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Income Tax Determin.

BUREAU OF LAW

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MEMORANDUM

McKee, Marilyn R. + William E.

TO: State Tax Commission

FROM: Vincent P. Molineaux, Hearing Officer

SUBJECT: WILLIAM E. AND MARILYN R. McKEE

Petition for Redetermination of Deficiency for Personal Income Tax and Unincorporated Business Tax Under Articles 22 and 23 of the Tax Law for the Years 1962, 1963 and 1964

A hearing on the above matter was held before me at the Syracuse District Office of the State Tax Commission on August 8, 1967. The appearances and the evidence produced were as shown in the stenographic minutes and the exhibits submitted herewith.

This is a Federal Notification Case and the question at issue is whether a dealer reserve account held by a bank is taxable income of the taxpayers for the years 1962, 1963 and 1964.

The taxpayer was in the business of selling mobile homes in Syracuse, New York and he reported for income tax purposes on an accrual basis. Taxpayer's procedure on the sale of a mobile home would be for the purchaser to make a down payment in cash and execute a retail installment contract for the balance of the cost plus insurance charges and a finance charge representing interest at 6 per cent per annum on the balance.

The taxpayer would then assign the retail installment contract to the Union Bank and receive the balance of the cash purchase price.

Taxpayer was also entitled to share in the finance charges, so to avoid complicated bookkeeping transactions, the bank at the time of the assignment of the installment contract would post to reserve account in taxpayer's name a percentage of the finance charges representing one-sixth of the 6 per cent charged to the purchaser.

According to the contract between the taxpayer and the bank, "So long as the Dealer (taxpayer) is not in default under any obligation to the Bank, the Bank will pay to the Dealer semi-annually, * * * an amount by which the balance in the reserve account, * * * exceeds 5% of the aggregate unpaid balances of such chattel paper." Early payment of the amount of the purchase price would result in an abatement of interest. If any purchaser of a mobile home failed to fulfill his commitment, the dealer-taxpayer would repurchase the chattel paper from the bank, and the reserve account would also be reduced by the amount of any interest that would not then be collectible.

Whether or not the amount posted to the reserve account at the time of the transaction is accrued income of the taxpayer and therefore subject to income tax, is the question under consideration.

The Income Tax Bureau has taken the position that the posting to the reserve account constitutes a fixed right of the dealer to receive the income.

Taxpayer claims that this cannot be so as the bank itself, at the time of posting, has not received the income, and the dealer-taxpayer may never have a right to it.

The leading Federal case on the subject of dealer reserve accounts is Commissioner of Internal Revenue v. Hansen (1959), 360 U.S. 446. In that case, the finance company who acted in a similar capacity to the bank in this case withheld 3 or 5 per cent, depending on the case, of the retail sale price and posted it in the reserve account to cover obligations of the dealer. The facts in the case did not show whether a portion of the finance or interest charges was also credited to the taxpayer, and the court specifically excluded a determination concerning finance charges participation. The court did hold that, inasmuch as the amount withheld was part of the purchase price and was eventually to be paid in cash or applied on obligations of the taxpayer, it did, under an accrual system of accounting, represent a fixed right to receive the income and, as such, constituted income for the year in which the transaction took place.

In General Electric Gas Corp. v. Commissioner, 8 AFTR 2d [illegible]; 293 F. 2d 35 (August 11, 1961)(5th Circuit), the gas corporation sold appliances and discounted the paper. A specified amount was included in the note which was designated finance charges, all of which was to be paid to the taxpayer, General Gas. The court, in following Hansen, supra stated that the status of the finance charges was undistinguishable from the principal sum due and, consequently, under an accrual system of accounting, was subject to tax in the year in which posted to the dealer reserve account.

In E.L.R. Shapiro and Ruben Shapiro v. Commissioner, 8 AFTR 2d [illegible] (1961) 295 F. 2d 306 (9th Circuit), taxpayer dealers engaged in the sale of used automobiles at the time of sale of the note to the Pacific Finance Company was assigned a percentage of the "time-price-differential" or service charge. The percentage was kept in a reserve account, which, as it reached certain percentage levels, was paid to the taxpayer. It was also used to discharge his obligations to the finance company. This case includes the two items stressed by the taxpayer in the current case,

(1) Prepayment by the purchaser could reduce the amount which had been credited, and

(2) In case of default by purchaser, the dealer's reserve was proportionately debited.

The court decided, in favor of the Commissioner, that under an accrual system the amounts credited to the reserve account, though not subject to immediate demand, were part of the amount due under the contract of purchase, and consequently, were accrued income subject to tax.

However, in *Gunderson Bros. Engineering Corp. v. Commissioner*, 42 T.C. 419 (1964) and *Luhring Motor Co. v. Commissioner*, 42 T.C. 732 (1964) the vendor-taxpayers in each case had ceased to discount their paper with a bank or finance company and had set up their own financing. In setting up their procedures, they only accrued the interest for finance charges ratably over the life of the contract on the ground that the interest or finance charges accrued only by the passage of time and that the right to the income did not become fixed until the service of providing the financing and collection procedures, which were the basis for the finance charges, had been provided and on the further ground that if the contract was terminated by early payment, or otherwise, the finance charges were abated.

