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DEFENDER

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From Parts Markup to Surcharges: An Overview of Trends in Warranty Rate Reimbursement Legislation and Litigation

By Donald W. Gould II and Andrew Sharenson, *Johnson DeLuca Kurisky & Gould, P.C.*


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Most auto dealers have become accustomed to the annual ritual of sequestering the controller or service manager to perform the daunting task of submitting a warranty reimbursement rate increase request to the manufacturer. This is often a difficult and contentious process that has given rise to a cottage industry of consultants and law firms promising to help dealers prevail in warranty reimbursement rate disputes with the manufacturer. Dealer gains on rights to receive rate increases for parts in addition to the labor rate have resulted in litigation and legislation on manufacturer attempts to recoup the increased warranty expenses with surcharges on new vehicle invoices. This article will examine the development of reimbursement rights for parts and how courts and legislatures have responded to manufacturers' attempts to recoup the extra costs through surcharges on new vehicle invoices.

Since the 1970s, a number of states' franchise laws have been amended to regulate the rates manufacturers reimburse dealers for warranty work to ensure that dealers are not forced to do warranty work for manufacturers at deeply discounted rates. Questions over whether these laws covered the markup for parts in addition to the labor rate have caused a strong majority of jurisdictions to amend their franchise laws to expressly require manufacturers to reimburse dealers for parts at a comparable retail rate. This has been a significant victory for auto dealers, because most manufacturers arbitrarily set their parts markup rate at 40% when the comparable retail rate is frequently twice as much or more. But, manufacturers have responded by charging warranty recovery surcharges on the invoice for new vehicles. This has resulted in a new round of legislation and litigation as dealers seek to prohibit these surcharges.

Most of the franchise laws originally addressed the issue of warranty reimbursement rates by requiring manufacturers to pay a rate comparable to the market rate or retail rate for comparable non-warranty repairs. The problem

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was that the statutes did not expressly state whether the reimbursement rate applied to both the labor rate and parts rate.

In *Kronon Motor Sales, Inc. v. Ford Motor Co.*, 41 F.3d 338, 339–40 (7th Cir. 1994), the court reviewed the Illinois statute that required the manufacturer to "adequately and fairly compensate each of its motor vehicle dealers for labor and parts." The statute further elaborated:

> In the determination of what constitutes reasonable compensation ..., the principal factor to be given consideration shall be the prevailing wage rates being paid by the dealers in the relevant market area in which the motor vehicle dealer is doing business, and in no event shall such compensation of a motor vehicle dealer for warranty service be less than the rates charged by such dealer for like service to retail customers of nonwarranty service and repairs."

Id. The court held that the lack of any reference to "parts" when defining "reasonable compensation" indicated that the legislature did not intend to require the manufacturer to adjust the rate for parts to reflect the market rate. Similarly, in *Brandon Chrysler Plymouth Jeep Eagle, Inc. v. Chrysler Corp.*, 898 F. Supp. 858, 862–63 (M.D. Fla. 1995), the court also held that the statute only applied to the labor rate because Florida's statute did not specifically state that it applied to parts. Instead, the statute only stated that "reasonable compensation" shall be paid to the dealer for "warranty repairs or service," and shall not be "less than the amount charged by the dealer for like work to retail customers for nonwarranty repairs or service". *Id.*

Fortunately, both the Illinois and Florida legislatures disagreed with the court's interpretation and amended the franchise statutes to expressly state that the manufacturer must reimburse the dealer for parts at the retail or market rate.[1] Twenty three jurisdictions followed Illinois and Florida's lead by amending their franchise laws to make it explicit that parts rates must be included and include a specific methodology to determine the retail rate for parts.[2] The total number of jurisdictions, including Florida and Illinois, that expressly include the parts rate will rise to twenty six this fall when recent legislation in Colorado goes into effect that will also expressly require manufacturers to pay the retail rate for parts.[3] Fifteen jurisdictions have franchise laws that explicitly require the manufacturer to pay the retail rate for parts, but do not set forth a specific methodology for determining the retail rate.[4] A small minority of jurisdictions leaves the issue for negotiation between the manufacturer and dealer, but set a statutory minimum markup that a manufacturer cannot go below.[5]

