Common Accounting and Tax Problems

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Problem #1: **Filing your dealership's tax return on the cash basis of accounting.**

In general, IRS requires any entity where inventory is a significant part of operations to file on the accrual basis of accounting.

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Problem #2: **Setting up a related finance company while your dealership and/or RFC are set-up as partnerships (or LLCs filing as partnerships).**

IRS regulations that allow you to deduct the loss on sale of finance receivables from a dealership to an RFC apply *only to corporations*. Therefore both the dealership and the RFC *must* be corporations (C-Corporations, S-Corporations, or LLCs filing as corporations).

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Problem #3: **Being overly aggressive when selecting the discount rate for selling receivables to the RFC.**

IRS rules require that notes be sold to your RFC at fair market value. In addition, you may not have a discount rate higher than your gross profit in the deal, as dealers may not sell receivables to the RFC for less than they have in the deal.

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Problem #4: **The RFC failing to pay for the receivables it purchases from the dealership.**

Because the sale of the receivables between the dealership and the RFC must be completed as though the RFC were a third party finance company, the RFC must pay in-full for the receivables it purchases in a *reasonable* amount of time.

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Problem #5: **Failing to properly document the sale of receivables between the dealership and the RFC.**

You must have proper legal documentation, which details and supports the sales of the receivables from the dealership to the RFC. Without the supporting legal documents, the IRS could argue that the sale of receivables never took place.

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Problem #6: **Selling receivables to the RFC with full recourse.**

When the RFC buys the receivables, it must assume full risk of loss if the receivable turns out to be a bad debt.

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Problem #7: **Setting-up the accounting integration and then assuming the financial statements are accurate.**

While accounting integration is very helpful, it is just one piece of the puzzle in assembling full accurate financial statements.

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Problem #8: **Charging off an account and restocking the repo into inventory at the balance owed on the charged off contract.**

Dealers often think that as long as they got the car back, they really didn't lose any money when the account was charged off. They just stock the repo inventory back in at the balance of the old account and re-retail the unit. This is *unacceptable*.

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Problem #9: **Commingling funds between the dealership and the RFC.**

Dealers often only have one cashier and all of the money collected during the day just gets deposited into the bank account of the dealership. IRS rules require the you separate collections belonging to the RFC and deposit them directly into the RFC's bank account.

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Problem #10: **Thinking the allowance for bad debts and the reserve for warranty claims are deductible for tax purposes.**

IRS regulations do *not* allow you to deduct any amount that is considered an estimate (which is exactly what the Allowance for Bad Debts and Reserve for Warranty Claims are). Charge offs and warranty claims may only be deducted on your tax return *when they occur*.

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<u>Problem #11:</u> **Dealers jumping into leasing without fully understanding the impact on their financial statements or their banking relationship.**

While leases can have certain sales tax and income tax benefits, operating leases are off balance sheet assets and so do not show on your financials making very difficult to get a line of credit from your banker. There is also almost no secondary market for leases.

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Problem #12: Owners failing to directly monitor portfolio performance and operations.

Far too often we hear of non-active owners discovering that an employee has committed fraud. This business handles vast amounts of cash and fraud is a common problem. As an owner, do not rely on your employees to feed you information.

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Problem #13: **Not following a written bad debt policy**

Companies should have a written bad debt policy for when an account should be written off.

Companies should use a guidebook for determining ACV.

Companies should be careful when recording lookback losses.

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Problem #14: **Companies failing to issue 1099 forms.**

IRS penalties for failing to issue 1099 forms have increased to $250 per form which can add up fast.

1099's for interest, rent, contract labor and cancellation of debt

Problem #15: **Companies taking inventory write downs without support.**

When doing an inventory write down at year end, Companies must use a guidebook value to determine the write down.

Make ready expenses should always be capitalized and included in the inventory balance

					Column F is lower of	
Sample of Inventory Writedown Calculation					D or E	
A	B	C	D	E	F	G
					Ending	
					Inventory	Inventory
Inventory	Cost	Make Ready	Total Cost	Guide Book	Valuation	Writedown
2010 Toyota Camry	8,600.00	350.00	8,950.00	8,000.00	8,000.00	950.00
2004 Acura MDX	10,800.00	750.00	11,550.00	12,500.00	11,550.00	None
2007 BMW 3-Series	15,500.00	800.00	16,300.00	15,750.00	15,750.00	550.00
2006 Chevy Suburban	12,500.00	325.00	12,825.00	13,500.00	12,825.00	None
			49,625.00		48,125.00	1,500.00

In this example, the inventory writedown would be $1,500 (Column D Minus Column F)

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Problem #16: **Expansion of IRS Audits.**

Government has access to so much more information. Agents now check DMV records to match sales information.

Agents are googling owners and company transactions looking for irregularities.

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Problem #17: **Companies failing to follow to IRS checklist.**

IRS has issued a 26 point checklist outlining how a RFC should be operated.

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RELATED FINANCE COMPANY CHECKSHEET

ORGANIZATION

1. Is the RFC a separate, legal entity from the dealership?
2. Does the RFC meet all state licensing requirements?
3. Does the RFC maintain all required, local business licenses?
4. Does the RFC comply with title and lien holder laws in its area?
5. Does the RFC have adequate capital to pay for the contracts?
6. Does the RFC have its own address and operate from separate facilities?
7. Does the RFC have its own telephone number?
8. Does the RFC maintain its own books, separate from the dealership(s)?
9. Does the RFC have its own employees?
10. Does the RFC compensate the employees directly?
11. Does the RFC pay its own expenses?
12. Does the RFC maintain its own bank accounts, separate from the related dealership(s)?

13. Does the lien holder on the finance contract change from the dealership to the finance company?
14. Does the dealership notify customers that the contracts were sold?
15. Does the RFC pay the dealership for the contracts at the time of purchase?
16. Does the RFC purchase any contracts from unrelated companies?
17. Does the RFC have written agreements with the dealership(s)?
18. If so, does the agreement state how the discount rate was determined?
19. Does the discount rate approximate the actual loss experience?
20. Are the finance contracts non-recourse?
21. Does the RFC handle repossessions?
22. Does the dealership sell any finance contracts to unrelated finance companies?
23. Does the RFC report income on a pro-rata basis?
24. Did the profit reported on the initial sale of the vehicle exceed the loss on the sale of the finance contract?
25. Does the RFC have a business purpose?
26. Did the RFC investigate items such as the borrower's credit history, length of the note, age of the vehicle, and payment history prior to determining FMV of the note?