

BHPH CORNER

IRS Audit Issues for Buy Here - Pay Here Dealers

Over the past year, we have seen an increase in IRS audits of our clients, in particular with our Buy Here-Pay Here (BHPH) dealers. Following is a summary of some of the issues we have seen raised in these audits and what steps BHPH dealers can take to minimize their risk of an unfavorable outcome.

Related Finance Companies

If you have established a related finance company (RFC) in connection with your BHPH business, the IRS will likely take a long look at the validity of the RFC. If it is determined that the RFC is not valid, the loss on sale of contracts to the RFC would be disallowed under audit. In its dealership audit technique guide, the IRS has outlined many characteristics of a valid RFC. Here are a few of the significant criteria likely to be considered under audit:

- Are contracts sold to the RFC at fair market value and is there a written, arms-length contract between the dealership and the RFC?
- Does the RFC operate and function as a separate legal entity (separate bank accounts; separate books and records; separate employees; separate signage, etc...)?
- Are customer payments made to the RFC and not the dealership?
- Does the dealership have any recourse associated with contracts sold?
- Does the RFC have adequate capital to pay the dealership for contracts purchased? If intercompany accounts are used, there should be a regular pattern of payments made and interest charged as appropriate on unpaid balances.

BHPH dealers should establish a process to regularly review and adjust the discount percentage used for contracts sold to its RFC. Some relevant factors would include expected future charge-off; changes in underwriting criteria or collection practices and what 3rd party purchasers are paying for the type of paper you are generating. Creating a history of adjusting the discount rate on a regular basis will demonstrate to the IRS that you are making every effort to sell the contracts at FMV.

1099 Reporting

As part of a routine audit, the IRS examiner will likely inquire as to the filing of required 1099s. In addition to the normal 1099 filings for payments to independent contractors, BHPH dealers need to be aware of the 1099C filing requirements for discharge of debt under certain circumstances. A full discussion of those requirements is beyond the scope of this article but dealers should be aware of the filings associated with certain charge off events and the potential penalties for failure to do so.

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S Corporation Basis

Another common IRS audit issue is the substantiation of basis to support losses allocated to individual shareholders from S Corporations. In many instances, the dealership entity will report tax losses while the RFC reports income. In order for the dealership losses to be deductible and offset the RFC income – individuals must have adequate basis in the dealership entity. Basis is established thru capital contributions, loans from shareholders or from previous earnings that have not been distributed. The examining agent will want to see an analysis of your basis and substantiation for any capital contributed or loans made over the years.

The BHPH business model differs quite a bit from a traditional dealership and lends itself to some unique issues in the event of an IRS audit. The thought of an IRS audit of your BHPH business might keep you up at night; however, proper planning and professional advice should help you rest easy. For a copy of the IRS audit guide for RFC's or for our summary of the 1099C reporting requirements – please visit our website at www.ksmcpa.com/buy-here-pay-here

For further information, please feel free to contact Jeff Taylor, with Katz, Sapper & Miller's Dealership Services Group at 317-580-2014. ♦

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