Tax reform: The end of the related finance company?

As soon as the "Tax Cuts and Jobs Act" passed on December 22, 2017, we started to receive calls about whether buy here pay here dealers could start to use the cash basis of accounting and stop using their related finance companies.

Under current regulations, dealers are required to use the accrual basis of accounting which causes significant cash flow problems for dealers as they are required to recognize BHPH sales into income and pay the income taxes in the year of sale, regardless of whether the dealer has actually been paid by the customer or whether the customer may default on the loan. As such most dealers have setup a related finance company which, through the use of discount, allows dealers to spread the income over the life of the customer's loan, allowing dealers to pay income tax only after they have been paid by the customer.

Under the new tax reform, businesses with income under $25 million will be able to elect the cash basis of accounting starting in 2018. However as things stand right now, this might not actually benefit BHPH dealers. Taxpayers who elect cash basis accounting are subject to the doctrine of cash equivalency. Under current IRS regulations for cash basis accounting, a dealer who receives an unconditional and assignable promise to pay from a customer must recognize the sale as income the same as if the dealer had actually received the cash. All BHPH sales are documented with a retail installment contract which is a promise to pay and therefore potentially a "cash equivalent".

The United States Court of Appeals for the Fifth Circuit established the cash equivalence doctrine for a promise to pay. The court stated that the promise to pay must be unconditional, made by a solvent person, assignable, not subject to set-offs and marketable. Since most BHPH dealers sell to subprime customers, an argument could be made that the promise to pay was not made by a solvent person, however the IRS will likely argue that the dealer would not have made the loan in the first place if they did not believe there was a reasonable chance of repayment.

Additionally under Treasury Regulations 1.1001-1(g) and 1.1274-2, when a debt instrument is issued in exchange for property (a BHPH sale of a vehicle), the amount realized into income as attributable to the debt instrument is the issue price (amount financed) of the debt instrument.

The IRS will spend 2018 implementing the tax reform passed by congress, but unless the IRS redefines cash equivalency, the cash basis of accounting will have little benefit to BHPH dealers. We recommend BHPH dealers discuss this issue with their CPA before rushing into electing cash basis.

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