DEFENDER
THE NADC NEWSLETTER

Income taxes and Related Finance Companies

Jeffrey Ingram

Jeffrey Ingram

Many franchise dealers, in an increasingly competitive market, have become interested in expanding their business model to increase profitability. With tightening credit markets, dealers are also seeking ways to be able to finance more purchasers. One way that many dealerships are increasing their profits and expanding financing is through the operation of a buy-here/pay-here dealership either as part of their existing dealership or in a related corporation.

As with many things, the way in which such an operation is structured can have significant tax implications. The tax implications may be the main factor in determining how to structure a buy-here/pay-here operation. One important consideration which should be taken into account is whether the dealership should operate as a traditional buy-here/pay-here dealer or as a dealership with a separate but related financing company.

An important difference between these two types of operations is in the payment of income taxes. An automobile dealership cannot operate on a cash basis for income taxes. It must use the accrual basis. Because of this, a dealership must immediately recognize as income the full sales price of a vehicle even if that price is not collected in full at the time of sale.

In a typical franchise dealership operation a sale may not create significant income tax differences whether the cash or

continued on page 4

Sidebar

Contents:

The Attorney Fee: A Dealer's Greatest Exposure — Part 2

Johnnie Brown

Johnnie Brown

Part 1 of this article appeared in last month's issue of Defender.

IV. How to attack excessive attorney's fees

This new sword that we and our dealer clients face requires us to approach consumer litigation differently. Defense counsel cannot take the normal approach of deposing everyone with relevant knowledge and serving voluminous discovery before evaluating the case for our clients. Fee-shifting statutes require quick attention and a streamlined approach to the evaluation of any case. Some practical suggestions follow.

Public policy

Any attack on a fee petition should advise the court on the public policy behind the award of attorney fees and the potential abuse that can result from such fee petitions. While fee-shifting is intended to provide access to the judicial system, the goal is clearly not simply to put money into the pockets of attorneys. On the contrary, outrageous fee requests fly in the face of public policy concerns.

The purpose of fee-shifting statutes is to ensure effective access to the judicial process. *See Hensley v. Eckerhart*, 461 U.S. 424 (1983). They "…were never intended to produce windfalls to attorneys…" *See Farrar v. Hobby*, 506 U.S. 103 (1992). The United States Court of Appeals for the Sixth Circuit in discussing fee-shifting

continued on page 3

President's Message

Michael Charapp

Death of a Salesman

No, Arthur Miller is not this month's guest columnist. But his use of a salesman as the central character of the well-known play, with his soured dreams of wealth and success, is important to this month's column.

The value of salesmanship is misunderstood. As a result, salespeople are generally poorly portrayed – like Willy Loman, or the prototypical used car salesman in his ill fitting suit and loud tie, or the insurance salesman whose pitch Woody Allen's character in 'Take the Money and Run" was sentenced to endure.

We've heard about the coming irrelevance of car dealers for years. This is a theme of no small interest to the members of NADC since we have, to a greater or lesser extent, tied our careers to the continuing relevance of car dealers.

We've heard all the smug criticisms. The car business is a dinosaur. With everyone having access to the internet, buyers will simply do all their shopping online to avoid the oppressive sales process in dealerships. They will happily visit web retailers of their choosing, the argument goes, and pick exactly the vehicle they want at the lowest possible price.

I don't think so.

Online retailers have had great success, but there are a number of reasons why brick and mortar car dealers have been able to withstand the onslaught. Customers do their research online, but they still want to touch, smell, drive, and experience a new car. Dealers have adapted and have learned to use the internet. They have heard the criticisms of the sales process and have worked to make it less painful for buyers.

But there is a more important reason, in my humble opinion. Brick and mortar car dealers are the home of salesmanship. And salesmanship will always be critical to success.

Nonsense, you say? Think about it from our everyday experiences. We are in the midst of a hotly contested national political campaign. What are the candidates doing daily? Selling – their ideas, their policies, themselves. From an even more personal angle, what are we, the legal professionals, doing on a daily basis? Selling – our client's case to a jury, our client's position in the transaction we are negotiating, even the need for our services. You get the point.

When I was in the car business, I had a successful salesperson tell me that his success was due to his ability to help people understand what they really want. At the time, I remember thinking how self delusional he was. I knew he was successful because he was able to get customers to buy what made him the most money.

