Trade Discounts and Interest-Free Loans from the Government

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The most common strategy to lower your tax bill is what could be called the "Scarlett O'Hara method" as in: "Why pay a tax today when you can put it off tomorrow?" Reporting income and paying the related tax in the next year -- and the year after that -- is generally always better because tax paid in the future costs you less (due to the time value of money). **What's new** in the past year is that trade discounts may offer you another way to send tax off into the future.

Flooring assistance is probably the best example. Many dealers report this factory money as a credit to interest expense upon receipt, which is often before the vehicle is sold.   This practice reports income early – not generally what you want for tax purposes. New rules now permit you to report these interest credits when you sell the vehicle, which usually occurs in a period after you receive the floor plan assistance.

How valuable is this tax benefit? It depends on the following factors:

- Amount of trade discount
- Year-end inventory level
- Future interest rates, and
- Length of time trade discounts are available

Generally, your tax benefit is better when the factors above increase. For this discussion, I'm assuming that tax rates are constant. But the tax benefit gets better if you think corporate tax rates will decline in the future (Note: top tax rates for individuals who have "S" corporation income are scheduled to decline from 38.6% today to 35% in year 2006).

The table below reports how much tax you might defer to a later year, using the assumptions we've provided. Your actual tax deferral will be different because the factors are variable at each dealership.

Deferral of Tax to a Future Year -- Not Tax Savings.						
Inventory Level	1,500,000	2,500,000	3,500,000	4,500,000	5,500,000	6,500,000
Tax Deferral	*$10,800*	*$18,000*	*$25,200*	*$32,400*	*$39,600*	*$46,800*

For example, if year-end inventory levels are $2,500,000 and trade discounts are 2%, you may reduce your tax bill by $18,000 in the first year, assuming a 36% tax rate. If trade discounts and inventory levels are comparable in future years, the tax deferral may continue for a similar amount. The example above assumes that you are currently reporting 100% of flooring reimbursements as a credit to expense on all units in ending inventory at December 31. If you don't receive all flooring credits by year end, the tax benefit will be less

It's important that I've used the term tax deferral, not tax savings. The dealership still owes the tax; but again, a tax paid tomorrow is preferable to a tax paid today. The real benefit is this: IRS has effectively granted you an interest-free loan. Granted, such loans are less compelling these days because interest rates have been at historic lows (has everyone refinanced yet?). The following table illustrates the actual savings measured in interest terms, not tax.

Actual Savings from an Interest-Free Loan					
	Number of Years That Trade Discounts Are Available				
Inventory Level	1	5	10	15	20
1,500,000	$514	$2,338	$4,170	$5,605	$6,730
2,500,000	$857	$3,897	$6,950	$9,342	$11,216
3,500,000	$1,200	$5,455	$9,729	$13,078	$15,702
4,500,000	$1,543	$7,014	$12,509	$16,815	$20,189
5,500,000	$1,886	$8,572	$15,289	$20,552	$24,675
6,500,000	$2,229	$10,131	$18,069	$24,288	$29,162

For example, if your inventory level remains at approximately $2,500,000 at year end and trade discounts continue for 10 years, the actual present value of the interest-free loan is worth a total of $6,950 (not per year), assuming a 5% interest rate.

To implement this tax strategy, tax forms must be prepared and filed with IRS to change your accounting method, and more work is required if new vehicles are on the LIFO inventory method. Fees to comply with these rules will reduce the actual savings reported above, and be wary of fees quoted as a percentage of your tax deferral amount.

What Should You Do?

Trade discounts come in all sizes and colors these days, and you should consult your CPA to help identify other factory incentives (e.g. advertising credits) that confer similar tax benefits. Compared to other strategies that defer tax to a later year, trade discounts may not be very obvious. By comparison, the tax benefits of using the LIFO method for new vehicles are much greater over time. However, each dealership is different and your potential benefit will depend on the factors mentioned above. In closing, if your new vehicle inventory is running at $2,500,000 or less, I’d take a hard look at the cost/benefit analysis.