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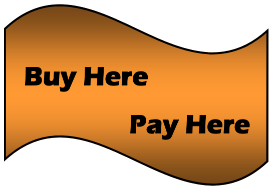
Considering Lease-Here / Pay-Here



By Mike North

We recently attended the 2011 Autostar user's conference in October of 2011. It was clear from speaking to dealers and vendors at this conference that Lease-Here/Pay-Here (LHPH) continues to generate a great deal of interest in the industry. We thought it would be worthwhile to revisit LHPH in this article.

Determining whether LHPH makes sense for your operation is a complicated analysis that will require legal, accounting and software guidance. The legal and regulatory changes are significant and a change to LHPH has significant impacts on both your employees and customers.

This article will serve as an introduction to the key issues surrounding LHPH:

Sales tax: This issue fueled the momentum towards LHPH in the industry. Currently, in most states (including Indiana), sales tax is due on the purchase price of the vehicle at the time of sale. This creates a significant cash flow burden on a BHPH operator. In addition, dealers that employ a related finance company (RFC), are not allowed a sales tax refund for bad debts in most states. Currently, RFC's can recover a partial sales tax refund for bad debts in Indiana. Under a LHPH structure, if the lease meets the necessary qualifications in the state in which you are operating, the sales tax is typically due as payments are received as opposed to the time of sale. This is a major cash flow advantage. It also eliminates the bad debt refund issues.

Federal Income Tax: In the BHPH industry, the loss on assignment of contracts to an RFC helps reduce the income tax burden caused by the initial recognition of gross profit in the year of sale, when little cash has been received from the customer. Under the LHPH structure, dealers may determine that an RFC is unnecessary because income is recognized as payments are received from the customer (assuming the contract qualifies as a lease under IRS guidelines). Another tax advantage is that the dealer would be entitled to depreciation deductions on the vehicles that are under lease. Although the entire lease payments are subject to federal income tax (not just the interest income), the deferral of income at the inception of the contract and the depreciation deductions, typically make LHPH a more attractive model from a federal income tax standpoint.

Financial reporting: This is typically one of the largest roadblocks in a conversion to a LHPH structure. The receivables associated with a lease that qualifies as an "operating" lease for financial reporting purposes would not be recorded on the financial statements. Instead, the cost of the vehicles leased to customers would be recorded as fixed assets. This is typically a much smaller number and considering that receivables usually serve as the borrowing base for the dealer's financing, this can create a problem with lenders. If the dealer is able to structure the leases in such a manner that they qualify as "Sales-Type Leases" for financial reporting purposes, the vehicles are considered sold and a receivable is recorded in the amount of the present value of the future payment stream. This results in overall financial reporting that closely resembles that of the typical BHPH dealer.

We have recently noticed an increased interest from lenders in better understanding LHPH. It seems clear that lenders are also feeling the buzz in the industry on this topic and do not want to be left behind.

To achieve the best sales tax, income tax or financial reporting results, the leases have to meet different criteria and the tests are not the same. A dealer considering a change to LHPH must look at each issue individually and find a lease structure that best fits their needs and goals.

Along with the tax and financial reporting concerns discussed above, there are regulatory differences to consider; different insurance risks; different software requirements and employees will have to be educated and trained. Specifically, the insurance risk will necessitate involving legal counsel and an insurance broker familiar with this industry. Keep in mind that the dealer is now the titled owner of their fleet of vehicles being driven by their customers. This risk should be analyzed and managed in accordance with the dealer's specific risk tolerance.

Although a potential conversion to LHPH may seem overwhelming, the benefits of the sales tax savings and the sales and income tax deferral can be well worth the time, effort and resources invested.

For more information on converting to a LHPH structure, please contact Mike North, a director in Katz, Sapper & Miller's Buy Here-Pay Here Services Group, at 317.580.2019. ◊