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Dealer Insights

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Could your dealership benefit from captive insurance?

If your dealership offers health insurance benefits to your employees, there's a good chance you've seen a climb in premium costs in recent years — perhaps a dramatic one. Rising premiums have left many dealerships with difficult choices about whether to continue to offer this important employee benefit.

To meet the challenge of rising costs, some dealerships are opting for a creative alternative to traditional health insurance known as "captive insurance." A captive insurance company is wholly owned and controlled by your dealership or by you, a family member or a trust.

Benefits abound

The captive insurance strategy is kind of like forming your own insurance company. Potential benefits of forming a captive insurance company abound, including:

- Stabilized or lower dealership health insurance premiums,
- More control over claims, loss control and insurance auditing,
- Lower administrative costs for health insurance benefits, and
- Access to certain types of coverage that are unavailable or too expensive on the commercial health insurance market.

With captive insurance, you can customize your coverage package and charge premiums that are a more accurate reflection of your dealership's true loss exposure.

Another big benefit is the fact that your dealership can participate in the captive's underwriting profits and investment income.

When you pay commercial health insurance premiums, a big chunk of your payment goes toward the insurer's underwriting profit. But when you form a captive company, your dealership retains this profit through the captive.

Also, your dealership can enjoy investment and cash flow benefits using a captive by investing premiums yourself instead of paying them to a commercial insurer.

Tax impact

A captive may also save you tax dollars. For example, premiums paid to a captive are tax-deductible and the captive can deduct most of its loss reserves. And if your captive insurance company is considered to be a "microcaptive" — which is currently defined as a captive with $1.2 million or less in premiums, which increases to $2.2 million on January 1, 2017 — you may elect to exclude premiums from dealership income and pay taxes only on net investment income. (For more information, see "How recent legislation affects microcaptives" on page 3.)

How recent legislation affects microcaptives

The Protecting Americans from Tax Hikes Act (PATH Act) contains provisions that could make forming a captive insurance company easier for dealerships. Specifically, the legislation increases the premium limit for a captive to be considered a "microcaptive."

Starting next year, this limit will increase from $1.2 million to $2.2 million. As a result, the microcaptive option will be available to more dealerships. Under this option, dealerships can exclude premiums from business income and pay taxes only on net investment income.

In addition, the legislation established a diversification requirement for microcaptives, which involves meeting one of two tests: 1) No more than 20% of premiums may come from any one insured, or 2) ownership of the captive must mirror ownership of the insured dealership (within a 2% margin).

The diversification requirement was added to combat what some legislators saw as abuses to the microcaptive designation by some businesses. The first test could be hard for smaller captive insurance companies to meet, while the second test will make it more difficult to use microcaptives as an estate planning tool.

Note, however, that you'll lose certain deductions for microcaptives with the strategy.

To qualify for federal income tax purposes, however, a captive insurance company must meet several criteria. These include properly priced premiums based on actuarial and underwriting considerations and a sufficient level of risk distribution as determined by the IRS.

The IRS has ruled that risk distribution exists when a captive:

- Insures the parent's 12 operating subsidiaries, none of which pay more than 15% of the premiums, or
- Receives more than 50% of its premiums from unrelated third parties.

But insuring only the risks of the captive's parent doesn't constitute sufficient risk distribution, according to the IRS. Recent U.S. Tax Court rulings have determined that risk distribution exists if there's a large enough pool of unrelated risks — or in other words, if risk is spread over a sufficient number of employees. This is true regardless of how many entities are involved.

Creative solution

Keep in mind that there are a few potential drawbacks to forming a captive insurance company. Among them are high start-up costs and heavy administrative burdens. And if your dealership ever decides to exit the captive for any reason, this move can turn out to be expensive and complicated. For these reasons, captive insurance may not be the right solution for dealerships that are short on cash or lack the capacity to handle the extra administrative work.

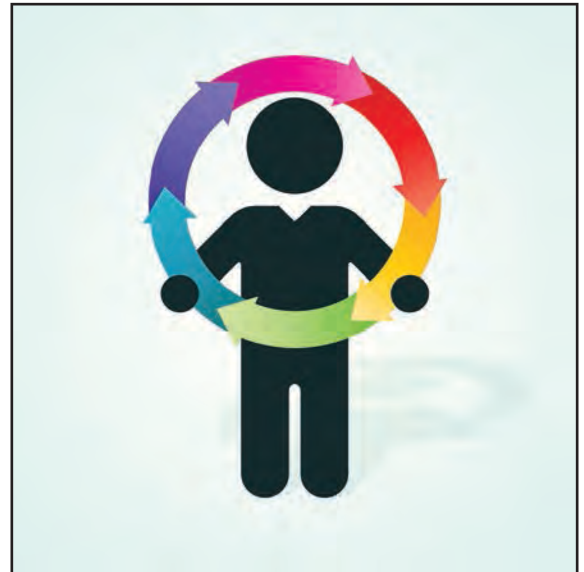
Nonetheless, under the right circumstances, captive insurance can be a creative solution to a problem faced by many dealerships today: rising health insurance premiums. Talk to your insurance agent or broker about the pros and cons of captive insurance for your dealership.

