A RELATED FINANCE COMPANY
"THE REAL BENEFIT"

BY KENNETH B. SHILSON, CPA

Much attention has been focused on the tax savings and tax deferral aspects of establishing a related finance company. Although the tax savings provided by this structure are important and should not be ignored, the ability to raise capital with this structure should be the real motivator.

For years banks and financial institutions have not been anxious to establish large lines of credit secured by retail sales contracts from customers. This seems strange considering banks have loan portfolios themselves and seemingly should be very comfortable with this type of arrangement. The problem relates to a financial institution's inability to obtain a perfected collateral interest in such contracts when a separate related finance company does not exist. When a used car dealer has only a single entity (the dealership) all collateral (car titles, sales contracts and all other assets) are the property of that entity. Often a bank creates a floor plan line of credit secured by the car titles at the dealership. If that bank (or any other) also lends against the sales contracts a collateral problem occurs. That results because the car titles also secure the installment sales contracts with the subprime customers. As a result, most bankers feel that floor-plan lending generally precludes lending against retail sales contracts if they are in the same entity.

In these circumstances, a dealer can avoid this problem by creating a separate finance affiliate and by transferring the sales contracts to that entity (at a discount which creates the tax benefit) thereby separating the collateral. These contracts can then be pledged as collateral to secure a separate line of credit in the related finance company while the dealership retains its floor plan financing arrangement. As the dealership generates additional contracts they can be sold to the finance affiliate and pledged to obtain additional borrowings.

In addition to the separation of collateral, lenders also favor the fact that a separate finance affiliate isolates the sales contract collateral from dealership operating liabilities. Further, it is easier to track portfolio performance when the portfolio is in a separate entity. Dealers who initially set up a separate finance company primarily for the tax benefits are frequently surprised when their lender approves a new line of credit for the aforementioned reasons. Although creation of a separate finance affiliate does not assure that capital will be available, dealers should not establish a related finance company without adequate capital.

Without capital, a related finance company cannot pay the notes it purchases from the dealership and this increases the risk of an IRS challenge substantially. In addition, a dealer cannot increase its note portfolio without borrowing because of the money it must put in the street each time a car is sold.

During the last ten years I have helped establish more then 200 related finance companies. None of these dealers would go back to the single entity approach. If capital, tax savings, and limited liability are important to you, establishing a related finance affiliate may be the solution!