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Successful Exiting for Auto Dealers

Strategic Use of the Full Estate Planning Toolkit in a Consolidating Market

By Robert L. Moshman, Esq.

There are great planning possibilities for owners of automobile dealerships to maintain control, protect assets from creditors, select domiciles, employ trusts, provide advanced succession planning, and engage in serious opportunity shifting.

Unfortunately, the stereotypical dealership owner will ignore almost all of this advice and do some last-minute planning instead. Sadly, this will not be sufficient and will shortchange the heirs, the employees, and the legacy of such owners.

However, the coming years will provide a golden opportunity for better planning. And there is a strong third-party marketplace to purchase dealerships in an industry that is rapidly consolidating.

Here, we look at the historical context of the automobile dealership, the applicable planning techniques that can be employed, and the important exit strategies that modern dealership owners can consider.

Presented With Our Compliments

A Rich History of Failure

America has had a long love affair with the automobile, but the highway to car fame is lined with wrecked companies that did not make it. There were 564 defunct American motor vehicle manufacturers as of 2009.

For example, the Argonaut Company existed from 1959 to 1963 in Cleveland, Ohio, with the dream of making a stainless-steel luxury car with a super-charged V-12 engine that could seat eight people and reach a top speed of 240 miles per hour. It would have been like a cross between an Escalade and the Batmobile. None appear to have been built. But this is America, where it is okay to dream.

At the dawn of the auto industry, there were hundreds of small manufacturers setting up small companies. Then a game-changing concept arrived. Henry Ford's assembly line made it possible to turn out cars in 93 minutes and lower their price from $850 to $240, enough to make vehicles attractive to the general public.

By 1914, Ford controlled 48% of the U.S. market. By 1921, Ford had 57% of the world's market. By 1927, Ford could turn out vehicles every 24 seconds. A total of 15 million Model Ts had been produced. This was a large part of why America made 90% of the world's automobiles at that time. [1]

In 1929, only 44 manufacturers remained in America, but Ford, General Motors, and Chrysler had 80% of the market; the writing was already on the wall for the other 41.

Vertical Integration

One ingredient of the surviving manufacturers' success was the use of vertical integration. Car manufacturers would purchase companies that would supply raw materials, own their own machinery and patents, and sell from their own stores. But this created a vertical monopoly that legislators found objectionable. So a franchise system developed that was a hybrid between a direct agent of the manufacturer and an independent retailer.[2]

Franchising resulted in somewhat competitive pricing, but it also set in motion a chain of economic events. Although denied the ability to own stores by various laws in virtually every state, automobile manufacturers used the franchise system as a means of raising capital. Along with selling stock, manufacturers would sell franchise rights and then sell cars to the franchises.

Americans wanted to buy cars, and there were lots of opportunities to do so. In 1954, the industry produced 9,144,919 cars and trucks. Distribution was handled by 42,000 franchised dealerships, which employed 680,800 people, representing 9.7% of the nation's entire retail sales force. [3]

Over time, the process of consolidation continued, with larger dealerships squeezing smaller dealers out of business and foreign cars elbowing their way into the market. It is the survival of the fittest in the economic jungle. But because of laws preventing manufacturers from closing dealerships without repaying franchise fees, manufacturers were essentially forced to continue producing unprofitable lines of cars and keeping unwanted dealerships alive. An excess of dealerships led to too much competition and to the cannibalization of sales and profits.

The downturn in the economy in 2008 and 2009 helped separate the surviving dealerships from those that were not sustainable. Between 2000 and 2006, new car sales in the United States were between 16 million and 18 million annually. By 2008, new car sales had dropped to 12 million; by 2009, the number had dropped to 10.4 million, the lowest level in 27 years.

There were about 22,000 auto dealerships in the United States in 2004; however, after the economic bubble burst, unprofitable dealerships were sold, terminated, and consolidated. Five years later, there were approximately 17,659 dealerships left. The number of dealerships had been reduced by about 20%.[4]

The Dealer's World

A car manufacturer completes its business when the auto dealer takes inventory. But an auto dealer who makes a sale is just starting his relationship with the customer. The initial purchase may currently only represent $23,000, on average, with a very small profit margin. However, there are far more profits in the transactions that follow.

