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INSIGHT

BY AXIOM ADVISORS & VVH CPAS AND ASSOCIATES

ADVANCES AND UPDATES IN THE PATH AND AFFORDABLE CARE ACTS – WHAT YOU NEED TO KNOW

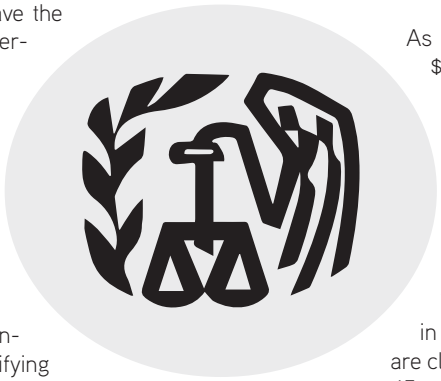
By Dan Flugrath, CPA, CFP

THE PATH ACT

Late last year, The "Protecting Americans from Tax Hikes" (PATH) Act of 2015 was signed into law. The Act includes provisions that created several important incentives for businesses and their owners.

This Income tax legislation provides welcome certainty for business and personal income tax planning. Now, businesses need not defer capital investment decisions, for fear they did not set aside sufficient funds for their income taxes. The PATH Act has made numerous provisions permanent and extended under the IRC Code.

We believe the following provisions are likely to have the greatest impact for automotive retail dealers, both personally and on their businesses.



BUSINESS EXTENDERS AND PROVISIONS MADE PERMANENT

179 Depreciation Expense

The PATH Act made permanent the $500,000 Section 179 expensing limitations. This will enable small businesses to expense up to $500,000 of investment in new or used equipment and other qualifying property, instead of having to depreciate the cost over the property's Class life. For tax years after 2014, taxpayers can revoke the section 179 without IRS consent.

In addition, for tax periods after 2015, the new law indexes both the $500,000 and $2 million limits for inflation, and clarifies that air conditioning and heating units may also be expensed.

Bonus Depreciation Extended Through 2019

The Act extends bonus depreciation for qualified property acquired and placed in service during 2015 through 2019. Eligible taxpayers will be able to claim bonus depreciation allowance for qualified property as follows:

Bonus Depreciation Allowance	Qualified Property Placed in Service Dates
50%	2015 through 2017
40%	2018
30%	2019

For new autos and trucks placed in service after December 31, 2014 and before January 1, 2018, the luxury limitations have been increased by $8,000. So, the available depreciation for cars and trucks placed in service for 2015 are $11,160 for cars and $11,460 for trucks, if used 100% for business.

These depreciation allowances, both section 179 and bonus depreciation, are important for automotive dealers, considering the significant capital needs required to run their businesses. With proper tax planning in conjunction with capital projects, a dealer can reduce taxable income through the use of these allowances.

As an example, a vehicle dealership that purchases $400,000 of machinery and office equipment during 2015 (or later years) could expense the amounts for tax purposes in the year spent using one of the depreciation allowances, depending on the dealership's current tax situation.

15-Year Write-Off for Qualified Leasehold and Retail Improvements

This provision is now permanent for property placed in service after 2014. Eligible, qualified Improvements are classified as 15-year MACRS, which can be written off over 15 years, which is a significant reduction to the otherwise 39 year life typical for these kinds of assets. Decreasing the period of write-off for property increases the amount of expense each year, thus decreasing taxable income.

A qualified leasehold improvement is any improvement to an interior portion of nonresidential real property if the following requirements are satisfied:

- The improvement is made under, or pursuant to, a lease by the lessee, lessor or any sublessee of the interior portion;
- The improvement is section 1250 property;
- The lease is not between related persons;
- The interior portion of the building is to be occupied exclusively by the lessee or any sublessee of that interior portion; and the improvement is placed in service more than three years after the date the building was first placed in service by any person.

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ADVANCES AND UPDATES IN THE PATH AND AFFORDABLE CARE ACTS – WHAT YOU NEED TO KNOW

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Portions of Qualified Real Property Can Be Expensed for Tax Years 2015 and Beyond

Up to $250,000 of Qualified Real Property (QRP) can be expensed, rather than capitalized and depreciated for tax purposes. QRP includes Qualified Leasehold and Retail Property.