But I was the one who was delusional. The more time I spent with successful salespeople, the more I realized how critical they are to the car business. We all know the other side -- the occasional stories of customers who are mismatched to their purchases. We know those stories because those are the deals that go bad that we tend to see.

In fact, however, a successful salesperson sells cars because he or she does help customers understand what they really want – cars they can afford, or rides that feed their egos, or wheels that they dream make them more attractive to the opposite sex. And that is why car dealers will continue to be relevant. You can't get that kind of service on the internet.

We, the members of NADC, have many reasons to be proud of our association. We've just completed our 4th annual meeting and conference. We have a solid organization based on a growing and active membership willing to share their experiences and learning with their peers. We are poised to pursue success into the future. And we have a bright future because, to paraphrase another literary giant, Mark Twain, the death of car dealers – and of the salespeople who are integral to their success -- has been greatly exaggerated.

Michael Charapp, President of the NADC, is a partner with Charapp & Weiss, LLP in McLean, VA.

The NADC website www.dealercounsel.com is an importaqnt source of information for members:

- *Member Directory, searchable by name, firm, state, area of interest and dealership type*
- *List Archive, a collection of messages shared by those members who sign up for the List Serve*
- *Events, conference information and downloadable materials from conferences and workshops*
- *Banners that link to associate member websites for information on products and services*
- *Forum, an online discussion of timely issues*
- *Those wishing to apply for membership will find an online application*

www.dealercounsel.com

Attorney Fee ... from page 1

statutes put it well by stating:

> "Congress intended to provide an economic incentive for the legal profession to try meritorious cases defining and enforcing statutory policies and constitutional rights in a variety of fields of legal practice. Congress did not intend that lawyers, already a relatively well off professional class, receive excess compensation or incentives beyond the amount necessary to cause competent legal work to be performed in these fields. Legislative history speaks of "fees which are adequate to attract competent counsel, but which do not produce windfalls…."
> *Coulter v. Tennessee*, 805 F.2d 146, 149 (6th Cir. 1986).

The Sixth Circuit also noted in Coulter that the fee-shifting statutes reviewed used the words "reasonable" fees not "liberal" fees. *Ibid.*

The product of reasonable hours times a reasonable rate does not end the inquiry. *Hensley v. Eckerhart*, 461 U.S. 424 (1983). There remain other considerations that may lead the court to adjust the fee upward or downward, including the important factor of the results obtained. *Ibid.*

An Arizona court has stated:

> This Court is somewhat troubled by the trend in American courts in abandoning the lodestar method in favor of a percentage based formula as advocated by Professor Silver and Class Counsel. The Court disagrees with the viewpoint that the application of the lodestar method is fatally flawed and that the application of ethical rules, such as our own ER 1.5 tend to violate the due process rights of class members. The one thing that the percentage-based formulas do, is make the work of the judge easier. The judge is not compelled to scrutinize the billing rates of counsel, or what genuinely constitutes a reasonable and fair award of fees, taking into consideration such factors as counsel's actual investment of time in the case, the novelty and difficulty of the issues involved and the skill requisite to perform the legal services properly. This Court believes that the abandonment of the lodestar methodology in favor of a market approach which is largely founded in fiction, particularly in a novel case such as the one at bar, is inappropriate.
> *Ladewig v. Arizona Dept. of Revenue*, 63 P.3d 1089 (A.Z. 2003)

Use of state statutes and mediation

Over the last 10 years, court-ordered mediation has become commonplace, and battles continue over the enforceability of arbitration provisions. Why not include among the dealer's closing documents a simple agreement to mediate consumer complaints before a lawsuit can be filed? I believe that agreements to mediate do not face the same arguments as arbitration and provide the consumer an avenue to communicate concerns to a perceived independent third-party.

Another avenue that a limited number of states, such as Ohio, Virginia, and my state, West Virginia, have implemented is a statutory requirement that the consumer gives the dealer an opportunity to cure the problem before any suit can be filed based upon consumer protection laws. In West Virginia, before a consumer can file a lawsuit alleging violations of our consumer protection statute, a consumer must notify a dealer in writing of the claim and give the dealer the opportunity to offer a settlement. Within 20 days, the dealer must advise the consumer in writing of the "cure offer" to the claim. The consumer then has 10 days to accept or decline. Should the consumer proceed to trial, the "cure offer" statute has some teeth. First, the dealer is allowed to show the cure offer to the jury in contrast to the usual inadmissiblity of settlement negotiations. Second, if the

continued on page 6

Income taxes ... from page 1

accrual method is used. For example, a dealership sells a vehicle for $20,000 taking $2,000 down and financing $18,000. The dealership immediately assigns the retail installment contract and receives $18,000. It has received $20,000 and must pay income tax on that full amount (less any appropriate deductions). This transaction at a buy- here/pay-here dealership is much different.

