement. The first step in calculating the lease payment is determining "gross capitalized cost," defined as the agreed upon value of the vehicle plus any other items the lessee pays over the lease term, including service contracts, insurance, a profit amount (money factor requirement), and a "lessor administration fee."¹ From this gross number is subtracted the amounts of any trade-in allowance, rebate, noncash credit or cash paid by the lessee (the CCR). The amount is further reduced by the residual value of the

¹ Even in the case of a cancellation or premature buyout of the lease, Taxpayer does not return any portion of this fee.

vehicle, which is the estimated value of the vehicle at the end of the lease term. The net amount is then divided by the number of months in the lease, resulting in the monthly payment for the lessee.

“Lessor administration fee” is not described in Taxpayer’s Lease Agreement, although Taxpayer suggests that the term refers to the costs of originating and administering the leases. However, the fee is apparently charged regardless of whether the lessee satisfies its obligation under the lease by making one pre-payment, or by making monthly payments over twelve to forty eight months. The fee can also vary, although the variance does not appear to be related to the interest charged on the lease. It is the inclusion of this fee into income, in what year, that is at issue. Taxpayer entered into over X# of leases in the Year A. A small portion of Taxpayer’s leases were pre-paid by the lessees, wherein the full amount of the gross and net capitalized costs are paid up front.

LAW AND ANALYSIS

Section 61 provides generally that gross income means all income from whatever source derived. Section 61(a)(5) specifically includes rents within the definition of gross income.

Treas. Reg. § 1.61-8(a) provides that gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property.

Treas. Reg. § 1.61-8(c), includes in rental income any expenses of the lessor paid by the lessee.

Under the 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 Treas. Reg. §§ 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 when the item is actually or constructively received, when the item is due, or when the item is earned. See Schlude v. Commissioner, 372 U.S. 128 (1963); Union Mutual Life Insurance Co. v. United States, 570 F.2d 382, 385 (1st Cir. 1978). 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 advanced payments are received. Schlude, 372 U.S. 128. Rent is the compensation or fee paid, usually periodically, for the use of any property. Black’s Law Dictionary, 5th ed., 1979. Treas. Reg. § 1.61-8 specifically provides that advanced rental payments are included in income in the year of receipt.

When Taxpayer obtains a vehicle subject to a lease with a CCR payment, it receives an undeniable accession to wealth.² When a customer makes a CCR payment, all subsequent lease payments are reduced. 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.

When an obligation of a taxpayer is paid by a third party, the effect is the same as if the third party had paid the money to the taxpayer who in turn paid his creditor. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929); Sachs v. Commissioner, 32 T.C. 815, 819 (1959), aff'd, 277 F.2d 879 (8th Cir. 1960). The amounts paid on behalf of the taxpayer are included in the taxpayer's income. O'Malley v. Commissioner, 91 T.C. 352 (1988). Payments that are made by a lessee on behalf of the lessor constitute rental income to the lessor even when the lessee makes such payments directly to a third party. See Amen v. Commissioner, 22 T.C. 756 (1954); Hyde Park Realty v. Commissioner, 20 T.C. 43 (1953), aff'd, 211 F.2d 462 (2d Cir. 1954); Pachisi v. Commissioner, T.C. Memo. 1978-93.

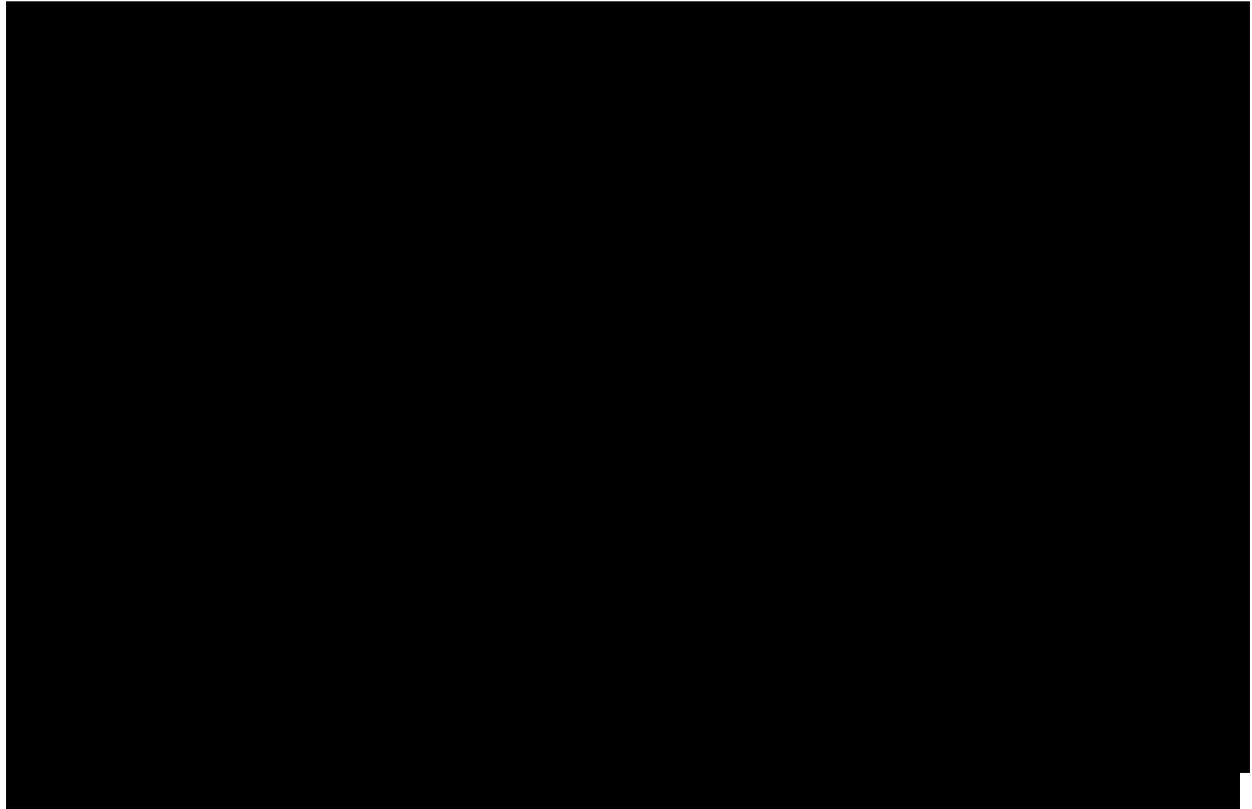
The customers' payment of a CCR under Taxpayer's leases has the effect of reducing the customer's future rental payments by reducing the net capitalized cost of the leased merchandise on which the monthly rent payments are based. The lessee makes a CCR, which amount is greater than the lessor administration fee, as well as monthly payments, for the use of a vehicle. Accordingly, there is a basis for regarding the CCR as advance payments of rent or payments in lieu of future rent.

These facts indicate that this transaction is, in substance, a sale of the merchandise by the dealer to Taxpayer, with a concurrent lease agreement between the customer and Taxpayer. Under these circumstances, it is appropriate to treat any CCR as paid by the customer to Taxpayer as an advanced payment. We conclude that to the extent that a customer pays a CCR, and that amount in cash or trade-in value exceeds the lessor administration fee (which clearly occurs for those pre-paid leases), then Taxpayer has received advanced rental payments. It follows that any CCR, and thus the lessor administrative fees, should be included in Taxpayer's income as advanced payments (rents) based on Old Colony Trust and its progeny.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



² Presumably, when a customer pays a dealer a CCR, Taxpayer uses these funds to settle its purchase obligation with the dealer.



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Please call if you have any further questions.

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