Management assessment

360-degree reviews reveal the big picture

The end of the calendar year is a fine time to review your employees' performance, including that of your managers. Thoughtful assessments of their successes and shortcomings in the past 12 months will help you provide constructive feedback as you head into the New Year.

But wait: You might not want to depend on just your own opinions when reviewing management performance. Consider expanding your "lens" by soliciting feedback from their co-workers and direct reports, outside sources (such as customers and suppliers), and the managers themselves (via self-evaluations). This multifaceted approach is commonly called a "360-degree review."



Crafting a feedback survey

The first step in this full-circle review process is to create a formal feedback questionnaire for evaluating your managers' performance. The survey should focus narrowly on the aspects of performance most critical to management success. Typically these include:

- Leadership ability,
- Communication skills,
- Job proficiency,
- Organizational skills, and
- Mentoring and coaching proficiency.

Of course, the specific job skills of managers will differ depending on the dealership area in which they work. For example, in the service area, you could ask subordinates to rate their manager's ability to enable the team to satisfy customers.

Make sure your 360-degree feedback survey isn't too long and detailed or else recipients might fail to complete it. Ideally, they should need no longer than 15 to 20 minutes to thoughtfully fill it out. Consider creating separate surveys for insiders (co-workers and subordinates) and outsiders (customers and suppliers) — they'll likely share different kinds of feedback. And ask open-ended questions instead of providing only a simple checklist.

Guaranteeing confidentiality

Ensuring confidentiality is crucial to implementing a successful 360-degree review program. Subordinates, co-workers, vendors and even customers should be able to provide feedback anonymously and be assured that their opinions will remain anonymous. Otherwise, they probably won't be totally forthright in sharing feedback, which defeats the exercise's purpose.

Once you've received the completed 360-degree surveys and managers' self-evaluations, use them (along with your own personal observations) as the basis for drafting a formal performance

review. Your review should provide managers with detailed feedback on how they've done over the past year in the areas most important to their job success — and, ultimately, the success of your dealership.

The full-circle feedback you receive may include some criticism of managers and suggestions for ways they can improve their job performance. Don't feel as if you need to share this with them verbatim, especially if it's harsh. Instead, use it to provide constructive criticism and create 2017 goals designed to help managers improve their performance in weak areas.

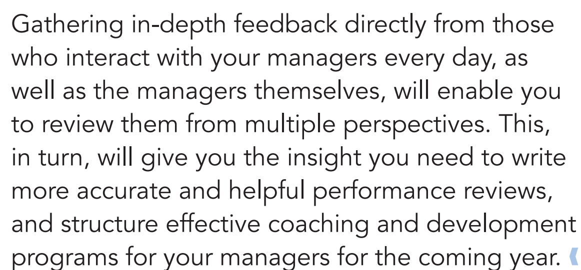
Linking goals to financials

As you set new annual performance goals for your managers, try to link them directly to your dealership's financial performance. For example, for new and used vehicle sales managers, you could set goals of combined monthly retail sales per salesperson of 10 units, a used-to-new vehicle sales ratio of 0.7 or higher, and a new vehicle inventory unit days' supply of 60 days or less.

Other examples: For F&I managers, you could set goals, such as gross F&I income of $850 or more per retail unit. And for Parts and Service managers, you might set goals of a 40% or higher parts department gross profit as a percentage of sales and a 30 to 45 days' supply of parts inventory on hand.

Your CPA can assist you in forming the ratios that would be most helpful for your dealership.

A better perspective



Gathering in-depth feedback directly from those who interact with your managers every day, as well as the managers themselves, will enable you to review them from multiple perspectives. This, in turn, will give you the insight you need to write more accurate and helpful performance reviews, and structure effective coaching and development programs for your managers for the coming year.

The pros and cons of using LIFO accounting

When asked whether they'd like to lower their income taxes, most dealership owners would answer, "Sure, sign me up!" One of the most effective ways for dealerships to accomplish this is by adopting LIFO accounting.

As you're probably aware, LIFO stands for "last in, first out" because, when calculating the cost of goods sold, it counts the last vehicles that arrived on the car lot as the first vehicles sold. Conversely, FIFO accounting — or "first in, first out" — counts the first vehicles that arrived on the lot as the first vehicles sold.

