A CAPTIVE FINANCE COMPANY:
WHY YOU NEED ONE

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Increased competition in the used car industry during the last few years has forced dealers to put more *"money on the street"*. Capital has never been more important and is often the single factor which limits a dealers growth. Lack of capital has forced some dealers into *"special financing"*. Other Buy Here, Pay Here, " BHPH " Dealers who retain their notes have been forced to react as follows:

1) To find ways to reduce taxes and other operating costs, thereby making more money available to purchase inventory and/or;
2) To borrow additional capital from a bank or financial institution, (if available) and/or;
3) To sell their notes receivable and other assets to outside parties in order to raise needed funds.

A review of the aforementioned alternatives indicates that choice one is the least expensive and by far the most   own " captive " finance company provides the proper structure which a dealer can use to raise the capital needed to replace inventory and to increase notes receivable.

Here is how owning your own finance company can reduce your taxes! The example, shown below, illustrates the tax benefit received when a BHPH dealer sells his notes to his own finance company.

After the sale, shown in the example below, the dealer has deferred the tax on $1,800 and still owns the note. The loss on the note becomes income in the acquiring finance company.

This income is recognized over the life of the notes, as collected. Dealers with portfolios of $500,000 or more often generate tax savings in excess of $200,000 using this technique. Tax deferral, and in some cases elimination of the tax generated when the dealer sells the car, frees up additional capital. The tax savings allows the dealer to grow without more outside financing.

Dealer Sale Of Automobile To Customer:		**When Dealer Sells Customer Note To Related Finance Company:**	
Sales Price - Installment Note	**$ 4,500**	**Discounted Receivable/Sales Price**	**$ 3,150**
Cash Downpayment	**500**		
Total Sales Price	**5,000**	**Less: Cost of Vehicle**	**-3,500**
Less: Dealer's Cost of Note	**4,500**		
Taxable profit without finance company	**1,500**	**Dealer's Loss on Note**	**$ -1,350**

Loss on Sale of Installment Note To Your Own Finance Company (see below)	**-1,350**	**Deferred Income of Related Finance Company**	**$1,350**
Current Year Taxable Profit by Dealer with finance company	**<u>150</u>**		

Dealers who need to borrow money find that lenders are more receptive to a finance company. This occurs because dealers can pledge their note portfolios rather than a car inventory which is constantly changing. Bankers and other financial institutions now realize that the liquidity and stability of a quality note portfolio is a better source of collateral than used car inventories.

Tax reduction and increased borrowing capacity are not the only benefits of creating your own finance company. In a previous article, I mentioned that used car dealers are now under close scrutiny by the IRS. A task force of agents has been organized in Houston to audit virtually every dealer in the area over the next few years. The primary focus of these audits is to convert dealers from the cash to accrual basis of recognizing income for tax purposes. After the change, dealers will be taxed on receivables before they are collected. The change in accounting methods normally results in more tax than dealers previously paid using the cash method. Therefore, dealers may find that creating and using a finance company to defer these increased taxes is the only viable alternative.

One note of caution, the new audit guide mentions that the IRS will closely scrutinize sales of notes between the dealership and a related finance company. This means that such transactions must be properly structured, documented and have economic substance. Professional assistance is needed to obtain the desired results.

For dealers who want to sell their notes to third parties, a captive finance company can be used to transact these sales. Dealers who wish to make partial portfolio sales, can retain the remaining notes for additional income and cash flow. Money obtained from note sales can be used to buy more cars and create new notes.

Lower taxes and increased borrowing capacity are the compelling reasons to have your own finance company. In addition, many dealers believe that separating the collection of notes from the selling of cars creates a better operating structure. Over the last five years we have helped more than 35 dealers create and implement their own finance companies. None have indicated a desire to return to the old structure of leaving the notes in the dealership. If you face any of the problems mentioned in this article, consider the finance company alternative. You won't be disappointed!