A few jurisdictions have not updated their statutes and stand about where Illinois and Florida stood in the 1990s when courts held that the statutes did not cover the parts rate because it was not specifically addressed in the statute. Kansas requires "reasonable compensation" for warranty work but does not define the term and does not state whether parts rates are included.[6] South Carolina requires manufacturers to "fairly and adequately" compensate dealers for parts and labor, but does not provide any further definition or process to determine what is fair and adequate. Maryland and Alaska have no specific statutes on warranty reimbursement rates.

And then there is Texas. Texas would seem to be leading the nation in protections for dealers as the statute defines "warranty work" as including parts and labor and requires manufacturers to pay an amount at least equal to the retail rate for similar nonwarranty work.[7] Texas even sets forth a methodology and procedure for requesting an adjustment of the labor rate and protesting the failure of the manufacturer to honor the request.[8] But the statute in Texas does not set forth a methodology and procedure for requesting an adjustment of the parts rate. Manufacturers have interpreted this as a purposeful omission and argue that Texas dealers cannot protest their parts rate under the statute. Dealers argued that the statute is unambiguous in that the definition of warranty work includes parts and the statute expressly states that dealers must be compensated for parts at the retail rate. No Texas dealer has pursued a protest on the parts rate all the way to a ruling before the Texas Department of Motor Vehicles. Also, dealers have spent most of their time at the legislature dealing with Tesla's efforts to repeal the state's franchise laws and have not put this issue before the legislature. As such, this issue has not been resolved in Texas.

In direct response to the additional costs imposed by the requirement to reimburse dealers for parts at the retail rate, several manufacturers have introduced a warranty cost recovery surcharge as an extra line item on the invoice for new vehicles. Dealers have responded with litigation and legislation.

In Maine and New Jersey, dealers challenged manufacturer surcharges as violating the franchise laws' requirement that the manufacturer reimburse the dealer at the retail rate. Dealers argued that the surcharges violated the statutes by allowing the manufacturers to avoid paying the retail rate. In both cases the dealers lost on the grounds that nothing in the warranty reimbursement rate statute expressly regulated the charges a manufacturer could include on its invoices.[9] In Illinois, however, the statute does allow the manufacturer to recover the increase warranty costs if it enters into an express written contract to establish a uniform warranty reimbursement policy with the majority of its franchisees in the state.[10] Dealers prevailed in an action against Nissan when the manufacturer assessed a surcharge without entering into the required agreement with a majority of its franchisees.[11]

Maine's legislature responded by amending the statute to expressly bar manufacturers from recovering its costs for reimbursing dealers under the statute.[12] Florida, North Carolina, Virginia, Connecticut, and West Virginia have also amended their franchise statutes to expressly bar manufactures from uses surcharges to recover any part of their warranty reimbursement costs.[13]

Of course, the manufacturers have tried to fight back and have challenged both the warranty reimbursement requirements and surcharge prohibitions on constitutional grounds. So far, the manufacturers have not prevailed.[14] While it appears that manufacturers efforts to set aside the warranty reimbursement statutes in the courts has subsided, there may be future battles in the state legislatures as most jurisdictions do not have express prohibitions on surcharges.

Dealer counsel, be aware of trends in the legislatures, courts, and administrative proceedings as these issues are currently evolving. Due to Tesla's efforts to repeal state franchise laws, there is a concerted effort to push back against state franchise laws that benefit car dealers that could potentially sweep up warranty reimbursement provisions.[15] It is already a challenge to guide dealers through the many requirements of the warranty reimbursement statutes, the extra steps that many manufacturers require to request a rate increase and the pitfalls of upsetting the manufacturer/dealer relationship by pursuing a protest. But if dealers, their counsel, and state dealer associations are not vigilant, there could be significant reversals of recent gains. ■

References

1. *See* 815 Ill. Comp. Stat. Ann. 710/6 ("For the purposes of this Section, the 'prevailing retail price charged by that dealer for the same parts' means the price paid by the motor vehicle franchisee for parts, including all shipping and other charges, multiplied by the sum of 1.0 and the franchisee's average percentage markup over the price paid by the motor vehicle franchisee for parts purchased by the motor vehicle franchisee from the motor vehicle franchiser and sold at retail."); Fla. Stat. Ann. § 320.696 (requiring parts to reimbursed based on the average of retail sales absent an agreement between the manufacturer and the dealer).

