by
Alan R. Silverman, CPA

PAY TAXES WHEN YOU GET PAID!

ADVANTAGES and disadvantages of RELATED FINANCE companies (RFC)

In over 27 years of providing tax services, I have dealt with a number of Buy Here Pay Here (BHPH) dealerships and have found that one of the most distasteful issues they face is paying income taxes on car sales before collecting a single payment. Not only are dealers paying income taxes on money not received, but as a creditor to a higher risk customer base, they could be paying taxes on funds that will NEVER be collected. No one wants to pay income taxes in advance of collection, especially when the collection is questionable and unknown at the time of the sale.

The U.S. Congress, acting to rectify this unfair provision in the tax code, passed an exception to the related loss rules allowing for the deferral of the income taxes on these notes. However, there are very specific rules and regulations that must be followed in order to take advantage of the exception. By implementing the proper policies and procedures, dealers can gain the ability to defer the payment of income taxes by selling the notes to a related finance company (RFC).

The following is a summary of some of the advantages and disadvantages to utilizing an RFC.

Advantages:

Cash Flow – You get to hold onto your money longer. You will be allowed to defer the payment of income tax until the money is collected. Therefore, not only will you not pay income taxes in advance, but you will only pay on the amounts you receive when customers make their payments.

Capital – By preserving more of your money, you can utilize it to better fund your business. This will result in a decreased need to borrow and allow you to re-invest in inventory.

Keep your customers – You will be in a better position to hold your own paper. You will not have to sell it at a large discount to collection companies in order to raise money. These companies make THEIR money collecting YOUR notes. Using an RFC will put you in a better position to keep your notes – and a larger percentage of your revenue.

Increased borrowing capacity – the retention of capital (money) and the deferral of income taxes may allow you to leverage the funds into increased borrowing capacity to get more return on your investment by putting more money on the street working for you.

Disadvantages:

Additional Administrative Procedures – In order to take advantage of the RFC rules, you will need to implement additional administrative procedures. You will have to operate two separate companies – a Sales Company AND a Finance Company. Therefore, you will have the additional administrative procedures related to operating two companies: two sets of books, two sets of payroll tax returns, two sets of income tax returns to prepare and file, two sets of state and local licenses, two separate bank accounts, etc. In addition, you will need to document and prepare legal agreements related to the sale of notes from the Sales company to the Finance company as well as other inter-company transactions. These are just some of the additional administrative procedures you must implement.

Additional Complexity – The additional complexity is not only the result of operating two separate companies but you will also be required to issue consolidated financials to third party lenders in order to show them what one company would look like. That is not as simple as adding the two sets of books together. You will have to consolidate and eliminate the inter-company transactions for the third party lenders in order to be able to borrow money. That adds an additional level of complexity beyond the day to day operation of the two companies.

Potential Change in Accounting Software – In order to handle the two separate sets of books for the two separate companies, you may be required to upgrade your accounting software. While some accounting software will handle the BHPH sale of vehicles, inventory, the issuance of Promissory Notes and the collection of payments, some software programs may not handle the dual company aspect of the operation and account for the deferral of income recognition.

Additional Expense – Initially, you may be able to offset the cost of additional software and equipment upgrades with Georgia state tax retraining credits. However, you will incur additional expenses for the increased administrative functions related to having two companies and you will incur additional accounting and legal fees due to the complexity.

IRS scrutiny – If you use an RFC, your increase your chances that the IRS will question whether or not you are allowed the deferral. I have found that the IRS is currently more aggressive. In my opinion, the increased aggressiveness is related to reduced tax collections as a result of the poor economy. The IRS does not like this exception in the tax law and will closely examine the use of the RFC. A client of mine recently was audited for the second time. The first time, the IRS allowed the sale of the notes and deferral of tax payments. The second time, 10 years later,

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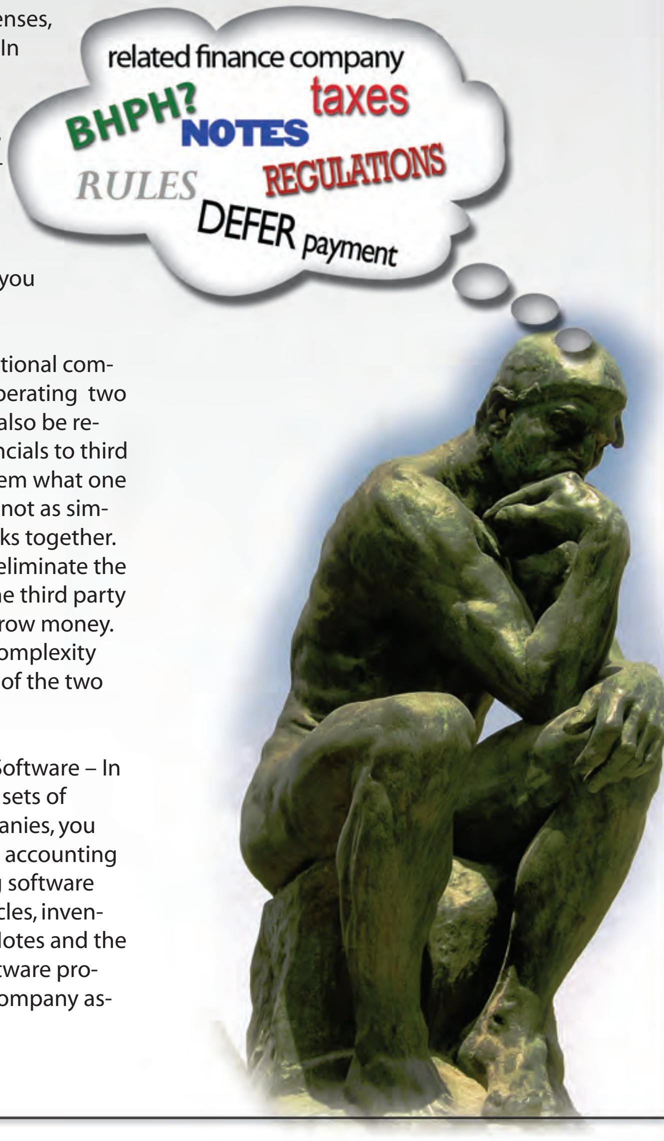

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From page

with no change in the law or how the company processed the loans, the IRS is challenging the deferral. The audit issue is still open at this time. Suffice it to say, even if you properly set up the RFC, you should still be prepared for scrutiny by the IRS.

These are just some of the advantages and disadvantages. Is it worth it? The answer to that and every other tax question ever asked is: IT DEPENDS.

Each company has different needs and goals. Some have aggressive growth plans. Some prefer conservative financing strategies while others have a high desire for administrative simplicity. In general, if you are highly organized, have a high desire to grow you business, and have a great need for outside capital, it is likely the advantages will outweigh the disadvantages. If you prefer a simple, low maintenance operation and do not have a need for outside capital, then this strategy may not be for you.

Determining the best course of action for your company is never simple. It is always in your best interest to discuss this with your tax and financial consultants in order to make an informed decision.

ALAN R. SILVERMAN, CPA - Partner
Alan has over 33 years experience in the accounting field, 15 of which have been serving the clients of Galanti & Co. Alan's no-nonsense style and willingness to work tirelessly to ensure his client's companies are in the best shape possible is greatly appreciated by those that work with him. He has expert knowledge of the tax issues and financial intricacies of a wide range of industries, including real estate, auto dealerships and construction, to name a few. He also manages tax planning engagements for individual clients.

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