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CERTIFIED PUBLIC ACCOUNTANTS

The Fix is In - Or Should it be Cut Out?

This is an article specifically aimed at dealers who also have a related finance company. In operating a BHPH, it is often a struggle to have customers pay the money owed on their note when their vehicle malfunctions. If your customer can pay a little each week toward the repair (which will keep the account in good standing), it may seem to make sense to roll the cost of the repair into the installment note. But if you do this, you tread on thin ice with the IRS.

Once the note has been sold to the related finance company (RFC), the note cannot be changed. The RFC's sole function is to purchase notes and collect them. Lately, I have seen dealers who finance the repair in the RFC and either keep a side note (in the dealership or RFC) or refinance the note to add the repairs in the original note. THIS IS NOT A GOOD PRACTICE.

When the note is sold, the risk of default is accounted for in the fair market value discount. By modifying the note, you put the valuation of the fair market value discount at risk. Further, there are issues with originating debt inside of the RFC that will not be addressed here (although this is a very serious issue). If you take a note in the dealership as opposed to adding it on to the original note, the vehicle cannot be held as collateral for the repair debt. Therefore, you would take a big risk by creating a separate note in the dealership.

Think to yourself, why would a company that is operated separately and who has no risk of recourse in the note they sold want to make an uncollateralized, high risk loan? The answer is that they would not if they were completely independent (this is an overriding factor of having a legitimate RFC).

What can you do to ensure that the vehicle will be repaired, and the car will keep running so that it will perform? Offer service contracts. Most dealers have them already them available and the contracts are offered to each customer. If you are selling vehicles in the lower price ranges with higher mileage, you may want to consider this as a standard practice.

What is the risk of continuing the practice of fixing the cars and adding the repair to the RFC receivables? First of all, if the IRS determines that the notes were not sold at FMV, they can "bust" the RFC relationship and take the entire receivable into income as well as reverse the entire discount expense taken. If you assume that 1 million of notes were on the books at 12/31/09, 1 million in receivables becomes income. Also, there may be legal issues with originating new debt within the RFC to deal with. Assuming you have a 40% blended individual tax rate, you could be hit with a tax bill of $400k on a 1 million dollar receivable. Essentially, this reverses the money you were saving by having an RFC. In addition, there would be penalties and interest levied on any tax due.

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