Profit DRIVERS

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PROFITABLE IDEAS FOR AUTOMOBILE DEALERS

INSIDE

Warranty Versus Extended Service Contract: Reinsurance

Edited by Vawter, Gammon, Norris & Co., P.C.

We invited Elizabeth Barber from GPW to submit the following article. Elizabeth addressed our group, the National Alliance of Auto Dealer Advisors (NAADA) at a recent meeting. VGN is a founding member of this exclusive group of CPA firms who collectively represent about 1,000 dealers and their related entities nationwide. This provides you access to some of the best minds and talents in the industry. If you have any questions regarding this article and would like to speak with her in person, please let us introduce you to her.

Finance and Insurance (F&I) departments can generate additional profit for automobile dealers. Commissions from the sales of F&I products, including extended service contracts (ESCs), are one source of additional revenues. Automobile dealers also have the opportunity to participate in the underwriting profit of various F&I products sold through reinsurance. To qualify for favorable tax treatment when reinsured, the products must qualify as insurance for tax purposes. The IRS has issued a significant number of private letter rulings (PLRs) establishing that ESCs are insurance for tax purposes.

From the consumers' perspective, ESCs look similar to warranties. If a consumer's car breaks down during the coverage period, it gets repaired either at no cost or after a deductible payment. Some ESCs are even called extended warranty contracts.

While these are significant similarities, warranties and ESCs are very different. One key difference is that warranties are a promise by the manufacturer, wholesaler or retailer that the product will perform as expected and that defects that existed at the time of sale will be repaired. A promise to repair an existing defect when the manufacturer could have prevented the defect lacks the required element of chance (fortuity) to be insurance. ESCs have fortuity and the issuer of the ESC

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VAWTER, GAMMON, NORRIS & COMPANY, P.C.
CERTIFIED PUBLIC ACCOUNTANTS

Specializing in Retail Automobile Dealerships:
1316 Hardwood Trail • Cordova, TN 38016
(901) 767-4030 • Fax (901) 767-8709
www.vgncpa.com

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has no control over the chance of a covered mechanical breakdown occurring. For manufacturers' warranties this is fairly straight forward, but what happens with certified used warranties?

Technical Advice Memorandum (TAM) 201438022, issued late in 2014, addresses the differences between ESCs and warranties from the Internal Revenue Service (IRS) perspective. This TAM focuses on "Certified Used" supplements (supplements) versus ESCs. The IRS picked out several differences between the supplements and the ESCs. The supplements could not be unbundled from the vehicle. No vehicle with a supplement could be sold without the supplement, and no vehicle without the supplement could add it. ESC could be added to any purchase. The supplement was a part of the purchase price of the vehicle and was not separately stated or bargained for. ESCs prices were separately stated and could be negotiated. ESCs were cancellable, while the supplements could not be cancelled by the consumer or the dealership. ESCs excluded any failure covered under the manufacturer's warranty, while the supplement extended the manufacturer's warranty and included coverage for those failures. Supplements were tied to the brands, while ESCs could be attached to any vehicle.

Based on these facts, the IRS concluded that the supplements were warranties and were not insurance for tax purposes. They also concluded that the ESCs were insurance for tax purposes.

There are other types of F&I products that also should be considered in this discussion, including lifetime and limited warranties. Our colleagues in the industry are working to get a PLR clarifying the position of the IRS on

limited warranty products. Until there is more guidance, there is potential risk that these products could be treated as warranties for tax purposes.

The treatment for tax purposes is important because it dramatically impacts the after-tax results and profitability for the automobile dealer's reinsurance company referenced earlier. The reinsurance company doing ESC business can recognize related income over the life of the contract, set up and deduct reserves for claims, and if the company writes under $1.2 million in premium, make an election to be taxed only on its non-underwriting income. Income related to warranties is considered to be part of the sales prices of the product and is included in income at the time of the sale. No reserves are allowed for warranty claim expenses and there is no favorable company-level tax election. Additionally, if a contract is considered a warranty for tax purposes, any income and expense items related to that contract are treated as part of the non-underwriting income of the reinsurance company assuming that risk.

Automobile dealers can help manage this issue by planning the products they reinsure and sell through their F&I departments. They can look for products without warranty in the name, look for cancellable products which do not cover anything covered under the manufacturer's warranty, separately state the ESC price and the vehicle price, and watch for more industry updates on this issue.

