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# HEADLIGHTS

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# IMPLEMENTING DMS CONVERSIONS

Dealers change dealer management system (DMS) providers for several reasons: They are dissatisfied with their current provider, looking for a more robust DMS, moving to a system with specific features they want, or they simply want to lower their costs. The exploration and evaluation process should start 10 to 12 months before the current contract expires, and the switch is usually implemented at the prior contract's end.

**Kenneth J. Gordon, CPA**
**Weisberg, Molé, Krantz & Goldfarb, LLP**

Although the dealership may save money on monthly fees over the life of a new contract, a conversion can be costly in other ways—in terms of time spent and disruption to dealership operations; additional staff training on the new system; and, if the conversion is not done properly, in bringing forward inaccurate data. Here are a number of steps that can be taken before and during the conversion process to minimize the disruption and ensure that the new system provides accurate data.

✔ **Do your due diligence.** As part of your due diligence in negotiating a new contract, be attentive to the necessity of having a good service conversion team willing to work with your key personnel and dealership staff. Insist that there be language in the contract to ensure that the conversion team spends enough time with dealership staff to allow for a successful conversion. Hiring an outside computer consultant with expertise in the DMS space can help in this process.

✔ **Clean your records.** Prior to conversion, clean up all schedules and accounts. Preconversion data needs to be brought forward in sufficient detail. Make the necessary adjustments so that controlled accounts can provide accurate detail and noncontrolled accounts can be clearly explained. Going forward, the dealership might need to provide detailed historical accounting information for outside parties such as the IRS, state income and sales tax auditors and for factory audits and balance sheet reviews.

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TAX CONCERNS FOR CAR DEALERS

✔ **Prepare your staff.** Once you have decided on a new DMS, get your staff on board with the new system, starting from department heads to all personnel who use the system. Consensus is a key determinant of a successful conversion. Be positive—conversions can be difficult and will be made more difficult if ownership and management do not maintain a positive, optimistic view of the conversion. Make it clear that this is an irrevocable move and avoid expressing feelings you have about how the “new system” does not do what the “old system” did. Ensure that your staff is aware that the conversion decision was not made lightly and will ultimately bring positive changes to the dealership.

✔ **Complete training.** Prior to the arrival of the vendor’s conversion team, ensure that all users have completed the pre-installation training that the new vendor provided. Your staff’s basic level of familiarity with the new system will expose any substantive questions that will make your custom configurations easier to deploy and leave the installers time to get these elements right the first time.

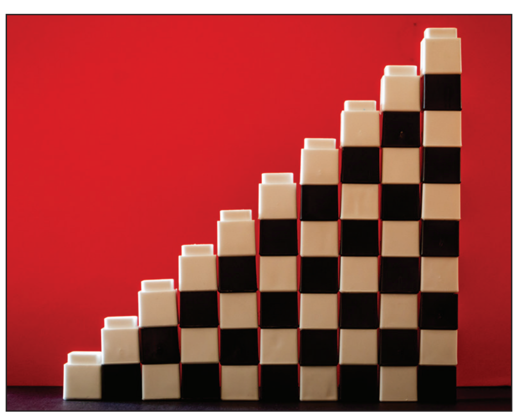
✔ **Consult your CPA firm.** As early in the process as possible, inform your CPA firm that you are considering a DMS conversion, and work with them prior to the conversion date. Consulting your CPA firm can be valuable in guiding you through the process of cleaning up your accounting records and record retention.

✔ **Review, review, review.** During the month of conversion and the month immediately after, review your monthly manufacturer financial statements to uncover any conversion-related accounting problems. Check for changes in ratios, such as gross profit percentages on sales that diverge from your historical trends and can provide a clue that your new DMS accounting system is not set up the way you want it. For example, if your service conversion team sets up your accounting system using data input and coding based on a general procedure they apply to all dealerships they service and your dealership accounts for certain items differently, you need to make them aware of that prior to and during the setup process.

When changing to a new DMS, it is important to recognize the difficulty in these conversions and prepare accordingly. Work closely with and consult your new DMS provider, third-party DMS consultant and your AutoCPAGroup member prior to, during and immediately after the conversion.

# INCREMENTAL FRANCHISES

**Carl Woodward, CPA**
**Woodward & Associates, Inc.**



Incremental franchise refers to a marginal (small-volume) franchise, typically associated with dealers located in nonmetropolitan areas who may be forced by their factory to give up their franchise. An incremental franchise is one that a purchasing dealer can add to his existing dealership location without requiring a separate location, though at times the buying dealer might have to build an additional showroom.

