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INCOME TAX TREATMENT OF CERTAIN DEALERS' RESERVES

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Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 8684]

The Committee on Finance, to whom was referred the bill (H.R. 8684) to amend the Internal Revenue Code of 1954 to provide for deferral of taxation of amounts withheld by a bank or finance company from a dealer in personal property to secure obligations of the dealer, until such time as such amounts are paid to or made available to the dealer, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

This bill deals with the time of reporting dealer reserves. On July 22, 1959, the Supreme Court in *Commissioner* v. *Hansen*, *Commissioner* v. *Glover* and *Baird* v. *Commissioner*, decided that this dealer reserve income is to be reported at the time it is properly accruable, or in general at the time of the sale of the installment paper where this immediately follows the sale of the property. However, many dealers following any of numerous circuit court decisions to the contrary, have not reported this income until the reserves were withdrawn by the dealers from the finance companies.

In view of this your committee's bill provides two alternative methods for paying the tax due on the income which has not previously been reported. First, it provides that such amounts can be treated as required changes in methods of accounting. This means that the reserves built up prior to 1954 (if such years are closed), need not be reported for tax purposes, and that only the excess of the current balance over the 1954 balance in the reserve is to be reported. A second alternative provided permits the computation of the deficiencies (or overassessments) which would arise if the income had been reported in the proper years, and then the sum of these amounts

(plus interest up to the time of selecting this alternative) may be paid in five annual installments, generally beginning in 1961.

This bill, as amended, is reported unanimously by your committee.

II. GENERAL STATEMENT

The usual dealers' reserves arise from the sale of customers' installment paper to finance companies. (Another type of arrangement is provided for by your committee's amendments. See item (5) in the explanation of the amendments.) The way in which these reserves arise can be illustrated by an example of an automobile dealer, a business where dealer reserves have been used quite widely. Initially the dealer sells a car to a customer, accepting his note together with a cash downpayment and trade-in as the selling price of the car. The customer then executes a note, usually on forms supplied by a finance company, and the dealer then sells the installment paper to the finance company in return for a partial payment to him by the finance company of the face amount of the paper. The finance company, however, reserves, or holds back, a portion of the balance due the dealer and in addition may set aside a portion of the finance charge on the paper otherwise due the dealer. Losses incurred by the finance company may be charged against these dealers' reserves, either the portion sometimes referred to as the "holdback" or the amount attributable to a division of the finance charge between the finance company and the dealer. In addition, if a customer pays off his note ahead of time there also may be a charge against these reserves, in this case usually against the finance charge portion.

In transactions of this general type the question is whether this reserve is income to the dealer in the year of the sale of the article and the sale of the installment paper to the finance company or, on the other hand, is income to the dealer only when he actually receives the reserved amount in cash from the finance company.

The Supreme Court on June 22 of this year in *Commissioner* v. *Hansen*, *Commissioner* v. *Glover*, and *Baird* v. *Commissioner*, held in these cases that the specific reserves involved were properly reportable as income when "the dealers acquired a fixed right to receive the amounts so retained by the finance companies."

Your committee agrees that dealer reserve income should be reported on a proper accrual accounting basis. Nevertheless, it believes that a hardship would be created by requiring all dealers to make a transition to this method of reporting this income in 1 year. It believes that in view of the fact that the Courts of Appeals in the Third Circuit,[1] the Fourth Circuit,[2] the Fifth Circuit,[3] the Eighth Circuit,[4] and the Ninth Circuit [5] have held that the reserves were not accruable as income until the year of withdrawal of the reserve, taxpayers had sufficient reasons for not reporting this income in the earlier year. This appears to be true even though in the sixth [6] and seventh [7] circuits and in numerous Tax Court cases the holdings were to the contrary. In view of the large number of circuit court decisions in favor of the taxpayers and the fact that from 1944 to 1958

[1] *Keasbey & Mattison Co.* v. *United States*, 141 F. 2d 163 (1944).
[2] *Johnson* v. *Commissioner*, 233 F. 2d 952 (1956).
[3] *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (1958).
[4] *Glover* v. *Commissioner*, 253 F. 2d 735 (1958).
[5] *Hansen* v. *Commissioner*, 258 F. 2d 585 (1958).
[6] *Schaeffer* v. *Commissioner*, 258 F. 2d 861 (1958).
[7] *Baird* v. *Commissioner*, 256 F. 2d 918 (1958).

without exception the circuit court holdings were in favor of the taxpayers, your committee believes it would be unfortunate to require the dealers involved to make substantial payments of tax for these back years all in the current year. This is believed to represent a particularly difficult hardship in the case of the many small dealers in personal property who have held what for them represent substantial sums tied up in these reserves. Information submitted to your committee also suggests the same is true of dealers and developers of low-cost homes.

In view of the hardship in these cases your committee's bill provides two alternative forms of treatment.

