

HEADLIGHTS

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RENT FACTORS IN DEALERSHIP REAL ESTATE

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Many dealers own dealership real estate either individually or through an entity, and lease the property back to the dealership. The benchmark is that rent charged should approximate market rate. Variance from the above rule can draw scrutiny from the IRS as well as impact the dealer's financial statement and relationship with business partners. Rent factors used can have a significant tax effect, depending on the type of entities involved, the individual ownership percentages and the individual owners' tax basis in these entities.

In one scenario, the dealer/owners of real estate organized as a limited liability company (LLC) charge below-market rent to their identically owned dealership, a C Corporation, which shows a large net operating loss (NOL) for the year that no carryback is available. The LLC owners' current year taxable income is understated to the extent the market rent factor exceeds actual rent charged. While there is

no current tax effect on the dealership, which reduces its NOL carry forward, the IRS will impute taxable income to the dealer/owners. In a second scenario, the ownership facts are the same as above, but the dealership is organized as either an

S Corporation or LLC. Additional rent must be imputed to the dealership, but the dealer/owners has insufficient basis in the entity. The entity-level deduction does not flow through to the shareholders and as a result, the IRS imputes taxable income to the dealer/owners.

The terms of the lease—set at market value—should govern all self-dealing rental transactions. If rent is below market, additional rent

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SPRING 2005

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must be imputed. Above-market rent should be reclassified as salary, dividends or distributions, depending on the facts.

Useful guides for dealers and owners are financial statements. Rent factors used affect the dealership's financial ratios, such as net profit retention or fixed expenses as a percentage of gross profit. This is also a factor when using benchmarking.

A single party may not own the dealership property and the operating business in the same percentages. If the property-ownership percentage is different from the dealership-ownership percentage, rent can be used as a means of transferring

income among different ownership interests.

Dealership rent factors used in self-dealing relationships between owners and their related dealerships should be formalized in an operating lease based on an analysis of rent factors in the dealership's geographic market. The lease term should extend long enough to protect the dealership in the event of changes in ownership of the property due to sale or death. A well-structured lease can help insulate the dealer from IRS scrutiny, provide accurate financial information to interested parties and diminish the possibility of ownership disputes. ☞

PREPARING YOUR DEALERSHIP TO SUCCEED IN SUBPRIME

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For your dealership to expect to succeed in subprime sales and financing, you need to make sure that your dealership is properly set up for the business. The details of this preparation are important and take a good understanding of everything that is involved to be successful. The key factors that need to be addressed are:

Staffing

Have a separate department that is dedicated and trained to service the subprime customer. Customers and dealership personnel should perceive it as the mecca of credit solutions and the starting point for a secure future. To be most successful, employees should be able to devote all of their time to the special finance business.

Policies and Procedures

Have specific policies and procedures on how to handle the subprime customer. Determine as soon as possible if the customer is a subprime customer, so he or she does not spend unnecessary time in the conventional process.

Inventory

The subprime department needs to purchase the inventory that is specifically tailored

for the customer. This is in both types and prices of vehicles. It has been proven time and time again that the separate inventory will result in greater sales than trying to find the right vehicle out of the dealership's regular inventory.

Advertising

To attract the subprime customer, you need to advertise to that customer. Let him or her know you want their business. Determine in your market what effective means exist to communicate your desire to do business with that customer.

Lender Relationships

Find the lenders in your market that are committed to the subprime business. They should be in the subprime business for the long haul and have people devoted solely to the subprime product.

All of these points boil down to one critical characteristic: commitment. To succeed in subprime sales and financing, the entire dealership needs to be committed. Without this commitment, the dealership will never capitalize on this growing and lucrative segment of the car-buying public. ☞



DEALERSHIP VALUATIONS

Carl Woodward, CPA
Woodward & Associates, Inc.

In most cases when dealerships are being valued, we need to determine the historical earnings for the last few years. This is done to assist in determining the blue sky, franchise and goodwill value of the dealership, along with the total value of the dealership. One component of valuing a dealership is to determine its “normalized” historical earnings. What does this mean? It means taking its final annual pretax earnings and making adjustments to show its “real” annual earnings. Some of the income and expense areas that need to be looked into in order to make annual “earnings” adjustments include:

1 Are there any special nonrecurring income and expense items? This could include special, one-time expenses, such as one-time lawsuit settlements, employee thefts, extraordinary losses not covered by insurance, extraordinary legal fees, factory audits, etc.

2 Is the dealership on the last-in, first-out (LIFO) method of accounting? If it is, then any adjustments for LIFO should be added back or subtracted from the annual earnings as if no LIFO adjustments had ever been made.

3 Have there been any special material write-offs for bad debts? Depending on the circumstances, one might add back this special write-off for bad debts.

4 Have there been any special material write-offs or write-ups for new, used or parts inventory? If so, one might make an adjustment for these special, one-time adjustments.


5 If the dealership depreciates its fixed assets using income tax depreciation methods, the amount of excess depreciation, tax depreciation over accounting (real-world) depreciation, should be added back to the earnings for the most recent year. Also, there should be allowances made from prior years’ earnings whereby the actual depreciation is different from accounting depreciation. This could include reducing earnings where tax depreciation in some years caused the depreciation expense to be less than accounting depreciation.

6 Is there any excess or underpayment of compensation to managers of the dealership, stockholders, relatives of stockholders, “friends” of stockholders, etc.? If this exists, then allowance should be made for the compensation, whether excessively low or high. Also, if there is a material amount of expenses incurred by the dealership by or on the behalf of the above individuals that would not normally be incurred by a dealership, then these expenses should be added back to the earnings of the dealership.

7 Is there any income generated by the dealership that is not run through the dealership’s accounting records? This income could include credit insurance commissions, service contract “overbills,” “retro” earnings on credit insurance and service contract sales, rebates from suppliers, etc. If this income exists and is material, it should be added back to the earnings of the dealership.

8 If the real estate is leased from a “related party,” such as a stockholder, etc., then the rent on the real estate needs to be adjusted to what an unrelated third party might charge. The guideline for annual rent would be approximately 10% of the fair-market value of the real estate, with the dealership paying property taxes, insurance and insurance on the building. If this rent using a 10% factor causes the rent as a percentage of gross profit to be more than 10%, additional analysis needs to be performed.

9 If there are any other related party transactions, these need to be reviewed to determine if any adjustments need to be made.

Once the above adjustments have been determined, they should be added or subtracted to each year’s preliminary annual earnings to determine the “normalized” earnings of the company. 



NADA: NEW ORLEANS

Aaron J. Winiarz, CPA

The NADA Convention held in New Orleans was one of the largest in the long history of the event. The list of vendors present continues to grow and the number of first-time vendors was possibly the largest ever.

The focus of this year's convention continued to be the Internet and the various customer relations software for retaining your own customers. As we all know, it is easier and less expensive to maintain your own customers than to try to advertise for new ones.

We wish to thank everyone who stopped by the AutoCPAGroup booth to speak to us as well as to register to win the autographed NASCAR helmet. Next year's convention is in Orlando on February 11-14, 2006. We hope to see you there. ✍

For assistance, please call 1-800-4AUTOCPA or see our website at www.autocpa.com. Headlights is prepared by the AutoCPAGroup for the clients of its members. It is recommended that you obtain professional advice with respect to any information that is covered in the newsletter.
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