This provision may be intriguing for a dealership that expands to another location, executes a 5-year lease on land and building from an unrelated party, receives approximately $250,000 of financial assistance from the manufacturer, and modernizes the interior portion of the property. In this instance, while the dealership should report the $250,000 manufacturer assistance as income, it can also elect to offset said amounts by expensing the interior improvements, using section 179 up to the allowable limits.

Energy Efficient Commercial Building Property Deduction

Deductions for energy efficient improvements to commercial buildings have been extended for property placed in service prior to January 1, 2017. The maximum accumulated deduction for improvements to a building is $1.80 per square foot.

30% Business Energy Credit

The Business Energy Credit is allowed for certain energy property placed in service on or before January 1, 2017. Eligible properties include fuel cell property, solar property and small wind energy property. For example, a solar water heater installed in a dealership would qualify for the 30% credit.

The 100% Exclusion of Gain on Qualified Small Business Stock

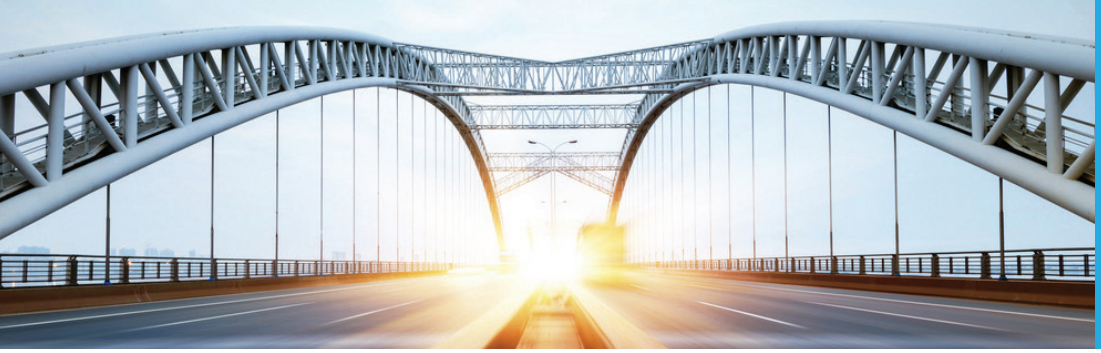
This exclusion is made permanent for tax years 2015 and beyond for non-corporate taxpayers. Qualified Small Business Stock is original issue of Stock in a C corporation whose gross receipts do not exceed $50 million, and conducts a Qualified trade or business. The shares must be original issued shares and held 5 years. Other restrictions apply.

Take this scenario, for example: three individuals each contribute $3 million to a regular C corporation to purchase a new dealership. The dealership leases the land and building by executing a 5-year lease with options to renew, and purchases the facilities after 5 years. The dealership pays out salaries to the individual owners for their living expenses. Eight years later, one of the owners decides to retire and sell their original shares in the dealership for $7 million, resulting in a $4 million gain. If all requirements of the IRC Section 1202 are met, this gain would be free of income tax.

The S Corporation Built-In Gain Recognition Period

This provision is made permanent with the PATH Act and provides for a recognition period of 5 years, versus the 10 year period of the original implemented legislation. This provision impacts corporate taxpayers who elected to convert to an S Corporation from a C Corporation, when the C Corporation had appreciated asset(s). If the appreciated asset is sold by the S Corporation within 5 years of making the S election, a corporate level tax will be imposed on the asset sale to the extent of the gain at the time of the S election.

For example, a dealership converts from a C Corporation to an S Corporation in 2012 and at the time of the conversion, there is land and a building with $100,000 of appreciation. In 2016, the dealership sells the land and building for a gain of $200,000. Because the sale occurred within 5 years



from the conversion, the dealership will be assessed additional corporate tax on $100,000, which is the amount the land and building had appreciated at the time of the conversion. If the dealership incurred a gain of only $60,000, then only that amount would be assessed the additional corporate tax.