Estate planning experts provide some insight about the unique factors affecting car dealerships.

"There are special concerns with auto dealerships, as they are highly leveraged," explains attorney Jerome M. Hesch. "All of the cars in inventory are financed with what are called 'floor plan' loans. It is not unusual for a dealership to have to use a substantial portion of its earnings to pay the principal on its floor plan loans."

"There can also be substantial deferred income if the dealership uses its own extended warranty company," continues Hesch, "and there may be income tax deferral opportunities in certain other limited situations."

For example, there is the possibility of deferring the payment of the income taxes owed on a sale of a dealership from the date of the sale to the outside third party for cash to a date far in the future.

There is a well-respected estate planning technique that can also be used for this income tax deferral, but only if the anticipated sale for cash will take place more than 24 months in the future. The obstacle is that the dealer cannot wait until the sale to a third party is close at hand to use this technique. In effect, income tax planning opportunities exist and need to be addressed.

"You also have to evaluate if the dealership has exposure if it treats its salespeople as independent contractors," notes Hesch.

Attorney Richard A. Oshins adds that a dealership is actually a collection of assets and separate businesses.

"Customer financing, leasing, warranties, and servicing of vehicles are all profitable businesses," says Oshins. "The dealer can set up each of these businesses as separate entities to keep liabilities contained and to provide income or transfer future appreciation to different family members."

Oshins notes that many techniques can work for the auto dealer if they are implemented properly, but this is often not the case. "Buy-sell arrangements and solo exits are different in other industries.

"There can be problems in trying to suddenly exit a car dealership," says Oshins. "Wealth planning is too late when there is already a buyer and a deal in place. The seller is then left resorting to charitable gift giving or paying taxes, and that means giving up a lot to someone else.

"The auto dealer needs to plan earlier, before value is built up and before strategies disappear," says Oshins. "Early planning is the key. That way, you can use opportunity shifting in many of the separate dealership entities while value is growing."

A Model Dealership

Let's build a car dealership from the ground up. The ground is the first piece of the enterprise. The business on top could go bankrupt, but the real estate owned separately can escape all creditors and retain value. In the best-case scenario, it is placed in a grantor trust or BDIT and remains outside of the grantor's estate.

Firewalls between different business units within the same dealership can isolate liability in the same manner that larger corporations create separate business units. "The liability component is almost as important as the tax planning," notes Oshins.

Thus, the trade-in department that sells used cars can be a separate entity. The financing department and repair shop can be separate entities. Sales of warranties can be from a separate entity. Even the main car-selling function can be subdivided into separate entities. For example, there can be Nissans in one showroom and Fords in an adjoining showroom. And these separate entities can be transferred to grantor trusts and BDITs early, when their value is lower, so that any appreciation in value remains outside of the grantor's estate.

Having the assets in trusts provides creditor protection and insulates the assets from disruptions from future divorces, for example.

Note: Setting up these plans provides an opportunity to select favorable jurisdictions for the situs for these entities and trusts. It is important to shift wealth to future generations and, when possible, select jurisdictions that do not impose state income taxes.

"A properly sitused trust is far less complex than buying back business assets from a divorced spouse," explains Oshins.

Unique Planning Issues

Estate planning expert Robert S. Keebler notes that dealers have unique challenges when working with various business entities. "It can get very complex," he says.

He mentions a variety of applicable factors: Along with having multiple businesses for leasing, warranties, and so forth, auto dealers have to contend with dealership agreement provisions with manufacturers, which control how they operate.

Many owners have also distributed shares to non-active family members. Later, they end up recapitalizing the business to "buy out" the share of the inactive members or provide them with non-voting shares.

These solutions can lead to frictions and other problems. Oshins points out that non-working family members could receive the land and building (plus other assets) while the dealership is transferred to the working children. Alternatively, life insurance can be transferred to the non-working members of the family.

"Dealerships that have been established for some time may have some of these separate entities set up as old 'C' corporations, while new entities may be set up as LLCs," notes Keebler. "There could be a last-in-first-out (LIFO) recapture exposure if the dealership is a C corporation," adds Hesch.