2. *See, e.g.,* Ariz. Rev. Stat. Ann. § 28-4451; Conn. Gen. Stat. Ann. § 42-133s (basing retail rate on one hundred sequential nonwarranty parts purchased); Del. Code Ann. tit. 6, § 4903 (same); Ga. Code Ann. § 10-1-641; Haw. Rev. Stat. Ann. § 437-56; Idaho Code Ann. § 49-1626; Ind. Code Ann. § 9-32-13-15.5; Ia. Code § 322A.5; Me. Rev. Stat. tit. 10, § 1176; Mass. Gen. Laws Ann. ch. 93B, § 9; Neb. Rev. Stat. Ann. § 60-1438; N.H. Rev. Stat. Ann. § 357-C:5; N.M. Stat. Ann. § 57-16-7; NY Veh. & Traf. Law § 465; N.C. Gen. Stat. Ann. § 20-305.1; Okla. Stat. Ann. tit. 47, § 565; Or. Rev. Stat. Ann. § 650.158; 63 Pa. Stat. Ann. § 818.9; Va. Code Ann. § 46.2-1571; Vt. Stat. Ann. tit. 9, § 4086; Wash. Rev. Code Ann. § 46.96.105; W. Va. Code Ann. § 17A-6A-8a; Wis. Admin. Code § 139.06. It should be noted that New York's statute refers to the prevailing market rate instead of the dealer's retail rate.

3. Col. Rev. Stat. § 44-20-141.5.

4. Ala. Code § 8-20-7; Ark. Code Ann. § 23-112-310 ("A manufacturer, distributor, distributor branch or division, or factory or division branch shall not pay to any of its motor vehicle dealers a labor rate per hour or parts price for warranty work that is less than that charged by the dealer to its retail customers . . . ."); Cal. Veh. Code § 3065; La. Stat. Ann. § 32:1262; Mich. Comp. Laws Ann. § 445.1577; Miss. Code. Ann. § 63-17-21; Minn. Stat. Ann. § 80E.04; Mont. Code Ann. § 61-4-204; N.J. Stat. Ann. § 56:10-15; Nev. Rev. Stat. Ann. § 482.36385; N.D. Cent. Code Ann. § 51-26-06; Ohio Rev. Code Ann. § 4517.52; 6A R.I. Gen. Laws Ann. § 6A-2-329; S.D. Codified Laws § 32-6B-61; Utah Code Ann. § 13-14-204; Wis. Admin. Code § 139.06; Wyo. Stat. Ann. § 31-16-117.

5. Ky. Rev. Stat. Ann. § 190.046 ("The compensation of a dealer shall not be less than the amount charged by the dealer for like services and parts, which minimum compensation for parts shall be dealer cost plus thirty percent (30%) gross profit, to retail customers for nonwarranty service and repairs, or less than the amounts indicated for work on the schedule of warranty compensation . . . ."); Miss. Code. Ann. § 63-17-211; Tenn. Code Ann. § 55-28-107; Wyo. Stat. Ann. § 31-16-117.

6. Kan. Stat. Ann. § 8-2415.

7. Tex. Occ. Code §§ 2301.22, 2301.402.

8. Tex. Occ. Code §§ 2301.402-03.

9. *See Acadia Motors v. Ford Motor Co.,* 44 F.3d 1050, 1057 (1st Cir. 1995); *Liberty Lincoln-Mercury, Inc. v. Ford Motor Co.*, 676 F.3d 318, 324 (3d Cir. 2012).