If a buy-here/pay-here dealer makes the same sale, i.e. sells a vehicle for $20,000 taking $2,000 down and financing $18,000, instead of assigning the retail installment contract, the dealership holds the contract. Because of this, the dealership collects only $2,000 at or near the time of the sale. Even though the dealership has collected only $2,000 it must still pay income tax based on the full sales price of $20,000 (less any appropriate deductions) as if all of that amount had been collected. This results in the dealership being taxed on cash not yet, and maybe never, received.

How does a related finance company affect this situation? In a dealership with a related finance company, the example would work in this fashion. The dealership still sells the same vehicle for $20,00 taking a $2,000 down payment and a retail installment contract obligation for the remaining $18,000. The dealership immediately assigns the retail installment contract to the related finance company. To keep the comparisons consistent, we will assume that the related finance company pays $18,000 for that contract. In this case, the dealership is treated no differently than the first example, i.e. it has received $20,000 and pays income tax on that amount. The related finance company, unlike the dealership can operate on a cash basis and report income as payments are actually made.

The true power of a related finance company becomes apparent when the facts are changed somewhat. If instead of paying the full face value of the retail installment contract, i.e. $18,000, the related finance company buys the contract at a discount, $12,000 for example, the dealership's income tax obligation is significantly reduced. In this example, the dealership effectively pays income taxes on $14,000 consisting of the $2,000 down payment and the $12,000 received for the retail installment contract. The related finance company, if it collects the note in full, will end up with a higher income level and therefore increased income taxes but those taxes will come in later years if, and only if, payments are actually received. This results in significant, immediate income tax deferrals.

As you might guess, the Internal Revenue Service has recognized the potential for abuse in this type of arrangement. Because of this the IRS issued a New Vehicle Dealership Audit Technique Guide for Related Finance Companies. That Guide provides significant help in determining how to structure this arrangement so as to maximize your client's income tax advantages while minimizing its risks with the IRS.

The IRS acknowledges that there are valid business reasons for having a related finance company. Using a related finance company separates sales and collection functions and allows personnel in the two entities to focus their efforts. A related company, because it has closer contact with the customer, may be able to offer lower financing rates. Because the dealer has control over the financing company's collection efforts, the dealer may also be able to avoid negative publicity that might otherwise arise from overly aggressive collection efforts.

If your clients decide to form a related finance company, they must be careful in how it is formed and operated. It must truly be a separate entity and must operate as a separate entity. A valid structure should ensure that: 1) title and retail installment contracts are actually transferred from the dealership to the finance company; 2) the discount applied to acquire the retail installment contract is a fair market value discount; 3) there is a fair dealer agreement between the two entities; 4) the retail installment contracts are sold without recourse as to the credit risk; 5) the dealership does not take part in any collection activities; and, 6) the related company is adequately capitalized and maintains its own books, bank account and address. To insure that the related finance company truly operates as a separate entity, the IRS has its agents look at a number of factors. You should look at those same factors and determine if the related finance company:

Is a separate legal entity from the dealership;

Meets all state licensing requirements;

Maintains proper business licenses;

Complies with title and lien holder laws;

Has adequate capital to purchase the notes;

Has its own address and operates from separate facilities;

Maintain its own books separate from the dealership;

Has its own phone number;

Has its own employees;

Compensates its employees directly;

Pays its own expenses;

Maintains its own bank accounts separate from the dealership;

Pays the dealership for the contracts at the time of purchase;

Has a written dealer agreement with the dealership;

Handles its own repossessions or uses a company it hires to perform repossessions;

Has a true business purpose; and

Investigates items such as the borrower's credit history, length of the note, age of the vehicle, and payment history prior to determining the value of the note.

You should also be sure that the lien holder listed on the vehicle titles is the related finance company, not the dealership and that the customer is notified that the retail installment contract has been sold. It can also be helpful if the related finance company purchases contracts from other dealers or if the dealership sells contracts to other finance companies. Finally, the dealership and finance company should be able to support the discount based on actual experience or in comparison to discounts charged by other financing sources.

If set up correctly, a related finance company can result in significant income tax savings for a dealership. It is worth the time and money up front to be sure that the entities are set up correctly. A little money spent now can result in significant long term savings.