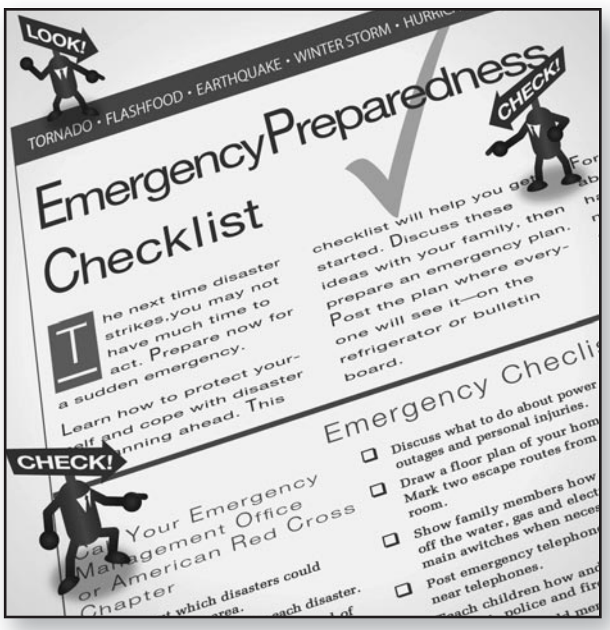
By: Elizabeth M. Barber, CPA, ACI

GPW and Associates, Inc. specializes in automobile dealer F&I focused captive and reinsurance management, and actuarial services all under one roof. E-mail info@gpwa.com

Keeping Your Business Running After a Disaster

Normally, when business owners think about the effects of a disaster, they envision large catastrophic disasters that affect an entire region. There are many disasters or events, however, that could severely affect your business ranging from power outages to fire to terrorism to large-scale natural disasters. We recommend that each of our clients develop a comprehensive business continuity plan to ensure that they are prepared to reopen their doors after a disaster.

The first step in creating a comprehensive disaster plan is to assign a team the responsibility of putting the document together. This may sound like common sense, but the makeup of your team will be vital to the effectiveness of your disaster plan. The different departments in your dealership will likely have varying requirements to open for business, and the people involved in these departments will obviously have the best handle on what it takes for the department to be open for business. Be sure to include a dealership executive to lead the group.



After establishing your group, put them to task identifying varying levels of disasters and then developing plans to keep the dealership open after they have occurred. It might make sense for your dealership to prioritize services following a disaster as some larger disasters may impact your service department. Indeed, your customers' automobiles will need to be repaired following a disaster.

Of course, coordination may be impacted depending on the type of disaster. A power outage, for example, probably does not need much coordination to overcome. A larger disaster, such as a hurricane or tornado, could require you to contact employees to let them know what the business's plans are. Furthermore, the disaster could actually compound the coordination issues that would exist. If the region's phone service is affected, communicating with your staff would become more difficult.

Speaking of phone service, ensure that your team realizes that communication will likely be one of the most vital and possibly most challenging parts for your organization following a disaster. If the scope of the disaster is regional, you could find yourself without landlines for some time and likewise for cell phone service. It is a good idea to query your employees regularly for up-to-date contact information, including phone numbers, e-mails and a secondary phone number to ensure that you can keep in touch with them following a disaster. Be sure that you store a copy of this information somewhere that is outside of the dealership but still accessible in a disaster should you need it.

Make sure that your dealership plans for a way to back up your data. Backing up data on-site, or even in the region, may not be a good idea as disasters that affect the region could also affect your backup center. There are a number of options for backing up your company's data, and the professionals at our firm can make recommendations to you on ways to guarantee your data is safe.

While you are developing plans to keep your business running in a disaster, it probably makes sense to review your insurance coverage as well. Guarantee that you have a good handle on the risks for which you are covered. This will be vital to ensuring that your business is well prepared for any disaster. Additionally, you may find that you need to obtain other coverage to keep your business protected.

The professionals at our firm can help you develop a business continuity plan. Please call us for more information.

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Profit Drivers has been created to serve your needs. We are available to answer any questions you have regarding your business or personal affairs. If there are topics you would like to see covered in ***Profit Drivers***, please let us know.