10. 815 Ill. Comp. Stat. Ann. 710/6(g).

11. *Nissan N. Am., Inc. v. Motor Vehicle Review Bd.*, 7 N.E.3d 25, 38 (Ill. App. Ct. 2014).

12. Me. Rev. Stat. tit. 10, § 1176 ("A franchisor may not otherwise recover its costs for reimbursing a franchisee for parts and labor pursuant to this section.").

13. Fla. Stat. Ann. § 320.696(6); N.C. Gen. Stat. Ann. § 20-305.1(b); Va. Code Ann. § 46.2-1571(B)5; W. Va. Code Ann. § 17A-6A-8a(3); Conn. Gen. Stat. Ann. § 42-133s(6).

14. *Alliance of Auto. Mfrs. v. Gwadosky*, 430 F.3d 30, 41 (1st Cir. 2005) (rejecting challenge constitutional challenges under the Commerce Clause and Contracts Clause to Maine's surcharge prohibition); *Alliance of Auto. Mfrs., Inc. v. Currey*, 610 Fed. Appx. 10, 14 (2d Cir. 2015), *cert. denied* 136 S. Ct. 1374 (2015) (upholding dismissal of constitutional challenge of Connecticut's anti-recoupment law). A challenge to Florida's statute survived a motion to dismiss, but it was later dismissed with prejudice by agreement. *See Alliance of Auto. Mfrs. v. Jones*, 897 F. Supp. 2d 1241 (N.D. Fl. 2012) (denying, in part, defendants' motion to dismiss).

15. *See, e.g., State Regulation of Warranty Payments: Special Interest Legislation Run Amok*, Daniel L. Goldberg, Samuel R. Rowley, January 19, 2016, available at https://www.ftc.gov/system/files/documents/public_events/895193/panel_2_-_goldberg.pdf; Neil Irwin, "Auto Dealers and State Legislatures Conspire to Make Cars More Expensive. Can Tesla Change That?" The Washington Post, May 14, 2013, available at http:/www.washingtonpost.com/blogs/wonkblog/wp/2013/05/14/auto-dealers-and-state-le; Jerry Ellig and Jesse Martinez, Mercatus Center at George Mason University, *State Franchise Law Carjacks Auto Buyers* (Jan. 2015), available at http://mercatus.org/sites/default/files/Ellig-AutoFranchise-MOP.pdf.

Mr. Gould is a Shareholder at Johnson DeLuca Kurisky & Gould P.C. in Houston, Texas. Mr. Gould devoted most of his practice to representing both public and private dealership groups. Mr. Sharenson is a Senior Counsel at the firm and practices almost exclusively in the auto dealership section of the firm.

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Executive Director's Message

Erin H. Murphy
NADC Executive Director

The NADC Fall Conference held October 6-8 in Chicago was by all accounts a great success! Attendees of the Fall Conference enjoyed a change in venue at the Four Seasons Hotel Chicago and eight informative, timely educational sessions as well as two in-house counsel breakout sessions. For the third time in a row, the conference piggybacked the ATAE Conference in an effort to accommodate folks attending both meetings. There were an outstanding 229 members in attendance . . . record breaking numbers for an NADC Conference!

NADC members who were not in attendance can benefit from the conference materials that have been uploaded to our website at www.dealercounsel.com. Please look under the "Discussions and Publications" section of the website under "Documents and Discussions" and please search "Conference Presentations". If you have questions, please contact Jennifer Polo-Sherk at jpolo-sherk@dealercounsel.com.

