



3925 River Crossing Parkway, Third Floor  
Post Office Box 40368  
Indianapolis, Indiana 46240-0368

Tel: 317.472.2200 - 800.469.7206  
Fax: 317.208.1200  
www.somersetcpas.com

A special supplement to  
*Overdrive*

## Related Finance Companies: A Good Business Decision and a Great Tax Move

Many dealers are finding that the buy-here, pay-here (BHPH) business is extremely lucrative. Along with running a profitable BHPH operation, dealers should be aware of some significant tax planning opportunities with regards to establishing a related finance company to carry the paper. In order to ensure that you can utilize these opportunities, we would like to highlight some of the potential pitfalls.

### Overview

The use of related finance companies (RFC) is a common practice in the retail automotive industry. Such companies serve many valid business purposes and were utilized before any tax advantage scheme was offered. However, some RFCs are being utilized by used and new car dealers to reduce or defer the reporting of income. This section of the article is to be used as an overview of RFCs. In it will be found reasons for establishing RFCs and issues faced in an IRS examination of an RFC issue.

There are three issues that exist in dealing with RFCs. The first issue involves the economic reasons for the arrangement. The second involves the validity (form) of the RFC itself, and the third and most critical issue involves the economic substance of the discounting transactions.

### Economic Reasons

There are several reasons for creating and using a RFC. Following are some of the major reasons that a RFC is created. Each of these reasons can provide a significant and valid business and economic reason for creating a separate entity to finance the dealer's receivables even if no third party receivables are acquired. There are other equally valid and legitimate reasons for using a RFC.

1. Providing credit to enable the purchaser to buy a car.

Many, if not most, of the purchasers that utilize the services of a RFC do so because of an inability to get credit elsewhere. In this way, the RFC serves a useful purpose in providing credit to individuals with little, no or bad credit. A properly operating RFC also focuses on the collection function outside of the dealership itself which relieves the sales personnel from a task that is time consuming since payment schedules are on a weekly or monthly basis.

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Real Estate  
Tax  
Wealth Management



**Economic Reasons (Continued)**

## 2. Improving the collection of accounts receivable.

A RFC can significantly enhance the collection of accounts receivable by requiring the borrower/buyer to remit payments to a third party even though the third party is related to the dealer. It has been the industry's experience that when payment is made directly to the dealer, a bad experience with the car often leads to a default on the note for the car. This in turn, creates a collection problem and possibly a publicity problem for the dealership. On the other hand, if a RFC is involved, experience shows that the customer is less likely to default on the payment. Given the general credit worthiness of the customers, this is a significant advantage. Some dealers, through effective management and controls, have RFC discount rates lower than what they can obtain from third parties and still make a profit on their RFC financing operations.

## 3. Avoiding licensing and other regulatory requirements on the dealer entity.

Many states have licensing requirements for finance companies. Establishing a RFC permits the dealer to isolate liability for violation of any requirements in a separate entity without jeopardizing the status of the dealership. In addition, some states have capital requirements for finance companies that may interfere with the normal operations of a dealership.

## 4. Preventing adverse publicity on repossessions and other collection actions from affecting the dealership.

Repossession and collection problems are a daily fact of life for buy here/pay here dealers. Creation of a RFC permits a new entity to undertake these actions, thereby insulating the dealer from any adverse publicity. Even in states where disclosure of the relationship is required, the resulting publicity is usually less adverse when a RFC is used.

## 5. Insulating the dealership from the financial risk of default on the notes.

The industry often deals with a customer base that generally has poor or non-existent credit. The default rate on buy here/pay here notes is substantially higher than on general bank loans. This economic fact is recognized both by the interest rates charged by the dealer or finance company and the reserves that independent finance companies generally maintain. A separate RFC removes the financial risk from the dealership entity.

## 6. Diversification of ownership.

Since the financing of used cars is not inherently a part of a dealership, a RFC permits the dealer to provide ownership in that specific business to both family and non-family members without diluting ownership in the dealership. This allows the dealer to separate the two businesses and reward certain employees or other individuals with an ownership interest in a segment of the business.