Work Opportunity Tax Credit

Employers who hire eligible employees of qualified groups, such as unemployed veterans or individuals receiving federal assistance can claim a work opportunity credit on their business tax return. The work opportunity credit has been extended through 2019. The amount of the credit is generally 40 percent of the qualified worker's first-year wages up to $6,000. Certification of the eligible individuals will usually be required by your state unemployment agency.

Military Reservists

Eligible small business employers can claim a tax credit for up to 20 percent of the military differential wage payments it makes to the activated reservist through 2015. If one of your employees is called up to active duty and the employer pays the activated reservist, the US government will allow 20% of that additional pay as a credit to offset the employer's tax.

After 2015, the credit is made permanent, and its application also applies to large employers, in addition to small business employers.

PERSONAL EXTENDERS AND PROVISIONS MADE PERMANENT

The American Opportunity Tax Credit

The American Opportunity Tax Credit is now a permanent credit, which provides up to $2,500 in partially-refundable tax credits for post-secondary education. The credit phases out for single taxpayers making from $80k to $90k, and for joint filers from $160k to $180k.

Election to Deduct State and Local Tax vs. General Sales Tax Deduction

The election to deduct state and local tax or general sales tax is now permanent. What this allows a taxpayer to do is select one of the two taxes to deduct on their personal tax return. In a state such as Florida where there are no state income taxes, a taxpayer would benefit from claiming a deduction for sales taxes paid in the year. In a state such as California where you have both income tax and sales tax, a taxpayer may want to assess which is greater. Perhaps in a year where large purchases were made, the sales tax deduction could exceed the income state tax deduction.

A word of caution in using the sales tax deduction is that a taxpayer will bear the burden of proof to support the amount of the deduction. For taxpayers who regularly use their credit cards for purchases, the task of tracking sales tax may be much less cumbersome than for a person who tends to purchase with cash.

The state and local income tax or general sales tax deduction selected is an itemized deduction subject to phase-outs when gross income is in excess of $309,900 for 2015.

We anticipate the above to be among the most impactful provisions in the 2015 PATH Act legislation. The above summary is not intended to constitute a complete outline of the PATH act enacted by Congress and the President.

AFFORDABLE CARE ACT

UPDATE FOR REQUIRED FILINGS

Small Businesses with Fewer than 50 Employees (representing about 96% of all employers):

Under the Affordable Care Act, companies with 50 employees or fewer are not required to provide coverage or fill out any forms in 2015, or in any year.

Larger Employers with 100 or More Employees:

The overwhelming majority of companies with 100 or more employees already offer quality coverage. Rules now phase in the percentage of full-time workers that employers need to offer coverage from 70 percent in 2015 to 95 percent in 2016 and beyond. Employers in this category who do not meet these standards are required to make an employer responsibility payment for 2015.

Employers with 50 to 99 Employees (about 2% of employers):

Companies with 50-99 employees that do not yet provide quality, affordable health insurance to their full-time workers must report information regarding their workers and coverage in 2015, but have until 2016 before any employer responsibility payments apply.

Filing Extensions and Deadlines

The deadline for filing Form 1095-B, Health Coverage, and Form 1095-C, Employer-Provided Health Insurance Offer and Coverage has been extended from February 1, 2016 to March 31, 2016.

The deadline for filing Form 1094-B, Transmittal of Health Coverage Information Returns, and Form 1094-C, Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns, is extended from February 29, 2016 to May 31, 2016 for non-electronic filers and from March 31, 2016 to June 30, 2016 for electronic filers.

In summary, the above advances and updates from the PATH and Affordable Care Acts are important to know as there may be a meaningful impact on your current tax situation as a result. The topics and examples presented in this article are not comprehensive, and as such, we recommend that you consult with your CPA to determine the full scope to ensure you are compliant and using the provisions to your full advantage.

*The above update contains excerpts from the IRS website.

