

September 21, 2007

Philip Markwell, Partner
Frost Financial Services, Inc.
8650 Governor's Hill Drive
Suite 355
Cincinnati, OH 45249

Re: GAP Plus

Dear Mr. Markwell:

As discussed, we have looked at some of the factors that might be considered in determining how to characterize the "Plus" feature on a "GAP Plus" product as viewed from two perspectives: a lender's ability to offer GAP Plus without being subject to state insurance regulation, and the income tax treatment of the Plus feature.

You have described the GAP Plus product as having two benefits – the cancellation of part or all of an existing debt, and the cancellation of what might be called a future debt. Specifically, as part of an automobile loan agreement, if the automobile is totaled in an accident or is stolen, the lender would agree to cancel the difference between the loan balance remaining at the time of the loss and any insurance settlement (the actual cash value) on the vehicle. The automobile loan agreement also would provide that in addition to cancelling part or all of the debt, the lender would provide a \$1,000 credit (or \$1,000 in future debt forgiveness) toward a new loan for the purchase price of a new vehicle (the Plus feature of the GAP Plus product). That is, if the consumer agrees to take out a new loan from the same lender on another automobile, the lender would cancel \$1,000 of the new debt.

Characterization of the Plus Feature as a Debt Cancellation Contract

The Office of the Comptroller of the Currency has authorized national banks to offer debt cancellation contracts ("DCCs") without being subject to state regulation. In its regulations governing the product, the OCC defines a DCC as follows: "[a] loan term or contractual arrangement modifying loan terms under which a bank agrees to cancel all or part of a customer's obligation to repay an extension of credit upon the occurrence of a specified event."¹

The GAP feature of the GAP Plus product is clearly a form of a DCC: The lender agrees to cancel a defined portion of the remaining loan balance following a total loss of the vehicle or its theft.² Whether the Plus feature fits within the definition of a DCC is not as clear. It raises several issues.

¹ 12 C.F.R. §37.2(f).

² See, e.g., OCC Interpretive Ltr. No. 1028 (May 2005).

First, the definition of DCC cited above states that a lender's cancellation of all or part of a customer's obligation to repay an extension of credit is triggered by "the occurrence of a specified event." Based on our experience with the DCC industry, normally a specified event is something that happens in the life of the borrower over which the borrower has no control, such as death, disability or loss of income. (Other triggering events accepted within the industry include divorce and a call-up to active military duty.) In comparison, the triggering event for the Plus feature appears to be solely within the control of the borrower – his or her election to seek a second loan from the same lender on a replacement automobile – which raises the question of whether a triggering event actually occurs.

Second, in an arrangement regarding a DCC, the triggering event upon which a claim for relief is made occurs after the underlying loan agreement is consummated. In the case of the Plus feature, the "triggering event" – the consumer's decision to finance a second automobile with the same lender – occurs before the loan transaction is entered into. That raises the issue of whether the consumer's decision to take out a loan from the same lender involves "the occurrence of a specified event." The phrase "occurrence of a specified event" in the definition of a DCC seems to imply that a triggering event occurs after a loan transaction is completed, not before.

Third, one could argue that there is no "debt" being forgiven under the Plus feature, because the borrower is never legally obligated on that portion of the new loan that is subject to the \$1,000 relief. (In comparison, on a DCC, the borrower is legally obligated on a loan until a triggering event occurs.) Viewed in another way, one could argue that what is actually happening in the Plus transaction is that a lender is agreeing to pay a portion (\$1,000) of the purchase price of the replacement automobile, in exchange for the consumer's election to take out a second loan from the same lender. How should the Plus relief be characterized if it is not appropriate to characterize it as a cancellation of debt? Is it a discount in principal from the lender? A gift from the lender? Some type of "future credit?" The answer is not clear.