Jeffrey Ingram, a member of NADC's Board of Directors, is a Shareholder with the firm of Galese & Ingram, P.C. in Birmingham Alabama.

Associate Members

ADP Dealer Services - Dealer Office Xpress
Association of Finance and Insurance Professiona
AutoStar
BLC Associates Inc.
Capital Automotive REIT
CNA National Warranty Corp.
Compli
Counselor Library.com, LLC
Crowe Chizek & Company LLC
Dixon Hughes PLLC
G W Marketing Services
gvo3 Consulting, LLC
MD Johnson, Inc.
National Arbitration Forum
National Business Brokers, Inc.
O'Connor & Drew, PC
Regional Acceptance Corporation
Reynolds and Reynolds
The Fontana Group
Wolters Kluwer Financial Services

Associate Member Spotlight: BLC Associates

At BLC Associates, our focus is on delivering the most comprehensive auto finance consulting services available and assisting you in protecting your client's interests. Our firm has more than 25 years of experience in the consumer vehicle lending and leasing industry and has worked with state and federal regulators, dealers and finance companies on various auto finance and lease disclosure issues.

BLC Associates has assisted a variety of auto dealers and law firms on Reg M and Reg Z compliance issues, including class actions and civil suits related to negative equity, contract back-dating and APR disclosures.

Additionally, our firm has worked with dozens of financial institutions and dealerships in developing auto financing and leasing programs including full-spectrum lending and lease-here-pay-here programs. Let us help you identify and resolve the auto finance issues affecting the dealers you are representing.

www.blcassociates.com

Attorney Fee ... from page 3

jury's award of actual damages is less than the amount offered as a cure offer by the dealer, the West Virginia statute specifically prevents plaintiff's counsel from recovering any fees or costs after the date of the cure offer.

Use of offers of judgment

After a quick and as thorough as possible analysis of your facts, offensively use an Offer of Judgment. Before extensive discovery is undertaken, we should consider making an aggressive offer of judgment to place pressure on the plaintiffs to settle the case. Although your state may vary, in most jurisdictions, I would recommend that an offer be made for a sum certain plus reasonable fees and costs. Drafting the offer of judgment in this manner, insures that the awarded damages, if any, can be easily compared with the offer of judgment.

Rule 68 of the Federal Rules of Civil Procedure states that if the consumer's award is less than the amount offered, the defendants will be entitled to their costs incurred after the offer of judgment was made, and some courts have even interpreted "costs" to mean attorney fees. What Rule 68 does not say is that if the jury's award is less than the offer of judgment, the plaintiff's attorney fees are stopped at the time of the filing of the offer of judgment. I would argue they should be. Why should the defendant have to pay for fees and costs made after the Offer of Judgment if a jury later determines that the previously filed offer was making the consumer whole? How did the attorney fees and costs benefit the plaintiff after that point in time?

In deciding how aggressive to be with your offer of judgment, you should consider whether your jurisdiction will add prejudgment interest to the jury's award of actual damages. A two, or even three, year wait can add significant value to the ultimate award that you are trying to exceed with your offer of judgment.

Attacking the "reasonable fee"

If possible, attack the hourly fee requested. In most Courts, the plaintiff's attorney must submit an affidavit stating how much a reasonable hourly rate is. A defendant can submit affidavits from attorneys in the community stating their hourly rates for similar work. I suggest that you have your affidavits affirmatively state that plaintiff's rate is unreasonable rather than asserting what is a reasonable hourly rate. In other words, make your affidavits on this issue specifically and factually address plaintiff's requested rate, not just generically speak to what a reasonable rate is in the community.

Attacking reasonable hours expended

Defense counsel can attack the number of hours that have been alleged by the plaintiff's attorney. First, an argument could be made that the number of hours includes ineffective or duplicate hours. Defense counsel can argue that plaintiff's attorneys spent excessive hours conferencing or sending more than one person to a deposition. However, these arguments must be supported by evidence and cannot be based on condescending opinions. The defense must demonstrate to the court that the additional hours spent did not contribute to the benefits gained by the plaintiff. *See Chin v. DaimlerChrysler Corp.*, 2007 WL 1437705, 11 (D.N.J. 2007).

Another example is excessive or multiple attorneys billing for the same time spent during litigation. *See Buckhannon Bd. And Care Home, Inc. v. West Virginia Dept. of Health and Human Resources*, 532 U.S. 598 (2001). Defense counsel can bring into evidence the billing records and provide evidence that many attorneys were present at the same time while only a few of these attorneys actually provided any tangible benefit.

