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Dealer Insights

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NQDC plans

Saving more for retirement

Many dealership owners and executives would like to save more money for retirement than they're allowed to sock away in their 401(k) plan. For 2016, the annual elective deferral contribution limit for a 401(k) is just $18,000, or $24,000 if you're 50 years of age or older.

This represents a significantly lower percentage of the typical owner's or executive's salary than the percentage of the average employee's salary. Therefore, it can be difficult for highly compensated owners and executives to save enough money to maintain their current lifestyle in retirement. That's where a nonqualified deferred compensation (NQDC) plan comes in.

Future compensation

NQDC plans enable dealership owners and key executives to significantly boost their retirement savings without running afoul of the ERISA nondiscrimination rules that apply to qualified plans, such as 401(k)s. These rules ban highly compensated employees from benefiting disproportionately in comparison to rank-and-file employees.

NQDC plans aren't subject to the IRS contribution limits and distribution rules that apply to qualified retirement plans.

NQDC plans are contracts between owners and executives and their dealerships that agree to pay out compensation at some future time, such as at retirement. Not only do they *not* have to comply with ERISA nondiscrimination rules, but they *aren't* subject to the IRS contribution limits and distribution rules that apply to qualified retirement plans. So, dealerships can tailor benefit amounts, payment terms and conditions to owners' and executives' specific needs.

There are several types of NQDCs. Among the most common are:

- Excess benefit plans,
- Wraparound 401(k) plans,
- Supplemental executive retirement plans (SERPs),
- Section 162 executive bonus plans, and
- Salary-reduction plans.

The key to an NQDC is this: Because the promised compensation hasn't been transferred to

you or your executives, it's not yet counted as earned income — and therefore it isn't currently taxed. This reduces current taxes and allows the compensation to grow tax-deferred.

Compliance requirements

While NQDC plans aren't subject to many of the qualified plan requirements, they're subject to Internal Revenue Code Sections 409A and 451 — which *don't* apply to qualified plans. Sec. 451 sets the parameters for income taxation of nonqualified deferred compensation, and Sec. 409A imposes strict requirements on the timing and form of deferred compensation payments and of any subsequent change in their timing or form. Specifically:

1. Employees must make the initial deferral election before the year they perform the services for which the compensation is earned. So, for instance, an employee who wishes to defer part of his or her 2016 compensation to 2017 or beyond must have made the election by the end of 2015. There are exceptions for new employees and certain performance-based compensation.

2. Benefits must be paid on a permissible payment date specified at the time of the deferral, such as death, disability, separation from service, change in ownership or control of the employer, or unforeseeable emergency.

3. The timing of benefits may subsequently be delayed subject to specific rules within Sec. 409A, but generally may not be accelerated except in special circumstances, such as plan termination or compliance with legal requirements. Elections to change the timing or form of a payment must be made at least 12 months in advance of a scheduled payment, and the election may be effective no earlier than 12 months after it's made. Also, the postponement must be at least five years. Distributions because of death, disability or unforeseeable emergency may be postponed for shorter periods.

Using a rabbi trust for funding

To be eligible for tax deferral and exemption from ERISA nondiscrimination requirements, NQDC plans must be "unfunded." However, there's no guarantee that the compensation will actually be paid in the future. Unlike the assets in a qualified retirement plan, NQDC compensation isn't segregated from the dealership's general assets and thus would be subject to creditors' claims in a corporate bankruptcy.

One possible solution: Your dealership could set aside the assets in a *rabbi trust*, which would require that deferred compensation payments be made from the trust in accordance with the terms of the deferred compensation agreement. This ensures that the dealership can't renege on its commitment to pay the compensation. Money in this grantor trust would remain a part of the dealership's general assets and still be reachable by creditors.

Penalties for noncompliance are harsh for the executive: They include taxation of any vested benefits at the time of the deferral plus a 20% excise tax and a "bump-up" in the tax underpayment interest rate.

Right for your dealership?

Another potential drawback of NQDCs is that, unlike 401(k) plans, you and your executives can't take loans from your plan. Nor can you roll the money over into an IRA or other retirement account when you retire or otherwise depart the dealership.

While NQDC plans have some drawbacks, such as these, their benefits can far exceed them. Consult with a CPA or employee benefits professional for more details on NQDCs to determine whether one is right for your dealership.