These franchises experience many pressures, some operational and some generated by the factory. The dealer may be forced to give up a franchise on orders by the factory, or he may not want this extra franchise and decides to sell it off.

When trying to sell or buy an incremental franchise, some in the industry may undervalue its true worth. Generally, these franchises are worth much more when sold as incremental franchises with the franchise value included in the sale of the selling dealer's business. In many cases, the buyer can include this new franchise in a more advantageous operational environment.

The gross profit of the incremental franchise generated by the seller will be added to the gross profit of the buyer. There will be some "slippage" on the gross profit. The buyer cannot normally expect to retain 100% of the seller's total gross profit and other income.

However, the increased expenses for the acquiring dealer are called variable and semi-fixed expenses. Based on this, the acquiring dealer might retain 30% of the retained gross profit and other income of this incremental franchise as net profit. Assuming the acquiring dealer expects to attain annual gross profit and other income of $500,000, and if we assume the variable and semi-fixed expenses consume 70% of this $500,000, the acquiring dealer would have increased annual pretax net profits by $150,000 (30% × $500,000).

The next question is how much the acquiring dealer should be willing to pay to increase his annual pretax profit by $150,000. If you expect a minimum 30% return on your investment and use the above gross profit numbers and expenses, then $150,000 ÷ 30% = $500,000. In other words, you should be willing to pay $500,000 for this franchise to add it to your existing dealership if you expect to have increased pretax net profits of $150,000. This $500,000 is probably much more than someone would pay for this franchise if it is packaged as part of an existing dealership.

Dealers considering selling their franchise to a third party or accepting a buyout offer from the factory (General Motors is currently approaching Cadillac dealers with buyout offers) should be careful to not undervalue their franchise. It may be worth more than they think.

If you are approached with any of these buy–sell or factory buyout offers, contact your **AutoCPAGroup** member to help evaluate the true worth of your franchise. ✍

# TAX CONCERNS FOR CAR DEALERS

**Tasha Sinclair, CPA/ABV**
**Tetrick & Bartlett, PLLC**

One thing we can say with absolute certainty is that 2020 has been like no other year in any of our lifetimes. When COVID-19 hit the United States, many car dealers were forced to shut down or offer limited hours of service to customers due to government mandates. Once restrictions were loosened, car dealers then had to meet customer demands for vehicles, and now many are working with meager

inventories. Fortunately, most car dealers received financial assistance by participating in the Paycheck Protection Program (PPP). The influx of cash during the economic uncertainty allowed dealers to keep employees on payroll and avoid any reduction in benefits. But with that assistance comes the potential of a tax burden.

With the passage of the Coronavirus Aid, Relief, and Economic

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Security Act (CARES Act), Congress said the forgiveness received under PPP would not be taxable. While this is true, Notice 2020-32, issued by the IRS in May 2020, takes the position that the expenses used for the forgiveness are not deductible. Although this was not the intent of Congress, it appears to be a correct interpretation of the Internal Revenue Code. Thus, without an act of Congress, the payroll costs, rent and interest expenses used to obtain PPP forgiveness are not deductible—making PPP, in essence, taxable.

The IRS guidance does not, however, address the timing of the reduction in deductible expenses. Very likely, borrowers spent the funds in 2020 but will not receive notification of forgiveness until 2021. Without guidance, we are uncertain in which year the expenses are not deductible—2020 or 2021? For someone whose PPP forgiveness is $500,000, the tax could be an extra $200,000+ in the year the expenses are not deductible. Until we know more, it is best to be prepared to pay the extra tax in 2020.

Another concern for car dealers on last in, first out (LIFO) is the potential of large recaptures in 2020 due to the low volume of inventory. Many dealers are working with half the new inventory they had a year ago. This significant drop in inventory could mean a significant increase in tax burden due to LIFO recapture.

**Example:** To estimate the potential impact, I looked at a dealer on LIFO for 40 years whose new inventory dropped from $15 million to $7.5 million. The LIFO recapture in 2020 is to be over $400,000. For this dealer, who is already having a profitable 2020, the tax on the recapture is over $150,000.

If you are in a similar or worse situation with your inventory levels and are on LIFO, you may want to consult your tax advisor on your potential LIFO recapture and the option of electing to go off the LIFO method. The election allows you to bring your LIFO reserve balance into income over four years. If you are taxed as a C corporation, you may have received a tax benefit at a higher rate than the rate on which you would be taxed when picking up the reserve.

In summary, each taxpayer's situation is unique, and proper tax planning requires an understanding of that taxpayer's full set of circumstances. Dealers should consult their **AutoCPAGroup** member before the end of the year to avoid any tax surprises in March and April 2021. ✍