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- Requested length of time

Please check the website www.dealercounsel.com for more information and hotel reservation instructions in the "Upcoming Events" section. We look forward to seeing you at the Annual Member Conference! ■

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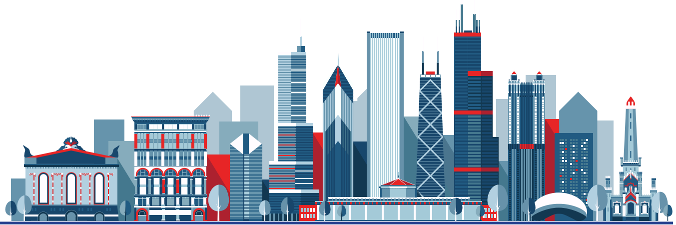

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Tax Reform: Excess Business Losses

By Jennifer Kobylarz, CPA, MST, Tax Services Team, *Rosenfield & Company, PLLC*

The Tax Cuts and Jobs Act ("TCJA"), passed on December 22, 2017, repealed the rule for excess farm losses under § 461(l) and replaced it with a rule for excess business losses. Whereas the previous rule limited the deductibility of farm losses by farmers who received certain subsidies, the new rule applies to all noncorporate taxpayers in all fields of business for tax years beginning after December 31, 2017 and before January 1, 2026. This limitation is for both active and passive businesses. Any excess business losses generated by a taxpayer will be disallowed in the current tax year and carried forward as a Net Operating Loss ("NOL") under the new NOL rules (discussed later) included in the TCJA.

The new rule appears to have been put in place as an "anti-tax-shelter" rule to limit the amount of business losses generated by sole proprietorships and other pass-through entities (*i.e.,* partnerships and S-corporations). Tax professionals have speculated that the motivation behind this new loss limitation may have been one or more of the following:

1. To prevent taxpayers from using business losses to offset nonbusiness income, including wages, interest, dividends, and capital gains;
2. To limit the tax benefit of 100% bonus depreciation; and/or
3. To limit the use of business losses to reduce income subject to the lower pass-through tax rates.

What are Excess Business Losses?

Prior to the passing of the TCJA, § 469 limited Excess Farm Losses for taxpayers who received certain subsidies. These losses were carried forward to the next tax year as deductions attributable to the farming business. Under the new law, the Excess Farm Loss Limitation no longer applies; rather, the law now imposes a limitation on Excess Business Losses ("EBL").

An EBL is the excess of a taxpayer's aggregate deductions for the tax year over the sum of the aggregate gross income or gain for the tax year plus the applicable threshold. The applicable threshold for a single filer is $250,000; the applicable threshold for a married filing joint ("MFJ") filer is $500,000.

To simplify it, a taxpayer cannot offset more than $250,000 (single) or $500,000 (MFJ) of non-business income with business losses.

Although business losses cannot be used to offset nonbusiness income (*i.e.,* wages, compensation, interest, dividends, etc.) in excess of the threshold, the wording of "aggregate deductions" and "aggregate gross income" indicates that the losses can be used to offset other profitable business ventures.

Thomson Reuters provided the following examples of EBL:

1. In 2018, T, a single taxpayer, has deductions of $500,000 from a business. T's gross income from the business is $200,000. T's excess business loss is $50,000 ($500,000 deductions – ($200,000 income + $250,000 threshold)). The $50,000 EBL is treated as part of the taxpayer's NOL carryforward in later years.
2. The facts are the same as example 1, except that T is married and files a joint return. T does not have an EBL because the aggregate business deductions do not exceed the $200,000 aggregate income plus threshold amount ($500,000 deductions – ($200,000 income + $500,000 threshold)).

Net Operating Losses

For an NOL incurred in tax years beginning before January 1, 2018, the rules under § 172 allowed for a two (2) year carryback or twenty (20) year carryforward of the loss. Additionally, there was no limitation on the amount of taxable income that the NOL could offset in the carryback or carryforward period. Under the TCJA, NOL carryforwards can no longer be carried back two years, but they can be carried forward indefinitely. Further, NOL deductions are now limited to 80% of the taxpayer's taxable income.

An EBL that is disallowed in the current year will be carried forward to the next year as an NOL carryforward. The EBL will be subject to the new NOL rules under TCJA.

Note that the EBL must be carried forward as an NOL even if the taxpayer has sufficient non-business income to absorb the business losses.