Other arguments can be made that the plaintiff's attorneys have reported duplicate hours for researching, reviewing and revising documents. Last, most plaintiff's counsel does not keep time as diligently as defense counsel. Use this to your advantage. There exist numerous reported decisions in which the courts have systematically cut fee petitions by 25% or more because of the lack of documentation by plaintiff's counsel. Remember, the burden is on the plaintiff to prove what was reasonable and necessary.

On the other hand, do not be cavalier during this process. Should plaintiff's counsel prevail, he will probably be able to collect for his fees and costs incurred during the fee litigation, which can sometimes be more combative than the underlying case. Expect that if you challenge the hourly rate and hours expended of plaintiff's counsel, that your billing records will be subjected to review also by plaintiff's counsel and the Court.

Conclusion

The fee-shifting provisions in Consumer Protection Statutes have given the public access to the courts for claims that seek very small damages for which they would otherwise have a difficult time finding an attorney to represent them. Although this has benefited the general public, the attorneys who take these cases have been given a free pass to charge unreasonable rates at the expense of the defendant. In reality, the fee-shifting provisions have caused the defendants their greatest exposure.

Johnnie E. Brown, a member of NADC's Board of Directors, is an attorney with Pullin, Fowler, Flanagan, Brown & Poe, PLLC, Charleston, WV.

New Members

NADC welcomes the following new members:

Fellow Members

Chris W. Costello
JM&A Group
Deerfield Beach, FL

Paige S. Fitzgerald
Troutman Sanders LLP
Richmond, VA

Elizabeth B. Shirley
Burr & Forman
Birmingham, AL

David I. Rubin
Harrison & Moberly
Indianapolis, IN

Associate Member

Diane Anderson
Murphy Moss Adams LLP
Seattle, WA

4th Annual Member Conference Held

Speakers at the 4th Annual Member Conference encouraged questions and comments assuring lively dialog right up to the closing moments. The following examples give a flavor of what was heard at the conference.

Compliance was the topic of the opening session that began with a lively presentation of the worst in auto advertising. "False advertising works, but obviously the risk is too great," said Rob Cohen, Auto Advisory Services, Inc. "Cap the doc fee at a number you can justify," advised Tom Hudson, Hudson, Cook, LLP.

Len Bellavia, Bellavia, Gentile & Associates, LLP, and Rich Sox, Myers & Fuller, PA led the discussion of franchise relations and how dealers can maintain control in negotiations with manufacturers.

Andy Koblenz, NADA, remarked that how we handle climate change and fuel economy is "the definitive public policy of our time for the auto industry." He reviewed regulatory issues affecting the topic. Co-presenter, Eric Chase, Bressler, Amery & Ross, PC, followed with predictions of what dealers can expect from manufacturers in the coming year.

Patricia Griffith, Ford & Harrison, referred to labor law as being "the divorce law of the workplace," and told attendees to "be sure your client has a good story to tell" and gave advice on how to do that. Jerry Coker, Ford & Harrison, followed with a discussion of labor union activity in dealerships.

Red Flag Rule compliance is required by November 1, 2008, and that and other identity theft issues were the topic of a panel consistiong of Mike Charapp, Charapp, & Weiss; Michael Benoit, Hudson Cook, LLP; and Paul Metrey, NADA.

John Gentile, Bellavia Gentile & Associates, discussed bankruptcy as a method of protection for dealerships threatened with manufacturer termination.

Andrew Weill, Benjamin, Weill & Mazer, described the efficacy of affiliate reinsurance programs. Lively discussion punctuated his presentation.

Presentations and handouts are available after log-in on the events page at www.dealercounsel.com.

There were 132 attendees and, according to comments made on the evaluation sheets, they found the presentations timely and informative.

Following the conference, attendance rosters were submitted to the appropriate states for continuing legal education credit..

NADC
NATIONAL ASSOCIATION OF DEALER COUNSEL
Volume IV, Number 4
April, 2008
Rob Cohen, Editor
rob.cohen@autoadvisory.com
Trudy Boulia, Assistant Editor
tboulia@harveyandmumford.com
Defender, The NADC Newsletter is published by the National Association of Dealer Counsel
7250 Parkway Drive, Suite 510
Hanover, MD 21076
410-712-4037
Fax 410-712-4038
www.dealercounsel.com