In Rev. Rul. 67-316, I.R.B. 1967-39,7 [1954 Code Sec. 451] modifying Rev. Rul. 64-126, C.B. 1964-1 (Part 1), 1781, the Commissioner of Internal Revenue has acquiesced in the decisions of the Tax Court of the United States in the cases of *Gunderson Bros. Engineering* and *Luhring Motor Co., Inc.*, *supra*, holding that finance or carrying charges included in an installment contract of sale may be accrued ratably over the period of the contract when the purchaser's right to an abatement of finance charges is provided (1) as a requirement of state law, (2) if written into the terms of the contract, or (3) if allowed as a matter of trade or business custom in the geographical area concerned.

Such acquiescence, however, is limited to the same or similar state of facts and in both cases, the taxpayers handled the financing themselves and not through a financial institution, thus, taking them out of the long-standing rule of the *Hansen* case (*supra*).

Since the present case is, in all respects, similar to *Hansen*, I recommend that the decision of the Commission denying the petition for redetermination be substantially in the form submitted herewith.

/s/ V. P. MOLINEAUX
HEARING OFFICER

VPM:lo
Enc.
February 16, 1968

3-7-68

STATE OF NEW YORK

STATE TAX COMMISSION

IN THE MATTER OF THE PETITION

OF

WILLIAM E. AND MARILYN R. [illegible]

FOR A REDETERMINATION OF A DEFICIENCY OF PERSONAL INCOME TAX AND UNINCORPORATED BUSINESS TAX UNDER ARTICLES 22 AND 23 OF THE TAX LAW FOR THE YEARS 1962, 1963 AND 1964

The taxpayers, William E. and Marilyn R. [illegible], having filed a petition for redetermination of a deficiency of personal income tax and unincorporated business tax under Articles 22 and 23 of the Tax Law for the years 1962, 1963 and 1964, and a hearing having been held at the office of the State Tax Commission in Syracuse, New York on the 9th day of August, 1967 before Vincent P. Molineaux, Hearing Officer of the Department of Taxation and Finance, and the record having been duly examined and considered,

The State Tax Commission hereby finds:

(1) That the taxpayers filed New York State resident returns of personal income tax and unincorporated business tax for the years 1962, 1963 and 1964 on which the amount shown to be due was paid.

(2) That based upon a field audit, the Income Tax Bureau on March 8, 1965 issued IT-38 FA on the ground that the dealer reserve posted to an account in taxpayer's name at Union Bank and Trust Co. of Bethlehem, Pennsylvania is income accrued to the taxpayer and is includible for personal income tax and unincorporated business tax for the years in which the chattel paper is executed.

(3) During the years at issue, taxpayer was in the business of selling mobile homes in Syracuse, New York and he reports for income tax purposes on an accrual basis. Taxpayer's procedure on the sale of a mobile home is for the purchaser to make a down payment in cash and execute a retail installment contract for the balance of the cost plus insurance charges and a finance charge representing interest at 6 per cent per annum on the balance.

(4) The retail installment contracts were then assigned to Union Bank and Trust Co. of Bethlehem, Pennsylvania. The taxpayer would receive in cash the balance of the purchase price of the mobile home and the bank would post to a dealer reserve account in the name of the taxpayer a percentage of the interest charged to the purchaser. The amount in the dealer reserve account would not be immediately available to the taxpayer but, on his application at 6 month intervals, any amount in excess of 5 per cent of his outstanding paper would be paid by check or credited to his regular account.

(5) Early payment by the purchaser of a trailer of the note and chattel mortgage, which had been sold to the bank, would result in an abatement of the balance of the interest and the reserve account would be charged accordingly.

(6) In the event that a purchaser failed to fulfill his commitment, the chattel paper would be bought back by the taxpayer dealer and the reserve account would be ratably reduced by a percentage of the interest which would now not be collected.

Based upon the foregoing findings, the State Tax Commission hereby

DECIDES:

(A) That under an accrual system of accounting, the service charge posted to the dealer reserve account at the time of the execution of the chattel paper represents a fixed right to receive the income, and as such, constituted income for the year in which the transaction took place.

(B) That the notice of deficiency determining personal income tax and unincorporated business tax to be due for the years 1962, 1963 and 1964 is correct.

(C) That the taxpayer's petition for redetermination of deficiency for the years 1962, 1963 and 1964 is denied.

DATED: Albany, New York on this 25th day of March , 1968.

STATE TAX COMMISSION

/s/ JOSEPH H. MURPHY
PRESIDENT

/s/ A. BRUCE MANLEY
COMMISSIONER

/s/ SAMUEL E. LEPLER
COMMISSIONER