Franchise fever

Take these steps before changing your brand lineup

You might dream about adding an automobile brand to your dealership's offerings or swapping a lackluster brand for a franchise with greater promise. After all, sales are strong, so this might be an optimal time to fire up the store's sales base. But if this is a strategy you're considering, take a step back: Look hard at your options, and what they entail, before forging ahead.

Do your homework

You could apply for a new franchise or take over an existing franchise from another dealership. Both options require diligent market research. When picking the best brand to add, never rely on instinct. Base your decision on historic and projected sales volume, recent demographic trends and objective third-party data.

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Create the right mix

Some brands are like oil and water. Others complement each other. Ideally, you want the right mix of products to appeal to a broad market without cannibalizing existing sales or sending an inconsistent marketing message. Also, some manufacturers have similar rules and service agreements, making certain combinations more compatible than others.

If your current product mix isn't working, consider swapping franchises with another dealership. But swapping franchises requires more than trading keys and moving vehicles. Other assets, such as signs, parts, accessories, prepaid advertising and manufacturer-specific service equipment, may need to be transferred.

You also may swap certain employees, such as sales, finance or service professionals trained to work specifically on one brand. Similar to adding a new franchise, swaps also require approval from manufacturers, lenders and licensing boards.

Factor in the factory

Most manufacturers are highly selective when it comes to granting new franchises or approving franchise sales or swaps. Manufacturers spend millions of dollars on promoting a distinct brand, and they'll prevent franchisees from doing anything that might cheapen or compromise their image. They also won't allow you to open a store that might cannibalize sales from other franchisors that offer their brand.

Review your franchise agreements carefully before adding another product line to the mix. Your existing agreement(s) may require you to

designate dedicated sales and service professionals for each brand — or even operate stand-alone facilities. Manufacturers also may ask for leasehold improvements as a condition to approving a new franchise. These requirements might make your plan cost-prohibitive.

Lay the groundwork

Dealerships typically must be licensed by the state for each brand they sell — and immediately notify the state board *in writing* if they plan to add, swap or drop a franchise. You'll also have to pay fees and complete an application packet that includes such documentation as financial statements, affidavits of extended service contracts and dealer agreements.

In addition, you'll need to work with lenders to transition the franchise's debt obligations. If you're buying or swapping a franchise, the original owner may retain some of its debt, but floor plans transfer with their respective collateral. Also beware that banks may change loan terms, depending on market conditions and the financial health of the new borrower.

A smart move?

Taking on another franchise or switching one of your existing franchises for another may, or may not, be a smart move for your dealership. Your CPA can help you with an objective analysis of the proposition and expected outcomes.

Should you consolidate your common-control leasing agreements?

Accounting standards in the past had made it cumbersome for dealerships to set up a separate leasing entity for their real estate or heavy equipment investments. That was because of the complicated financial reporting requirements to combine (or "consolidate") the entity's financial results. But it's easier now to create a separate legal entity as an effective way to achieve various tax and financial planning objectives or to limit your legal liability.

Effective in 2015 for calendar year-end dealerships, the Financial Accounting Standards Board (FASB) allows a simplified reporting alternative for privately held companies. This option eliminates the need to consolidate common-control leasing arrangements. It also may be worthwhile for dealerships that have established qualifying leasing arrangements but haven't yet adopted the simplified reporting option.

Seeking a less difficult way

Consolidated financial statements can be confusing. Under Generally Accepted Accounting Principles (GAAP), before the FASB offered the simplified reporting option, all dealerships that leased real estate or equipment from one or more owners were subject to the consolidation requirements of variable interest entities (VIEs). Now consolidation of leasing entities can be a thing of the past for qualifying privately held dealerships that elect an alternative reporting method.

This is especially beneficial for private dealerships that in the past have submitted consolidated financial statements to their lenders or manufacturers only to then be asked to provide consolidating schedules to *reverse* the effects of consolidating the operations of common-control entities. Users of dealership financial statements are typically more

interested in cash flow and tangible net worth of the stand-alone dealership than in the combined performance of a consolidated group presented under GAAP.

Meeting certain conditions

In response to pressure from private business owners and their stakeholders to simplify GAAP, the FASB granted private companies the option to elect *not* to consolidate financial reporting from VIEs that lease property to them, if the following conditions are met:

Common control. The dealership (the lessee) and the VIE (the lessor, or leasing entity) must be under common control, *and* substantially all of the activity between the dealership and the VIE must be related to the leasing activities between those two companies (including supporting leasing activities, such as issuance of a guarantee or providing collateral on the obligations related to the leased asset).