In general terms, the first alternative permits taxpayers to treat the correction of the method of reporting this reserve income as a required change in method of accounting, usually for the year 1959, which is the year of the Supreme Court decision (although in earlier years if the taxpayers were on notice of deficiency on this issue and in similar cases). The effect of treating this reserve income as a required change in method of accounting is to ignore adjustments to income to the extent of dealer reserves set up in years prior to 1954 (if they are closed years). Your committee believes that it is proper to treat this correction of dealer reserve income as a required change in method of accounting since from a practical standpoint the Court decision has this effect, whether the taxpayer proceeds to comply with the decision on his own part or the change is made only after an examination of his return by a revenue agent.

For taxpayers who elect this alternative to treat the correction of the reporting of dealer reserve income as a change in method of accounting, the additional income to be reported will be the difference between the opening dealer reserve balance in the year of change (usually 1959) and the opening dealer reserve balance in 1954 (or earlier year if still open). Then if this difference increases taxable income by more than $3,000 in the current year, the tax attributable to it can be determined by spreading the income evenly over the year of change and 2 preceding taxable years, where this results in a lower tax than the inclusion of the entire amount in the income of the year of change. This is the treatment now provided under section 481 in the case of a required change in method of accounting. Also, as provided under section 481, the effect of the adjustment can be determined by recomputing the income under the correct method for as many prior years as the taxpayer can establish his taxable income.

As an alternative to the application of section 481, the taxpayer can elect to redetermine his taxes, properly reporting this dealer reserve income, on a year-by-year basis with respect to all years open on June 21, 1959. In these computations this reserve income would be includible in his taxable income in the proper year under the Supreme Court decision. The tax computed on this basis (first taking into account the effect of any net operating loss carrybacks or carryforwards) and then the interest on any resulting deficiency (or overpayment) is determined for the period from that year up to the time the taxpayer makes his election to apply this alternative rule. The resulting deficiency (and/or overpayment) for each year, plus interest, if in aggregate they equal $2,500 or more will be payable in up to five annual installments beginning with the due date for the payment of tax for the taxable year in which this election is made.

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The election to apply either the required section 481 treatment or the election to determine the deficiencies on a year-by-year basis and then pay any net amount of increase in tax in up to five annual installments (where it amounts to more than $2,500) must be made before July 1, 1960.

The effect of these two elections with respect to a taxpayer can be illustrated by the assumed set of facts shown in the tabulation below:

	1954	1955	1956	1957	1958	1959
Opening balance in a dealer's reserve	$14	$18	$23	$20	$25	$22
Additions made to reserve each year	9	9	5	8	4	----------
Withdrawal from reserve each year	(5)	(4)	(8)	(3)	(7)	----------
Increase or decrease in income	+4	+5	−3	+5	−3	----------

Assuming a taxpayer elects the involuntary section 481 treatment given the assumptions made above, he would determine the adjustment to be made to his taxable income by subtracting the opening 1954 balance in his reserve of $14 (if he has no prior open year) from the $22 shown as the opening reserve balance for 1959 (if he has not been on notice for an earlier year). This would result in an increase in income of $8 to be taken into account in 1959. If this were $8,000 instead of $8, the tax attributable to it could be determined by spreading this income ratably over 1959 and the 2 prior years, computing the tax in this manner and then adding this tax to the tax otherwise due in 1959. Alternatively, the taxpayer could redetermine his income on a year-by-year basis for the entire period, if he so desired and his records permit it.

If the taxpayer decides to follow the second alternative he must recompute his tax in each of the prior years which was open on June 21, 1959, determining what his tax should have been in each of these years as distinct from the manner in which he reported it because of his erroneous method for reporting dealer reserve income. The second row of figures in the tabulation, namely, the addition made to reserves in each of these years, indicates the income which should have been taken into account in each year. The third row of figures, or the withdrawals from reserves for each year, on the other hand, indicate the amounts which actually were taken into account with respect to dealers' reserves in each of these years. Therefore, the net increase or decrease which should be made in income, shown by the fourth row of figures, is the difference between the two prior rows. After computing this increase or decrease in income for each of these prior open years, the tax would then be redetermined by including (or deducting) these amounts. Next the interest would be computed with respect to any of these resulting deficiencies (or overpayments) from the due date of the deficiency (or overpayment) up to the date of the election occurring prior to July 1, 1960. The sum of these amounts of tax and interest represent the amount of the payment which must be made if this second alternative rule is provided. This amount can be paid either in one payment on the due date in 1961 for the filing of the 1960 return or if over $2,500 may be paid in up to five equal annual installments again beginning in 1961 with the due date of the 1960 return. The bill in general provides under this second alternative that no interest is to be paid with respect to the deferred amount beyond the date of the election to apply this second alternative.

Special rules explained in the technical section of this report provide for cases where the taxpayer under the second of these two alternatives does not pay the installment when due, and also for cases where the taxpayer ceases to engage in a trade or business. Special rules also provide for the case of an individual who dies, or a partner whose entire interest in a partnership is transferred or liquidated. Generally in these cases, the unpaid installments become due at the time of the death, cessation of business, etc.

Dealer reserve income is in general defined as the consideration derived from the sale of a customer's installment paper, etc., which is attributable to the sale of either real or tangible personal property and representing amounts held in a reserve account by the finance company to provide security for final payment on the installment paper, etc.