Keebler notes that sales to intentionally defective grantor trusts (IDGTs) and grantor retained annuity trusts (GRATs) can be useful for auto dealers, but he warns that close attention must be paid to the cash flow of the business and transfer restrictions on such techniques.

Who is insuring all of these cars and entities? With sufficient inventory and monies flowing through a dealership, it can make sense to have another entity provide captive insurance, i.e., a form of self insurance.

Finally, exit planning specialist John H. Brown points out that "branding" issues of the franchise have an important role.

For example, a Volkswagen dealer was required by the manufacturer to replace his showroom for branding purposes. This would have cost him $3 million. Because he was leasing the land, he would have to put big money into a building on land he didn't own. Rather than comply, he took that opportunity to sell the business.

Superior Planning

Oshins focuses on the use of various growing sub-entities of the dealership for opportunity shifting. The leasing company can be used for opportunity shifting. The warranties business and the repair shop can be used this way as well.

According to Oshins, "Eventually, the owners will need to leave the business and may want to transfer it to their kids or sell it, but they need to deal with this issue earlier in time—before the dealership appreciates in value."

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Another option is to set up an entity for the real estate of the dealership, transfer it to a beneficiary defective inheritance trust (BDIT), and lease it back to the dealership. Lease payments then flow into the BDIT, which is a trust for the benefit of the auto dealer, but the trust assets remain outside of the dealer's taxable estate. Transferring this real estate out of the owner's estate makes sense because it's under-valued in the current economic climate.

Growth of the dealership may beget more growth. "If you are successful as a dealer, you may absorb a competitor or the manufacturer may give you an opportunity to build another dealership," says Oshins.

The Planning Process

Ideally, a car dealer will start the planning process early on, identify goals, and engage in estate and succession planning. Having the right advisors for this process is critical.

"A lot of dealers started out as salesmen who used to just sell cars. They don't have the knowledge about how to run a dealership and maximize the profits as a business. They haven't experienced how to set up entities to reduce risk," notes Oshins. "Then when they realize they need to do some planning, they use the CPA who did their income tax returns and who they grew up with instead of a specialist."

Brown observes that the auto dealer's exit is often a sole owner selling to a third party. The dealership owner is typically a male with a large personality, and he may own more than one dealership.

Perhaps due to ego, the typical scenario is that the owner holds 100% of the business in his own name, does little planning until the last minute, and doesn't feel that anyone in his family is capable enough to continue the business.

Although there are a variety of exit planning techniques for other industries (succession planning funded by life insurance, ESOP buyout, family members and manager buyout), the auto dealership is often too large and complex for those approaches. "Once you get to that size level," says Brown, "owners prefer to sell to third parties because they get more money with less risk than other exit path alternatives."

Meanwhile, there has been a readily available market for dealerships for a long time—something that is not true of other industries. Consolidation has been taking place for 50 years or more. Many existing owners have 60 or 70 dealerships and continually acquire more. With sophisticated and well-funded buyers standing by, the process is somewhat simplified.

In either scenario, whether the sale is to a third party or within the family, the owner still needs to transfer wealth earlier rather than later because it is a growing business due to acquisitions.

Franchise buyers will typically want everything in the dealership with the possible exception of the land. The land is the only asset that may not actually appreciate much because of where auto dealerships are located. For the most part, the auto dealer's land is not going to become a shopping mall. It is usually only suitable for another auto dealership.

Finally, Brown notes that business planners concentrate on cash flow and ongoing business value without understanding estate planning, while estate planners concentrate on transfer taxation rather than cash flow and business needs.

The ideal exit planning strategy for an auto dealer, or any businessperson for that matter, is to start planning early, with qualified advisors, and marry the business and estate planning functions into a genuine exit planning strategy.

TECHNICAL REFERENCES

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4. Jeff Bennett, For Car Dealers, a Bleak Lot Brightens, *The Wall Street Journal*, (February 23, 2011).

Many thanks to my distinguished guests for their excellent input and assistance.

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***Note:** Jerome M. Hesch, Robert S. Keebler, and Richard A. Oshins are all members of the National Association of the Estate Planning Councils' "Estate Planners Hall of Fame."*