Since the EBL is carried forward as an NOL, the limitation is deferring the loss deduction until the next year that the taxpayer has taxable income (not necessarily business income). For example, assume a taxpayer has an EBL of $700,000 in year X. In year Y, the taxpayer has no EBL, taxable income of $750,000, and the NOL carryforward of $700,000 of EBL from year X. The taxpayer will have taxable income of $50,000 in year Y ($750,000 taxable income - $700,000 Prior Year NOL from EBL).

Unlike passive losses (which can only offset passive income), EBLs carried forward as NOLs are not limited to offsetting business income in the next year. Since the EBL carryforward falls under the NOL rules, the NOL can be applied against all types of income. However, any additional EBL in the next tax year would also have to be carried forward as an NOL.

Ordering Rules

The EBL limitation rules are applied at the shareholder or partner level, based on the shareholder's ownership interest or the partner's interest in the partnership.

Business loss limitations are applied in the following order:

1. Limitations based on the taxpayer's tax basis in the entity (*i.e.,* shareholder or partner basis);
2. At-risk limitations;
3. Passive activity loss limitations; and
4. EBL limitations.

The language of § 461(l) does not specifically address whether losses that are disallowed at the passive loss level are included in the EBL limitation calculation; however, based on how the other loss limitations are applied under the code, losses which are limited at the passive activity level are presumably excluded from the EBL limitation calculation (*i.e.,* losses disallowed at the at-risk level do not then get limited again at the passive loss level). The American Institute of Certified Public Accountants ("AICPA") wrote a letter to the IRS on August 13, 2018 requesting clarification and guidance on this limitation as well as how it will interact with other new code sections, such as the § 199A Deduction. Although there are areas of this limitation that need clarification, we are unlikely to see any guidance from the IRS on this issue this year. ■

Jenn earned her Bachelor's degree in Accounting and later her Master's degree in Taxation from the University of Central Florida. She started her career working for a major auto dealership which showed her a deep insight into the industry. Her family has deep roots in the automobile industry, so her passion and insight was already there. Jenn joined Rosenfield & Company in 2012 and has truly enjoyed the small firm environment while providing the level of service and resources of a major firm.

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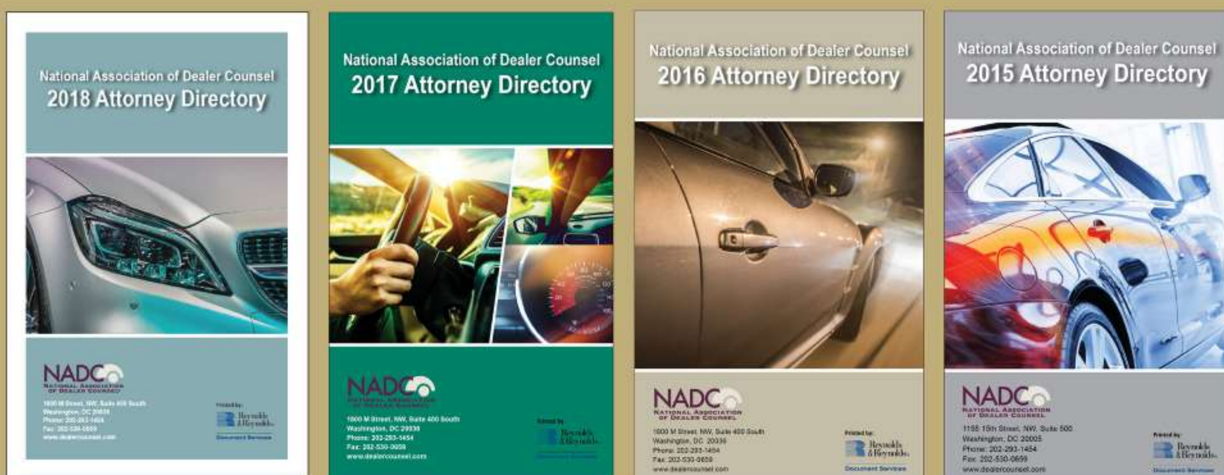

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