This bill is reported unanimously by your committee.

III. EXPLANATION OF THE COMMITTEE AMENDMENTS

Your committee has made the following substantive amendments of the House bill:

(1) As passed by the House, section 2 made the relief afforded by the bill applicable to persons who "computed" taxable income under an accrual method of accounting. Your committee's amendment insures that a taxpayer will be eligible for the relief provided if, for the taxable year in question, he was required to compute his taxable income under an accrual method, even though he may have computed his taxable income under some other method in the first instance.

(2) As passed by the House, the provisions of the bill applied to taxable years which were open at the time the taxpayer made one of the elections provided by the bill. Your committee's amendments (in secs. 3(b), 4(a), and 5(3)) make the provisions of the bill applicable to taxable years which were open for assessment or refund on June 21, 1959, the day before the pertinent decisions of the Supreme Court, whether or not they were closed at the time of the election, and extend the period for assessment or refund appropriately. This change would permit a taxpayer to elect the relief afforded by section 3 or section 4 with respect to taxable years which, otherwise, would have been closed before there was an opportunity to make the election.

(3) Your committee has amended section 4(b) so as to change the maximum period for paying deficiencies and interest in installments (if the taxpayer makes the elections under sec. 4) from 10 years, as provided by the House, to 5 years.

(4) As passed by the House, subsection (f) of section 4 provided that the privilege of paying deficiencies in installments shall be terminated, and the unpaid installments become payable on notice and demand, if the individual, the partnership of which he is a member, or the corporation, as the case may be, ceases to engage in the business in which the dealer reserve income arose. Your committee's amendments of section 4(f) provide that the privilege of installment payment shall not terminate unless the individual or corporation, as the case may be, ceases to engage in any business, or unless the partnership of which the taxpayer is a member terminates.

(5) Your committee has amended the definitions and rules of section 5 to provide that the provisions of the bill will apply not only

where the dealer obtains evidences of indebtedness from the purchaser and disposes of those obligations to a finance company, but also where the purchaser obtains a part of the purchase price directly from the finance company and (by a separate arrangement) a part of the selling price or a part of the finance charges, or both, is retained by the finance company in a reserve account to be ultimately paid to the dealer.

IV. TECHNICAL EXPLANATION OF THE BILL

Section 1. Short title

Section 1 of the bill, as amended by your committee, provides a short title for the bill: "Dealer Reserve Income Adjustment Act of 1960."

Section 2. Persons to whom this act applies

Section 2 of the bill, as amended by your committee, describes the persons to whom it applies, namely, any person who, for his most recent taxable year ending on or before June 22, 1959, (1) computed, or was required to compute, his taxable income under an accrual method of accounting; (2) treated any dealer reserve income, which should have been taken into account in such taxable year, as being accruable for a subsequent taxable year; and (3) makes an election under either section 3(a) or 4(a) of the bill before July 1, 1960.

Your committee's amendment to section 2 makes it clear that the bill covers not only those persons who, in filing their returns, computed income under an accrual method of accounting but also those who have been required to compute income on the accrual method by the Internal Revenue Service.

Section 3. Election to have section 481 apply

Section 3(a) of the bill provides that if, for the year of the change, the treatment of dealer reserve income is changed (whether or not the change is initiated by the taxpayer) and the person described in section 2 makes the election provided for in section 3(a) and does not make the election under section 4(a), then, for purposes of applying section 481 of the Internal Revenue Code of 1954, the change shall be treated as not being initiated by the taxpayer.

Section 481 of the Internal Revenue Code of 1954 requires that if there is a change in the taxpayer's method of accounting, then, generally, all adjustments necessary as a result of the change to prevent omissions or duplication of income or deductions are required to be taken into account for the taxable year of the change. Under section 481(a), however, if the change was not initiated by the taxpayer, then any adjustments attributable to taxable years to which the 1954 Code does not apply are disregarded. Section 481(b) (1) and (2) of the code provides limitations on the tax for the year of the change if the net amount of the adjustments attributable to 1954 Code years which must be taken into account for the year of the change increases taxable income for that year by more than $3,000. The necessary adjustments required by section 481 are to be taken into account for the taxable year of the change.

Subsection (b) of section 3 describes the year of the change in the case of a person exercising the election provided for in section 3(a). Under the House bill that year is the first taxable year ending after

June 22, 1959 (irrespective of whether the taxpayer changed to the proper method in such year), or the earliest prior taxable year in respect of which assessment of any deficiency or refund or credit of any overpayment is not prevented by any law or rule of law if, for such prior taxable year, the taxpayer either (1) filed a claim for refund or credit with respect to the treatment of dealer reserve income, or (2) was notified in writing, either by statutory notice of deficiency, or otherwise, of a proposed deficiency attributable to the erroneous treatment of such income. In applying subsection (b) the House bill did not specify which date was to be used in determining whether assessment of a deficiency or refund or credit was prevented. Your committee has changed paragraph (2) to specify that in making the determination the question turns on whether or not assessment of any deficiency or refund or credit of any overpayment was prevented on June 21, 1959, the date immediately preceding the date of the Supreme Court's decision dealing with dealer reserve income. For this purpose, the notice in writing includes a 15- or 30-day letter issued under established procedure, or other similar written notification of a proposed deficiency.