Which choice is better depends on various factors. But if you've dismissed the idea of using LIFO accounting in the past, it doesn't hurt to reconsider the benefits of this approach.

Accounting advantages

Using LIFO can reduce current income taxes for your dealership if the price of vehicles is rising, as it usually is. This is because counting the vehicles that arrived most recently as the first ones off the lot raises the cost of goods sold, which lowers net income and current taxes.

Note: You can also use LIFO accounting in your parts department. This may increase the cost of goods sold for parts and accessories, thus lowering profits and income taxes.

The fine print

On the surface, using LIFO accounting would appear to be an easy call for dealerships. However, there are a few details in the "fine print" of LIFO accounting rules you need to understand before deciding which accounting method you should use.

An example helps illustrate the concept. Let's assume that a dealership paid $20,000 for a 2016 model car in the spring and $22,000 for the same model vehicle in the fall. In December, it then sold one of these cars for $26,000.

From an income tax standpoint, the dealership can count either of these vehicles as having been sold. If it counts the car it bought in the fall with the LIFO method, the taxable profit on the sale would be $4,000. However, if it counts the car it bought in the spring with the FIFO method, the taxable profit on the sale would be $6,000.

In addition to lowering current taxes, using LIFO can result in other benefits for your dealership. These include:

- Making it easier to match your inventory costs to revenue,
- Minimizing write-downs of vehicles to fair market value because of declines in inventory costs, and
- Improved cash flow.

Also, the tax benefits of LIFO accumulate from year to year. This results in a LIFO reserve, which is the difference between LIFO and FIFO inventory calculations. The LIFO reserve is kind of like an interest-free loan from the IRS, and it can grow very large over a number of years.

The tax benefits of using LIFO rest on the fact that LIFO reduces your dealership's profit on each vehicle sold. While this is good from a tax standpoint, it's bad from a financial statement reporting standpoint. And if you use LIFO for figuring your income taxes, you also have to use it on your financial statements — which will lower your reported net income. Therefore, publicly traded dealerships often use FIFO because they usually want to report higher, not lower, profits to their shareholders.

Using LIFO can result in other benefits for your dealership. These include: Making it easier to match your inventory costs to revenue.

Meanwhile, if you own a privately held dealership and are planning to put it up for sale soon, think carefully about using LIFO. For one thing, to maximize your sales price, you'll want to show higher profits — not necessarily a lower tax liability. Also, you'll have to recapture the LIFO reserve into income when you sell if the transaction is structured as an asset sale. Doing so will reduce your after-tax proceeds from the sale.

In addition, when using LIFO, you must record the LIFO reserve in your inventory records while also performing annual LIFO valuations. The extra effort and cost incurred to complete these accounting and recordkeeping tasks may dissuade some dealerships from opting for LIFO over FIFO accounting.

Your best decision

Under the right circumstances, using LIFO accounting can be a smart tax-saving move for dealerships. But there isn't a one-size-fits-all approach for deciding which inventory accounting method you should use. So, be sure to talk to your accounting professional for assistance in making the best decision for your dealership.

Guard your margins to boost vehicle profits

The good news: Profits for dealerships are at an all-time high, with the average net pretax dealership profit hitting $1.17 million in 2015.

The bad news: The average dealership net profit margin has remained flat for the past five years at just 2.2%.

These figures, which were recently reported by the National Automobile Dealers Association, illustrate one of the biggest challenges faced by many dealerships today: the transparency of vehicle pricing.

Recognize the shift

Back in the "good old days," most car buyers had no idea how much dealerships paid wholesale for vehicles. But today, it takes just minutes for an Internet-savvy customer to find wholesale pricing information on cars they're thinking about buying.

This dynamic has drastically shifted the leverage in many vehicle negotiations, potentially putting car buyers on a more equal footing with dealerships. As a result, many dealership salespeople feel pressured to accept customer offers for vehicles that are lower than they might have accepted in the past.

"After all," the thinking sometimes goes, "if I don't accept the offer, the customer will just go to my competitor down the street who will probably accept it. So I may as well make the sale, even if it's not as profitable as we'd like."

Think profitably

One solution to this problem is to retrain your salespeople in basic negotiation tactics. This means setting a minimum vehicle sales price, based on a minimum target gross profit margin, and then making sure they *stick to it*.

To accomplish this, you could base commissions not only on vehicle sales, but also on the *profitability* of each sale. For example, you could pay a full commission on sales that meet your minimum gross profit target and then reduce the commission proportionally for sales that don't meet the target.

Hold the line

In order to increase net pretax profit, you must guard your margins carefully. Emphasize this to your salespeople and structure your commissions to incentivize them to hold the line on your pricing.

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