TO APPLY OR NOT TO APPLY? WHAT TO CONSIDER WHEN PURSUING A DEALERSHIP OPEN POINT

By Lucian Bacallao, CPA

With dealership buy/sell activity hitting record figures in 2015, we also saw another strong year of factory "open points" or "add points." During the year, new vehicle sales grew to nearly 17.5 million units. Likewise, there was an explosion of private equity and family offices growing their auto retail presence, and increased public group dealership acquisitions. Given this dynamic industry backdrop, it's not surprising that open point activity in 2015 mirrored the trends in the buy/sell market.

While some may find the open point application process cumbersome, with little chance of being awarded the point in question, it's important to see past the short-term hurdles and focus on the long-term opportunities. Even if a dealer isn't awarded a point, failing to respond to an open point opportunity could create the impression that the dealer is disinterested. At the very least, by responding favorably, the dealer's name will end up circulating around the OEM's market/dealer development department and could increase the likelihood that the dealer is considered or even awarded a point in the future.

Before applying, however, dealers should outline their strategic goals and ensure that an open point aligns with their business plan. It's bad form to show interest and spend time and resources to apply for a point, only to decide later that such a pursuit was not in your business's best interest. If an OEM perceives their time being wasted to due to a dealer's poor preparation, the relationship may be damaged.

A complete open point application can be a time consuming effort, and if an advisor or consultant is engaged, it can also become an expensive one. Making clear, strategic decisions early on is critical, as dealers typically have only a month or so to respond to open point requests. So, what should dealers keep in mind when evaluating the pursuit of an open point? This list below - while not comprehensive - captures the key considerations to bear in mind.

Pre-Application Considerations

1. **Financial Capital** – Serving as an initial litmus test, if a dealer or group does not - or cannot - prove there is sufficient capital to invest in a new operation and bear the potential losses new dealerships sometimes encounter, the likelihood of being considered for a point decreases dramatically. While some options exist to ensure an applicant has enough capital to fund a new dealership, this area must be clarified early on, to avoid potentially wasting time and resources.

2. **Franchise/Brand Experience** – Preference is typically given to dealers with some franchise experience. A seasoned, committed General Manager with brand experience goes a long way with an OEM. However, the more proven success with their product line and processes, the better a dealer fares in becoming a finalist in the open point process.

3. **Local Market Expertise** – A great Toyota dealer in New York may have a larger learning curve running a Toyota dealership in Texas than a Honda dealer down the street from a proposed location. While brand experience is important, a local name and understanding of a local market bodes well for an open point applicant. Ask yourself: do you really know that market and do you know what it takes to succeed in it?

4. **Exceeding Current Benchmarks/Metrics** – Are you taking care of business today? If you don't have above average sales efficiency, retention, and CSI scores, chances are your group will be overlooked. It may make more sense to delay applying for 6 – 12 months while you work to improve these areas, and then take a shot at an open point. Not only will your team and store benefit from these improvements, but they'll offer proof of your ability to help turn around or improve a store's results, a trait similar to the resiliency required to start a point from the ground up.

Application Considerations

5. **Unique Qualifications** – OEMs want to hear from dealers in their own words what makes them unique and why they should be considered for the point in question. We find dealers often know these things instinctively, but have a difficult time writing or articulating them in a manner that truly conveys their unique value proposition. Unique qualifications should include customer and employee perks, why the dealer's store(s) are successful, and anything that would resonate as a creative or special approach to the business.

6. **Plans for Success** – What will you do in the market? How will you successfully launch the dealership? Starting from scratch can often be more difficult than buying a struggling store in a market, since there will be no current customers for a new point. Consumers who frequent other dealerships can be creatures of habit, and having a plan to attract them to the new point is paramount. How will you build the back-end, meet or exceed the new vehicle planning volume, and do so quickly enough that an OEM will trust that you are the right team for the new point?

7. **Presentation** – Pulling together all the requests made by the OEM for an open point can be a tedious task. Furthermore, you'll have to lay out your business plan and written content addressing various requests outside of the financial statements and CSI reports. Consistent, well-planned, and creative packages will stand out to an analyst who may be reviewing dozens of open point packages for a single point, and could help the dealer move on to the latter rounds of the process.