Thus, if for the calendar year ending December 31, 1959, the taxpayer changed to the proper method of accounting for dealer reserve income, but for the taxable year 1956 a statutory notice of deficiency relating to the treatment of such income was issued and that year was the earliest taxable year in respect of which assessment of a deficiency was not prevented on June 21, 1959, then, if the election under subsection (a) is timely exercised, 1956 shall be treated as the year of change. In such a case, the net amount of any adjustments found necessary as a result of the change which is attributable to years subject to the 1954 Code shall be taken into account for the year of the change. The net amount of the adjustments attributable to pre-1954 years is to be disregarded. If, in that case, no notice of a proposed deficiency of any type had been issued, and if no claim for refund had been filed, then, for the purposes of applying section 481, the taxable year 1959 shall be treated as the year of the change, and any net increase in the amount of the reserve credited to his account at the beginning of that year over the opening balance of the reserve credited to his account at the beginning of the first taxable year subject to the 1954 Code shall be included in income for the year of the change.

Subsection (b) also provides that, for purposes of applying section 3(a) of the bill, section 481 of the 1954 Code shall be treated as also applying to the earliest year subject to the 1939 Code in respect of which assessment of any deficiency or refund or credit of any overpayment was not prevented on June 21, 1959, by the operation of any law or rule of law in the same manner it would have applied had it been enacted as part of the Internal Revenue Code of 1939. Thus, if a 30-day letter specifying adjustments relative to dealer reserve income was properly issued in respect of the taxable year 1951 and the resulting deficiency in tax may be asserted for that year, then, if the taxpayer timely exercises the election provided for in subsection (a), 1951 shall be considered to be the taxable year of the change and section 481 shall be applied to that year and be given effect for that year in the same manner as it would have applied had it been enacted as a part of the 1939 Code and the change to the proper method of

accounting had not been initiated by the taxpayer. Since, in such a case, the bill makes section 481 applicable only to 1951, any adjustments resulting from the change attributable to pre-1951 years shall be disregarded. The income of each taxable year succeeding the year of change in respect of which the assessment of any deficiency or refund or credit of any overpayment is not prevented, by the operation of any law or rule of law will, of course, be recomputed under the proper method of accounting.

Section 4. Election to have section 481 not apply; payments in installments

Subsection (a) of section 4 of the bill, as it passed the House, provides that if a person to whom the bill applies changes, or is required to change, his treatment of dealer reserve income to the proper method of accounting for such income, he may elect to treat such change as not a change in method of accounting in respect of which section 481 of the 1954 Code applies for purposes of chapter 1 of the code (and the corresponding provisions of prior law).

Your committee has made a change in this subsection corresponding to the change made in section 3(b)(2). As changed, the election shall apply to all taxable years ending on or before June 22, 1959, for which the assessment of any deficiency, or for which refund or credit of any overpayment, whichever is applicable, was not prevented on June 21, 1959, by the operation of any law or rule of law.

If an election is exercised under section 4(a), taxable income (or net income in the case of a taxable year to which the 1939 Code applies) shall be redetermined under the proper method of accounting for dealer reserve income for each taxable year to which the election applies, without regard to section 481. For purposes of the redetermination, net operating losses affecting the computation of tax for any prior taxable year not otherwise redetermined under this subsection shall be taken into account.

Paragraph (1) of section 4(b) of the bill provides that if an election is made under section 4(a) not to have section 481 of the Internal Revenue Code of 1954 apply and the net increase in tax resulting solely from the election exceeds $2,500, a further election may be made to pay such net increase in tax in installments. The House bill provides that the election may be made to pay any portion of the net increase, which is unpaid at the time the election is made, in 2 or more, but not exceeding 10, equal annual installments. Your committee's bill reduces the number of annual installments provided by the House bill over which the net increase may be paid from 10 to 5. Concerning such installment payments, if the person making the election under section 4(a) is a partnership, the $2,500 limitation is applied separately to each partner with respect to his individual liability.

Paragraph (2) of subsection (b) of section 4 of the bill defines the term "net increase in tax" as the amount, if any, by which the sum of the increases in tax (including interest) for all taxable years to which the election applies resulting from the election exceeds the sum of the decreases in tax (including interest) for all such taxable years resulting from the election. In determining the net increase in tax under this section, the tax for each taxable year affected by the election under section 4(a) is redetermined taking into account the adjustments necessary to reflect the change to the proper treatment of dealer reserve income. If the result is an increase in tax for any taxable year,

interest under section 6601 of the Internal Revenue Code of 1954 is computed from the last date prescribed for payment of the tax to the date the election is made and is added to the increase to determine the increase in tax under this paragraph. If the result is a decrease in tax for any taxable year, interest under section 6611 of the Internal Revenue Code of 1954 is computed from the date of the overpayment to the date the election is made, and the amount of such interest is added to the overpayment to determine the decrease in tax under this paragraph. The increases in tax under this section are added together and from this total there is subtracted the decreases in tax to arrive at the net increase in tax (if any). If any of the taxable years to which the election applies are years to which the Internal Revenue Code of 1954 is not applicable, interest on the increase or decrease, as the case may be, is computed under the applicable interest provisions of prior revenue law.