A final advantage is that a RFC can be expanded, depending upon the dealer's desire, to finance unrelated receivables as well as those of a particular dealership. It should be pointed out that although this is possible, it rarely happens.

## Validity or Form of RFC

The second issue that should be considered, the form issue, is how a valid RFC is structured and operated. Since the purpose of the RFC is to isolate liability or segregate transactions in a separate entity, the RFC should meet several criteria to be treated as a separate, valid business. These criteria are:

1. The RFC should be a separate, legal entity.
2. The RFC should meet all licensing requirements of the jurisdictions in which it operates.
3. A major factor is that the RFC should be adequately capitalized in order to pay for the contracts.
4. The RFC should have its own employees and compensate them directly. However, the fact that the RFC and the dealership or other related entities may elect to use a common paymaster does not indicate, in any way, that the RFC does not have its own employees.
5. The RFC should obtain and maintain all appropriate local business and similar licenses.
6. The RFC should have a separate telephone number.
7. The RFC should have a separate business address, which may be a post office box. Even if a separate business address is maintained, it is common for the RFC to have an office at the dealership.
8. The RFC should maintain a separate set of books and records.
9. The RFC should comply with all title, lien, and recordation rules in the jurisdictions in which it operates.
10. The RFC should notify customers of the purchase of their notes.
11. The RFC and the dealership should have a purchase contract for the receivables that both complies with the appropriate state law and provides evidence of how the FMV of the receivables was determined.
12. The RFC should pay the dealer for the receivables at the time of purchase. The RFC can generate the cash to make the payment from any combination of capitalization of the RFC, bank or third party borrowings, or borrowings from related entities or shareholders. Borrowings from related entities or shareholders could diminish the validity of this factor.
13. The RFC should be operated in a business-like manner.

Clearly, to the extent that these attributes are absent, a serious question as to the substance of the RFC exists.

## Economic Substance

The third and most important issue that should be addressed is the sale of discounted receivables at fair market value (FMV). Sales of receivables must have economic substance to qualify for tax purposes; valid business reasons alone will not suffice.

The FMV of a receivable or group of receivables will depend on a number of factors, with the facts and circumstances of each receivable determining the importance of each factor. Purchasing receivables is not an exact science, and many subjective factors enter into the determination of value. The industry's position is that a deep discount is warranted in nearly all transfers of receivables. The factors that directly influence the amount of discount include:

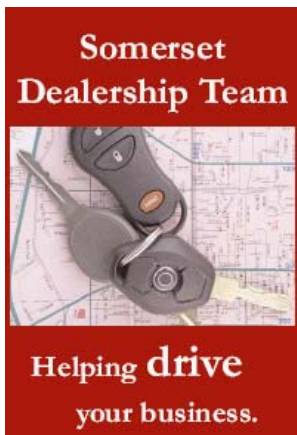
1. Absence of or poor credit history.
2. History of payments on the note.
3. Amount of time left on the note.
4. The age of the vehicle.

Reviews of some third-party finance company documents indicate that these companies can offer to acquire the receivables from dealers at up to a 50 percent upfront discount. These discounts apply whether or not the finance company buys in bulk or "cherry picks" the best accounts.

A dealer can use a RFC to discount its receivables and have it accepted for tax purposes. To summarize the above discussion, the following three factors need to be addressed:

1. The discounting transactions must have economic substance. All of the relevant facts and circumstances must be considered. Remember that the primary reasons for selling receivables are to obtain cash (improve cash flow) or to shift risk. If both of these are missing, it is a good indication that the sales transaction lacks economic substance.
2. The form of the transactions and the form of the RFC must be perfected.
3. The receivables must be sold for fair market value. The seller and purchaser must base the discount on some reasonable factors, not on an arbitrary determination of the discount rate.

The benefits to a related finance company are tremendous; but as you can see, many potential pitfalls abound. Accordingly, you will want to consult with an advisor who is fully aware of the BHPH business and how to properly structure and utilize RFCs.



Somerset CPAs, P.C.  
Dealership Team  
317-472-2200  
info@somersetcpas.com

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