Finally, there is the issue of whether the Plus feature would draw the attention of state insurance regulators in the solvency of the product provider – one of the principal concerns behind state regulation of insurance. In First Nat'l Bank of Eastern Arkansas, v. Taylor,³ the seminal case involving DCCs, the court determined that the offering of DCCs by a national bank was not subject to state insurance regulation. Among the reasons for the court's holding was that DCCs "do not require the bank to take an investment risk or to make payment to the borrower's estate. The debt is simply extinguished when the borrower dies." That is, because a DCC involves the cancellation of debt and not the payoff of a debt, a lender's ability to satisfy a DCC claim is not affected by whether the lender is solvent when the claim is made. In the case of the Plus feature, if the lender becomes insolvent, it likely will be unable to deliver on the promised \$1,000 benefit because it would be unable to extend the credit upon which the benefit it based. In this regard, we note that the State of Wisconsin Department of Financial Institutions specifically states that a DCC benefit cannot include the promise to

³ 907 F.2d 775 (8th Cir. 1990).

make a future loan.⁴ Similarly, in the case of Douglass v. Dynamic Enterprises,⁵ the Supreme Court of Arkansas stated that a DCC-type product was insurance, based in part on the fact that one of the promised benefits was the ability to reduce the price of a new car.

If the Plus feature cannot be characterized as a DCC, that calls into question whether the bank has the authority to offer the feature and, just as importantly, whether the feature would be subject to state insurance regulation.⁶

Income Tax Treatment

To the extent the Plus feature fits within the definition of a DCC, there is the question of whether the relief afforded by it constitutes cancellation of indebtedness income that is subject to income taxation. Without going into all of the specifics of that issue here, whether a debt cancellation benefit constitutes cancellation of indebtedness income under the Internal Revenue Code (“I.R.C.”) is open to some interpretation.

From a lender’s point of view, there is the question of whether information return reporting is required under I.R.C. Section 6050P for relief under a DCC. The only guidance on this subject – which is nonbinding precedent – is a 2001 Private Letter Ruling in which the Internal Revenue Service stated that “the cancellation of a [credit] card holder’s obligation to pay the account balance pursuant to the occurrence of [specified events] under the [DCC] Program does not constitute an identifiable event under Section 1.6050P-1(b)(2) of the Income Tax Regulations. As a result, the Bank is not subject to information return reporting under Section 6050P of the Internal Revenue Code.”⁷

In issuing a final regulation concerning reporting requirements under I.R.C. Section 6050P, the IRS provided the following guidance on reporting requirements in the context of debt forgiveness on an educational loan:

Commentators requested clarification as to whether an organization is required to report amounts forgiven pursuant to the terms of a debt obligation, including loan forgiveness under the FFELP [Federal Family Education Loan Program] upon a stated event (such as death, disability, or satisfaction of the service requirements of the Teacher Loan Forgiveness Program). The IRS may issue future guidance under section 6050P addressing amounts forgiven pursuant to the terms of a debt obligation for purposes of section 6050P. Pending issuance of future guidance, applicable entities will not be subject to penalties under section

⁴ State of Wisconsin, Dep’t Fin. Inst. Ltr. to Phil Markwell dated April 24, 2006.

⁵ 869 S.W.2d 14 (Ark. 1994).

⁶ Another issue that is implicated if the Plus feature cannot be characterized as a DCC is how the fees associated with the Plus feature would be regulated under the Truth-in-Lending Act.

⁷ PLR 200131027 (May 9, 2001).

6721 and section 6722 for failure to report under section 6050P amounts forgiven pursuant to the terms of a debt obligation.

In addition to the reporting issue, there is the fundamental question of whether relief under the Plus feature is taxable as cancellation of indebtedness income. Because the IRS has not addressed that issue, most lenders include a disclosure in a DCC stating that if a borrower makes a claim under the DCC, he or she should consult with their tax counsel to determine whether a satisfied claim results in any tax liability.

On the other hand, as discussed above, it may be inappropriate even to characterize a claim under the Plus feature as resulting in the cancellation of debt. Indeed, some GAP contracts describe the feature as a “credit” as opposed to debt forgiveness. That raises the question of whether other possible income tax liability comes into play. The Internal Revenue Code defines the term “gross income” very broadly as “all income from whatever source,” unless specifically excluded within the Code.⁸ Based on that definition, it is possible that independent of how the Plus relief is characterized, its benefit still would be subject to being taxed. Again, the IRS has provided no definitive guidance on the issue.

Sincerely,

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⁸ I.R.C. § 61.