Subsection (c) of section 4 of the bill provides that if an election is made under subsection (b) of that section to pay the net increase in tax in installments, the first installment shall be paid on or before the date prescribed under section 6151 of the Internal Revenue Code of 1954 for payment of the taxpayer's income tax for the taxable year in which the election was made. Each succeeding installment shall be paid annually on or before the date which corresponds with the date prescribed for payment of the first installment, determined without regard to any extension of time for payment of the first installment.

Section 4(d) provides that if a taxpayer has elected the installment privilege provided by section 4(b) and thereafter it becomes necessary to redetermine the taxpayer's tax for any year covered by the election provided by section 4(a), the net increase in tax shall be redetermined. The net increase in tax is the amount computed under section 4(b)(2) based on the effect on the taxpayer's tax of changes in the treatment of his dealer reserve income. If an increase in the net increase in tax results from the redetermination, such increase shall be prorated over all the installments. The part of the increase prorated to installments which are not yet due shall be collected at the same time as, and as a part of, such installments. The part of the increase prorated to installments, the time for payment of which has arrived, shall be paid upon notice and demand from the Secretary of the Treasury or his delegate. Except for the interest which was computed to the date of election under section 4(b) as part of the redetermination of the net increase, no further interest will be imposed on the amount prorated to past installments unless payment is not made within 10 days after the date of the notice and demand. Unless an extension of time for payment has been granted, failure to make payment within 10 days after the date of notice and demand of the part of the increase prorated to installments the date for payment of which has arrived will (under sec. 4(g)) cause all of the unpaid installments to become due upon notice and demand. If a decrease in the net increase in tax results from the redetermination, such decrease shall, in accordance with the provisions of section 6403 of the Internal Revenue Code of 1954 (relating to overpayment of installment) be credited against the installments which are not yet due, resulting in a pro rata decrease in each of such installments.

Under paragraph (1) of subsection (e) of section 4 of the bill, if the taxpayer exercises the election under subsection (a) not to have section 481 of the 1954 Code apply, the imposition of interest on any underpayment of tax, and the payment of interest on any overpayment, attributable to the election are suspended for a specified period of time. The period of suspension begins on the date of the election and ends on the date prescribed for filing the return (determined without regard to extensions of time) for the taxable year in which the election is made. This rule is applicable irrespective of whether the election under subsection (b) of section 4 is made.

If the taxpayer exercises the election under subsection (b) of section 4, then, under paragraph (2) of section 4(e), no interest will be imposed for the period on or after the date fixed under section 4(c) for payment of the first installment unless payment of the unpaid installments is accelerated under subsection (f) or (g) of section 4.

Paragraph (3) of section 4(e) provides that if payment of unpaid installments is accelerated under subsection (f) of section 4, interest provided for under section 6601 of the 1954 Code shall be payable (if the unpaid installments are not paid within 10 days from the date of the notice and demand) from the date of the notice and demand provided for in subsection (f) of section 4 of the bill to the date of payment. If payment is accelerated under subsection (g) of section 4, interest determined in accordance with section 6601 of the 1954 Code shall be payable from the date fixed under subsection (c) of section 4 for paying the unpaid installment to the date of payment.

Subsection (f) of section 4 of the House bill provides for the acceleration of the payment of installments described in section 4(b) under certain conditions. It provides that the installment privilege shall be terminated, and any unpaid portion of the installments shall be paid upon notice and demand from the Secretary of the Treasury or his delegate if, (1) in the case of an individual, he dies or ceases to engage in the trade or business in respect of which the election under section 4(b) applies; (2) in the case of a partner, his entire interest in the partnership is transferred or liquidated or the partnership ceases to engage in the trade or business in respect of which the election under section 4(b) applies; or (3) in the case of a corporation, it ceases to engage in the trade or business in respect of which the election under section 4(b) applies, unless the unpaid portion of the tax payable in installments is required to be taken into account by an acquiring corporation under section 5(d).

Your committee's bill alters the termination provisions of subsection (f) of the House bill by providing for termination of the installment privilege if, (1) in the case of an individual, he dies or ceases to engage in a trade or business; (2) in the case of a partner, if his entire interest in the partnership is transferred or liquidated or the partnership terminates; or (3) in the case of a corporation, it ceases to engage in a trade or business unless the unpaid portion of the tax payable in installments is required to be taken into account by an acquiring corporation under section 5(d). This change liberalizes the installment privilege by permitting its continuation even though the taxpayer terminates the trade or business in respect of which the election under section 4(b) applies so long as the taxpayer is in a trade or business or so long as he retains an interest in the partnership, whichever is applicable. As changed, this provision is substantially the same as section 481(b)(4)(C) of the 1954 Code.