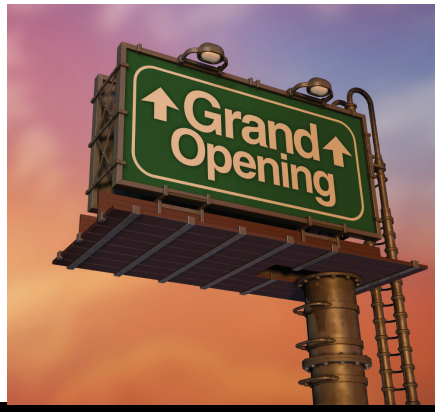
Tips on Pursuing an Open Point

- If you're not sure how to be considered for an open point, reach out to your market representative/district manager and share your interest in open point opportunities.
- Be prepared with information regarding your financial health and your desire to expand your business.
- Ask what it takes to be considered for a point and always be over-prepared to discuss your business and why you have the ability to successfully launch a point without sacrificing your current operation(s).

Persistence Can Pay Off

Although some manufacturer open point application requirements can be extensive (especially Porsche and Toyota), applying for a point could be great for a dealer. Without having to pay blue sky up front (some would argue that losing money early in a new point is a form of blue sky) and in a market where demand exceeds supply, dealers sometimes realize initial OEM estimates were too conservative and enjoy even greater success than imagined.

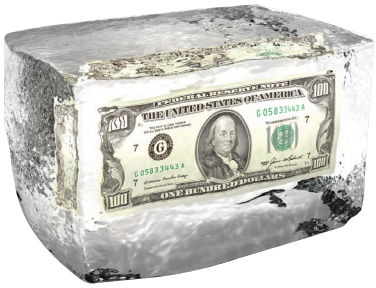
While few dealers are awarded a new point their first time applying, there are many reasons to continue trying. Not only will you know what it takes to complete an application package, but you will also have a foundation to build on for any future applications. When all is said and done, it may take two or three applications with the same OEM before being awarded an open point, but the persistence could payoff in the long run.



MAXIMIZING PROFITABILITY BY UNDERSTANDING FROZEN CAPITAL

By Marilou C. Vroman, CPA, CFE

Through years of economic challenges, dealerships have faced the reality that conventional approaches to profitability are not enough to ensure business success. While a healthy bottom line is worth celebrating, it is important to have a thorough understanding of the dealership's cash position and how to identify road blocks to positive cash flow. Specifically, dealers and controllers should monitor the balance sheet to locate impediments to positive cash flow, including frozen capital.



Frozen capital results when dealership resources are being used ineffectively. In other words, it occurs when excess cash is being invested in or used by assets that are not producing income in the dealership's ordinary business cycle. For example, the typical dealership should have a 45 day supply of parts inventory in stock. If a dealership sells $100,000 worth of parts each month, then the parts inventory should be $150,000 ($100,000 cost x 1.5 months). This quantity of inventory ideally will maximize profits and minimize the dependence on dealership cash resources. In the example above, if the inventory escalates to $200,000 or a 60 day supply, $50,000 worth of dealership cash is tied up in parts inventory and not generating profit for the dealership in the ordinary business cycle. The extra 15 day supply of parts would be classified as frozen capital.

Without healthy working capital and positive cash flow, a profitable dealership can go out of business. Fortunately, the cost of funds in recent years has been low, and therefore the cost of maintaining frozen capital has most certainly declined. However, if dealership profitability were to decline, and cash became scarce, liquidity issues could become costly. For example, in a cash shortage, a dealer may opt to lean more heavily on floorplan resources and become less compliant with the terms of the floorplan financing, creating an "out of trust" situation. This can lead to a soured banking relationship and may threaten the floorplan line, which for some dealers is the lifeblood of the business. While the parts inventory is a clear example of frozen capital, there are several areas on the balance sheet where cash strains can exist. Other examples include receivables, vehicle inventory, fixed assets, prepaid items and deposits. The following are examples of how to identify these impediments to positive cash flow:

VEHICLE INVENTORY: In variable operations, excess vehicle inventory can challenge the dealership's cash position. While floorplan will take the burden off the dealer, interest should not be spent on inventory that is aged and less likely to produce gross profit. Typically, used vehicle inventory should be maintained at a 45 day supply. To calculate, multiply the average monthly vehicle cost of sale by 1.5. Subtract this amount from the inventory balance to determine the excess investment in inventory. As with the parts inventory example above, inventory supply in excess of 45 days is considered frozen capital. In addition to considering days supply, inventory aged beyond 60 days should be cycled out and replaced with fresh inventory to increase the likelihood of profitability.