Collateral. The dealership explicitly guarantees or provides collateral for any obligation of the VIE related to the leased asset, and the principal amount of the obligation at inception doesn't exceed the value of the leased asset.

If you elect to apply the alternative method to a leasing arrangement, you must apply it to *all* current and future leasing arrangements satisfying the above conditions.

Even with the simplified reporting option, footnote disclosures must list the amount and key terms of debt, asset retirement obligations and other liabilities that could result from your activities with the VIE. It's also important to explain any commitments or contingencies that might cause your dealership to provide financial support to the VIE.

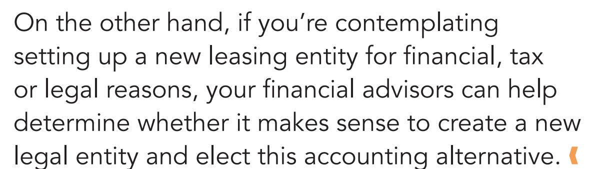
Revisiting leasing arrangements

Common control leasing arrangements have certain benefits that make them worth revisiting now that the financial reporting has been simplified. For instance, a retiring dealer-owner may lease the dealership's real estate to the operating business at a rental rate commensurate with comparable properties. This setup generates a steady income stream for the retiree — without burdening lower-net-worth, second-generation owners with property ownership and management obligations.

Leasing arrangements also help protect dealership operations from legal claims if someone is injured on the property. And they may safeguard the dealership's operating assets from creditors if the leasing entity defaults on its debt or files for bankruptcy.

Making the switch

As you work on your dealership's December 31, 2015, financial statements, revisit the reporting options for existing common-control leasing arrangements. In many cases, opting out of the consolidation requirement will simplify matters, if you're eligible.



On the other hand, if you're contemplating setting up a new leasing entity for financial, tax or legal reasons, your financial advisors can help determine whether it makes sense to create a new legal entity and elect this accounting alternative.

Heads up on increased IRS penalties, new CFPB role

Dealerships should be aware of a legislative development that will affect IRS penalties for the 2016 tax year as well as a new regulatory arrangement with the Consumer Financial Protection Bureau (CFPB) now in effect.

Trade Preferences Extension Act tax trap

There is one often-overlooked result of the Trade Preferences Extension Act of 2015 (TPEA) signed into law last summer: If your dealership fails to file information reporting returns with the IRS or provide accurate and timely statements to payees, you could be subject to higher penalties.

More specifically, the TPEA increases by up to 150% the potential penalties for businesses, including dealerships, that don't file timely and accurate information returns or provide timely and accurate W-2 and 1099 statements to employees, contractors and vendors.

Increased penalties also apply if your dealership doesn't file Forms 1094-C and 1095-C (if you're an applicable large employer or "ALE") or Forms 1094-B and 1095-B (if you're not an ALE but are self-insured). These are new forms that are required for the first time in 2016 by the Affordable Care Act.

The new higher penalties are effective for most information returns and statements required to be filed after December 31, 2016. Short-term penalty relief is available for incorrect or incomplete information filings for Forms 1094-B, 1095-B, 1094-C and 1095-C if you can demonstrate that your dealership made a good-faith effort to comply with the new ACA information reporting requirements. Penalty relief isn't available for failure to file or furnish payee statements.

CFPB oversight of nonbank auto financiers

The "cold war" between auto dealerships and the Consumer Financial Protection Bureau (CFPB) recently entered a new phase when it was announced that the agency will now oversee nonbank auto lenders' and automakers' captive finance units. This will bring 34 of the largest nonbank auto lenders under CFPB regulatory supervision, representing around 90% of the nonbank auto loan market. Previously, only large banks and credit unions with at least $10 billion in assets were under the CFPB's oversight.

The agency will now monitor nonbank auto financiers in several ways. For example, it will look to ensure that the lenders are complying with rules that govern fair marketing and disclosures, require them to provide accurate information to credit bureaus, and strive to protect consumers from unfair debt collection tactics. It also will monitor whether or not nonbank auto financiers are following fair lending practices.

Be prepared

Compliance issues are weighing in more heavily at dealerships than in the past. Be aware of the stiffer penalties under TPEA — and of the CFPB's expanded oversight — as you evaluate your compliance efforts this year.

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