Subsection (g) of section 4 of the bill provides, in accordance with the normal rule in the case of taxes permitted to be paid in installments, that if any installment is not paid when due (taking into account any extension of time for payment) the whole of the unpaid portion of the installments under the provisions of section 4(b) becomes due and shall be payable upon notice and demand from the Secretary of the Treasury or his delegate.

Subsection (h) of section 4 of the bill provides that the running of the periods of limitation provided by section 6502 of the Internal Revenue Code of 1954 (or corresponding provision of prior law) for the collection of any amount of tax payable in installments under section 4(b) shall be suspended for the period of any extension of time for payment permitted under section 4 of the bill.

Section 5. Definitions; special rules

Under subsection (a) of section 5 of the bill as it passed the House, dealer reserve income is defined to mean that part of the consideration derived by the person to whom the bill applies (i.e., the dealer) from the sale or other disposition of customers' sales contracts, notes, and other evidences of indebtedness (or derived from customers' finance charges connected with such sale or other disposition). The term includes only that part of the consideration which is attributable to sales of real property or tangible personal property to customers by such dealer in the ordinary course of his trade or business and which is held in a reserve account by the financial institution to which such dealer disposed of such evidences of indebtedness, for the purpose of securing obligations of such dealer, obligations under such evidences of indebtedness, or both.

The definition of "dealer reserve income" contained in subsection (a) of section 5, as it passed the House, relates to transactions in which the dealer initially accepts the customers' obligations as a part of the purchase price of the property sold and then disposes of the obligations to a financial institution. Your committee has retained the language of the definition as it passed the House (except for a minor change in the language describing the purpose of the reserve account), but has extended the definition so as to include transactions in which the customer deals directly with a financial institution in obtaining financing for his purchase.

Under paragraph (2) of subsection (a) of section 5, as amended by your committee, dealer reserve income also means that part of the consideration derived by a dealer from a sale, in the ordinary course of his trade or business, of real property or tangible personal property in cases where part or all of the purchase price of the property sold is provided by a financial institution to or for the customer (or derived by such dealer from finance charges connected with the financing of such sale), which is held in a reserve account by the financial institution for the purpose of securing obligations of such dealer or of such customer, or both.

Thus, the bill does not apply to the accounting for income derived from the sale or other disposition of evidences of indebtedness or other obligations described in section 5(a)(1) relating to the sale of intangible property such as stocks, bonds, copyrights, patents, etc. In addition, the bill has no application to the income derived from the sale or other disposition of customers' evidences of indebtedness or other obligations by a person not the vendor of the property to which the obliga-

tion relates, nor to the income from dealings in obligations attributable to casual sales of property not in the taxpayer's ordinary course of trade or business. Further, it is immaterial whether or not the person to whom the bill applies guarantees the customer's obligation in excess of the reserve retained by the financial institution.

Under subsection (b) of section 5 of the bill as it passed the House, the term "financial institution" is defined to mean any person regularly engaged in the business of acquiring evidences of indebtedness of the kind described in section 5(a). Your committee has amended this definition to include persons regularly engaged in the business of financing sales of the kind described in paragraph (2) of section 5(a), as amended by your committee. It thus includes banking corporations, finance companies, building and loan associations, and other similar type organizations, as well as an individual or partnership regularly engaged in the prescribed businesses.

Under subsection (c) of section 5, unless inconsistent with the purpose and intent of this bill, the terms used in this bill shall be interpreted as having the same meaning as when used in the Internal Revenue Code of 1954, and all provisions of law shall apply with respect to this bill as if the bill were a part of such code.

Subsection (d) of section 5 provides an exception to the requirement in section 4(f) that the installment privilege terminates if the taxpayer is a corporation which ceases to engage in a trade or business. In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a) of the Internal Revenue Code of 1954, the acquiring corporation shall, for purposes of this bill, be treated as if it were the distributor or transferor corporation.

Subsection (e) of section 5, as amended by your committee, for which there is no corresponding provision in the House bill, provides that, for purposes of applying sections 3 and 4 of the bill, if assessment of any deficiency or credit or refund of any overpayment for any taxable year was not prevented on June 21, 1959, by the operation of any law or rule of law (other than the provisions of ch. 74 of the Internal Revenue Code of 1954, relating to compromises or closing agreements, or the corresponding provisions of prior laws) the period within which such assessment or credit or refund may be made shall not expire prior to July 1, 1961. This subsection will permit, notwithstanding any law or rule of law other than the provisions of chapter 74 of the code (relating to compromises or closing agreements), the assessment of any deficiency, or credit or refund of any overpayment, in respect of any taxable year to which section 3 or 4 is otherwise applicable, if such assessment, credit, or refund was not prevented with respect to such year on June 21, 1959. For example, if credit or refund for a specified year was not prevented by the statute of limitations, or a judicial decision that had become final, on June 21, 1959, but would (except for this subsection) be prevented on a later date, such as September 1, 1959, then for purposes of applying section 3 or 4 credit or refund may, nevertheless, be made with respect to such year if the taxpayer exercises his election prior to July 1, 1960, and files claim for credit or refund prior to July 1, 1961. This subsection does not suspend the period of limitation with respect to any taxable year closed by operation of a compromise or closing agreement nor reopen any taxable year in respect of which the statute of limitations had expired before June 21, 1959. The provision does not shorten the period of limitation otherwise applicable.