VEHICLE RECEIVABLES: In addition to monitoring inventory, the sales department needs to monitor vehicle receivables. Vehicle receivables can be the largest balance due to the dealership at any given time including contracts in transit. Contracts in transit should typically be funded within three business days or less. To calculate the frozen capital, divide the dollar value of contracts in transit outstanding by the average retail vehicle selling price to determine the equivalent number of units. Then, calculate the average number of units sold by the dealership in three business days. Subtract the average three day unit sales from the equivalent units in contracts in transit and multiply by the average vehicle selling price. This amount represents the excess investment in contracts in transit. The calculation for vehicle receivables is essentially the same methodology. Divide the outstanding deposits by the average retail vehicle deposit amount to determine the equivalent number of units. Subtract the average three day unit sales from the equivalent units in deposits and multiply by the average vehicle deposit amount to arrive at the excess investment in vehicle deposits. Frozen capital in vehicle receivables can stem from slow processes of deal flow from the date of delivery through F&I and accounting, incomplete funding packages sent to lenders, and ineffective credit policies or account collection procedures.

CUSTOMER AND WARRANTY RECEIVABLES: In fixed operations, frozen capital can reside not only in parts inventory, but also in customer receivables and warranty receivables. It is best to reduce the dealership's risk by limiting the extent of credit granted to customers for repairs of their vehicles. Credit should only be granted on a case by case basis, to the best customers where a good relationship exists and there is past history of prompt collection. Dealerships should formalize the credit process with a credit application and reference checks if there is any question about a customer's credit worthiness.

Parts and service receivables also include wholesale accounts typically from independent repair and body shops. These accounts are typically more dependent on the extension of credit to facilitate greater revenues. These balances can grow quickly if not monitored. The typical balance of parts and service receivables should not exceed 50% of the current month retail and wholesale parts and service sales.

The amount of frozen capital in warranty receivables is dependent upon the warranty claim payment cycle by the manufacturer. For a manufacturer that pays warranty claims weekly, the warranty balance should not exceed 25% of the current month warranty sales. For a manufacturer that pays monthly, warranty should not exceed one month of warranty sales. Excess warranty receivables can be prevented by a regular and thorough review of the warranty receivable schedule with management, identifying the status of every claim. Aged balances should be the exception and should be supported by evidence of appeals or specific communication with the manufacturer regarding the claim.

OTHER AREAS OF CONCERN: In addition to receivables generated by sales, other receivables should be evaluated, such as receivables due from employees, the manufacturer or related parties. Consider whether pay advances or allowing employee purchases on credit will increase productivity or morale to justify the cash invested. Other items such as prepaid assets and deposits should also be evaluated. Prepaid assets, such as large insurance premiums, rents and advertising, can sometimes be negotiated to favorable payment plans rather than making the entire investment up front. Capital investments should also be analyzed in detail to validate whether a lease or financing would be preferential to payment in full.

Upon examination of all sources of frozen capital, dealers should add the dollar amounts of each type of excess investment and multiply by the dealership floorplan rate or best rate of return for other investments to determine the true annual cost of frozen capital. Ultimately, dealers may be surprised to find out how expensive it can be to allow cash to be tied up in frozen capital. Taking the time to ensure that all dealership personnel are focused not only on profitability, but also on maintaining positive cash flow, is essential. In the end, dealerships can maximize profitability by realizing the importance of collecting receivables, refreshing and maintaining proper inventory levels, and purchasing assets with the greatest return on investment.

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