Subsection (f) of section 5, which is identical with subsection (e) of the House bill, provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this bill. Such regulations will include the manner in which the elections provided by this bill are to be made and the application of the provisions of this bill in the case of partnerships. Such regulations may prescribe, for example, that if the person exercising the election under section 4(a) is a partnership the election under section 4(b) to pay the net increase in tax in installments may be made by each partner individually.

V. STATEMENTS OF TREASURY DEPARTMENT

Your committee has received the following statements of the views of the Treasury Department on H.R. 8684, as referred to your committee, and on the amendments adopted by your committee:

OFFICE OF THE SECRETARY OF THE TREASURY,
Washington, January 12, 1960.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to a request for the views of this Department on H.R. 8684, passed by the House of Representatives September 9, 1959, to provide transitional provisions for the income tax treatment of dealer reserve income.

1. Position of the Treasury Department

The Treasury Department does not object to the enactment of H.R. 8684, except for the provision which allows a taxpayer, under certain conditions, to spread the payment of an increase or deficiency in tax over a 10-year period. Because of the administrative problems created by this provision, and because its intended purpose can largely be accomplished within a shorter period, we recommend that the installment period provided for in section 4(b)(1) be changed from a maximum of 10 years to 5 years.

The Bureau of the Budget has advised that there is no objection to the presentation of this report.

2. Explanation of the bill

H.R. 8684 is designed to relieve certain dealers in real and tangible personal property from a heavy transitional tax burden which would result under the Supreme Court decisions in the cases of *Commissioner* v. *Hansen*, *Commissioner* v. *Glover*, and *Baird* v. *Commissioner* (360 U.S. 446, June 22, 1959). In these cases the Supreme Court decided that dealer reserve income (explained below) is to be reported at the time it is properly accruable, or in general at the time of the sale of installment paper where this immediately follows the sale of the property. However, many dealers, following several circuit court decisions to the contrary, had not reported their income until the reserves were withdrawn by the dealers from the finance companies.

The bill provides two alternative methods for paying the tax due on the income which had not previously been reported. First, it provides that such amounts can be treated as arising from required changes in methods of accounting subject to the transitional rules contained in section 481 of the 1954 Code. In general, this means

that the reserves built up prior to 1954 need not be reported for tax purposes, and that only the excess of the current balance over the balance in the reserve at the beginning of the year 1954 is to be reported. An alternative permits the computation of the deficiencies (or overassessments) which would arise if the income had been reported in the proper years, and then the sum of these amounts (plus interest up to the time of selecting this alternative) may be paid in 10 annual installments, generally beginning in 1961.

Other provisions of the bill provide for cases where the taxpayer under the second of these alternatives does not pay the installment when due, and also for cases where the taxpayer ceases to engage in the trade or business with respect to which the election arose. Special rules also provide for the case of an individual who dies, or a partner whose entire interest in a partnership is transferred or liquidated. Generally, in these cases, the unpaid installments become due at the time of death, cessation of business, etc.

3. Comments on the bill

The usual dealers' reserve arises from the sale of customers' installment paper to finance companies. The way in which these reserves arise can be illustrated by an example of an automobile dealer, a business where dealer reserves have been used quite widely. Initially the dealer sells a car to a customer, accepting his note together with a cash downpayment and trade-in as the selling price of the car. The customer executes a note, usually on forms supplied by a finance company, and the dealer then sells the installment paper to the finance company. The finance company, however, reserves, or holds back, a portion of the balance due the dealer and in addition may set aside a portion of the finance charge on the paper otherwise due the dealer. Losses incurred by the finance company may be charged against these dealers' reserves, either the portion sometimes referred to as the "holdback" or the amount attributable to a division of the finance charge between the finance company and the dealer. In addition, if a customer pays off his note ahead of time this also may be charged against these reserves, in this case usually against the finance charge portion.

In transactions of this general type the question is whether this reserve is income to the dealer in the year of the sale of the article and the sale of the installment paper to the finance company or, on the other hand, is income to the dealer only when he actually receives the reserved amount in cash from the finance company. Since 1931, the Commissioner has consistently taken the position that the dealer realizes income when he acquires a fixed right to receive the amounts retained by the finance company, rather than at the time cash is actually withdrawn from the dealer reserve account. The Tax Court, since 1940, has consistently upheld the contentions of the Commissioner but, from 1944 through 1958, the Third, Fourth, Fifth, Eighth, and Ninth Circuit Courts of Appeal took a contrary view. When, in 1958, the Sixth and Seventh Circuit Courts of Appeal held in favor of the Commissioner, the Supreme Court agreed to resolve the matter.

While this matter was awaiting Supreme Court review, several bills were introduced during the 1st session of the 86th Congress in the House of Representatives and one in the Senate which would have settled the issue, by statute, in favor of the taxpayers. However, on June 22, 1959, the Supreme Court sustained the position of the Commissioner in *Hansen*, *Glover*, and *Baird*. Thereafter, the House

Ways and Means Committee, agreeing that dealer reserve income should be reported on a proper accural accounting basis, unanimously reported this bill which, in effect, upholds the Supreme Court decision and also provides transitional relief for those taxpayers who had erroneously relied on the prior circuit-court cases.

While the Treasury Department does not object to the alternative forms of relief provided in the bill, the 10-year period given for paying the deficiencies computed under section 4 appears longer than is needed to provide reasonable relief from the transitional tax burden in the typical dealer reserve case. Such an extended period will increase substantially the problems of administering this relief measure, particularly in the enforcement area. Accordingly, we urge that the 10-year installment period be reduced to a 5-year period.

4. Technical comments

Dealers' reserve income is in general defined as the consideration derived from the sale of a customer's installment paper, etc., which is attributable to the sale of either real or tangible personal property and representing amounts held in a reserve account by the finance company to provide security for final payment on the installment paper, etc. It has recently come to our attention that, as a result of the present definition of "dealer reserve income" in section 5(a) certain dealers whom the bill was intended to relieve are not covered by the bill. Apparently many dealers in real property and tangible personal property have derived dealer reserve income from notes and mortgages given by their customers *directly* to the financial institution. In *Key Homes, Inc.* (30 T.C. 109 (1958)), the Tax Court held that the dealer reserve cases were controlling where a builder deposited with a savings and loan association a certain sum as additional security to protect the association's loan to the home purchaser. It appears that such a taxpayer, having relied upon the same circuit court decisions which were reversed by the Supreme Court in *Hansen* may be entitled to the same treatment as proposed under the bill where sales of customers' installment paper are involved. If your committee's decision is favorable to broadening the definition of "dealer reserve income" to include the *Key Homes* type of case, we would appreciate an opportunity to discuss corrective changes with you.

It has also come to our attention that section 4(f) of the bill, relating to conditions under which installment payments may be accelerated, may be unintentionally restrictive because of the phrase "the trade or business" appearing on lines 9 and 13 of page 8 of the bill. We do not feel that relief should be denied or payments of tax accelerated just because a taxpayer happens to change from one business to another. We believe the substitution of the phrase "a trade or business" in these instances would take care of this problem. This would also conform the bill to the language used in the acceleration provisions of section 481 of the Internal Revenue Code.

5. Revenue effect

Enactment of the bill will permit taxpayers in some cases to spread payment of their tax deficiencies over 10 years with a resulting substantial immediate loss of revenue. This loss would, of course, be recovered as the installments are paid over the 10-year period (or the 5-year period recommended by the Department). Had legislation to overrule the Supreme Court been enacted, deferring all dealer reserve

income until such time as it was withdrawn from the reserve accounts, it is estimated that the transitional loss (permanent deferment) of revenue would have amounted to over $100 million plus a $7 million annual loss resulting from increments in the reserve accounts.

Sincerely yours,

JAY W. GLASMANN,
Assistant to the Secretary.

TREASURY DEPARTMENT,
Washington, January 27, 1960.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, U.S. Senate, New Senate Office Building, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to your request for the views of the Department on several amendments adopted by your committee in its consideration of H.R. 8684, a bill to provide transitional provisions for the income tax treatment of dealer reserve income.

The first amendment would revise section 2 of the act, which describes the persons to whom the act applies, to include persons who were reporting their income on the cash basis and were required by the Commissioner to change to the accrual method. The second amendment would amend section 4(b) of the act by reducing from 10 years to 5 years the period over which the taxpayer may spread the payment of a net deficiceny arising from unreported dealer reserve income. The third amendment would liberalize section 4(f) of the act, which provides rules for terminating the installment-payment privilege, so that a taxpayer can continue to use the installment-payment privilege so long as he remains in some trade or business even though he is no longer in the trade or business to which the dealer reserve income relates. The fourth amendment would liberalize the definition of "dealer reserve income" in section 5 of the act so as to provide relief in cases where dealers in real property and tangible personal property derive dealer reserve income from notes and mortgages given by their customers directly to the financial institution. The fifth amendment would add a new subsection to section 5 of the act to apply the act retroactively to June 21, 1959, to cases which would otherwise have been closed by the running of the statute of limitations since that date.

The Department recommended the adoption of the second, third, and fourth of these amendments in its report to you on H.R. 8684 dated January 12, 1960. The Department also has no objection to the first of the five amendments.

The Department is opposed to the retroactive feature of the fifth amendment. We recognize that the purpose of this amendment is to provide relief as of the date the Supreme Court settled the treatment of dealer reserve income. However, as you know, it has been the consistent position of this Department that changes in the revenue laws should be given prospective application only.

The Bureau of the Budget has advised the Treasury Department that there is no objection to the presentation of this report.

Sincerely yours,

JAY W. GLASMANN,
Assistant to the Secretary.

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