Tax Cut and Jobs Act: Impact on Dealerships

Highlights from the December 21, 2017 HBK Dealership Tax Act webinar

***Rex Collins, CPA, CVA** | Principal, Niche Leader | HBK CPAs & Consultants and HBK Dealership Industry Group*
***Nicholas Demetrios, CPA, MBA** | Principal | HBK CPAs & Consultants and HBK Tax Advisory Group*

On December 21, more than a hundred automobile, construction equipment and agricultural equipment dealers across the country tuned in to a one-hour webinar designed to explain how the provisions of the Tax Cut and Jobs Act will impact dealers and their dealerships. Following are notes from the webinar on the major issues that affect dealerships.

Note: The provisions of the new law apply to the 2018 tax year, with the exception of 100 percent expensing, which is effective September 27, 2017. As well, certain issues are going to require Treasury to issue regulations on the practical implementation of these laws. The IRS is likely to begin issuing clarifying regulations in January.

Changes to C-corporation tax rates

The Act introduces a flat 21 percent corporate tax rate, which eliminates the current graduated rates of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 35 percent on income from $75,000 to $10 million. Despite the cut in rates, dealers should not rush to convert to C-corporation status. There are many factors to be analyzed before moving away from pass-through entity status.

Corporate Alternative Minimum Tax (AMT)

The corporate AMT has been repealed. As a dealer operating as a C-corporation, you will not have to concern yourself with the alternative minimum tax in 2018. However, dealers with AMT credit carryovers will be allowed to offset regular tax liability with those credit carryovers and may be able to claim a refundable portion of the credit in excess of regular tax liability. Any unused credits are fully refundable in 2022.

The individual AMT still exists, but most of the deductions that trigger AMT have been eliminated or modified. Exemption amounts for joint filers increase from $86,200 to $109,400; the phase-out range increases from $164,725 to $1 million.

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Business interest expense limitations

This is great news for most dealers. The new law creates a deduction limitation of 30 percent of the business's adjusted taxable income, which is essentially earnings before interest, depreciation and taxes. Any interest amounts not deducted can be carried forward indefinitely.

There are, however, various exceptions. The business interest limitation will not apply to dealership floor-plan financing – indebtedness used to finance the acquisition of motor vehicles held for sale and secured by the inventory – for dealers of automobiles and trucks, farm equipment, recreational vehicles, motorcycles and boats, for sale or lease. You can deduct the interest expense on your floor-plan financing without regard to the 30 percent limitation.

Construction equipment dealers are subject to the 30 percent limitation. Businesses with average gross receipts of $25 million or less are exempt from the 30 percent limitation, however, this gross receipts threshold is lower than the average gross receipts for most dealers.

Other businesses are limited as to the deductibility of interest as described in the above paragraph. The concession for dealership floor-plan financing was won in a phone meeting with the Ways and Means Committee, which had approved a carve-out for real estate and public utilities previously. It appears the interest carve-out only relates to the floor plan, so there are still limitations of the deductibility of interest for the dealership property mortgage and term notes relative to the acquisition of blue sky, equipment, or a line of credit for other business purposes.

Please note: Dealers with multiple business lines who might not qualify for floor-plan financing exceptions or have the other items of interest should track interest deductions separately until further guidance on handling those deductions is issued.

One hundred percent expensing: depreciation and cost recovery

The Tax Cut and Jobs Act allows for one hundred percent expensing of the cost of qualified property acquired and placed in service after September 27, 2017, and before Jan 1, 2023. This replaces the current 50 percent bonus depreciation we've been working with in some form or fashion since 2003. It applies to used property as well as new, a major change from previous law regarding bonus depreciation.

Dealerships using the one hundred percent floor-plan interest deduction cannot use one hundred percent expensing. However, the 50 percent bonus depreciation still applies for property put in place through September 2017.

In summary, if you have new or used property put in place after September 27, 2017, and you are using the floor-plan financing exceptions for interest expense deductions, the one hundred percent expensing provisions are not available. . The only dealerships that can use the one hundred percent expensing provision are those with under $25 million in gross receipts. Also, construction dealers, who do not qualify for the floor-plan financing carve out, can use the hundred percent expensing for qualified property.

Luxury auto depreciation

"Luxury" autos include all passenger autos under six thousand pounds. The maximum allowable depreciation for these vehicles increases from $3,160 to $10,000 the first year of ownership, from $4,100 to $16,000 in the second year and from $2,450 to $9,600 the third year, and will be indexed for inflation. These autos also qualify for $8,000 of first year bonus depreciation. For passenger autos eligible for bonus depreciation, which are those that are used entirely for business, depreciation can amount to as much as $18,000 in the first year. Regulations for vehicles dealers use as loaners or rentals have not changed and are not subject to these limitations.

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Farm machinery and equipment

The depreciable lives for farm machinery and equipment are reduced from seven to five years. This equipment can now use 200 percent declining balance MACRS depreciation.

Section 179

The new tax law allows dealers to continue to use Section 179 expensing in addition to taking the dealership floor-plan financing interest exemption. Section 179 is limited by the taxable income of a dealer, so it could be used to reduce taxable income to zero. The amount of qualifying property that can be expensed increases from $.5 million to $1 million and the phase-out amount from $2 million to $2.5 million. The list of real property items that qualify for 179 expensing is expanded to include qualified improvement property. Dealers with large rental fleets will not be helped by 179 financing as they typically have more than $2.5 million in vehicles in service and will be phased out of the deduction..

Many subsequent improvements to nonresidential buildings will now qualify for 179 treatment and immediate expensing, including roofs, heating and air, fire protection, and security systems.

Real estate depreciation

Current provisions remain in effect regarding the depreciable lives of real property, which is 39 years for nonresidential and 27.5 years for residential.

Separate definitions for "qualified leasehold improvement property" are eliminated and replaced with a more inclusive "qualified improvement property." Assets that fall into this category are depreciated using a 15-year life. They are eligible for 179 expensing, but not for 11 percent expensing. Under old qualified leaseholder improvement rules, the beneficial lives and expensing could not be used unless the building was in service for at least three years and was pursuant to a lease with unrelated parties. These have been eliminated under the "qualified improvement property" requirements. This represents a substantial new benefit.

Like Kind Exchanges

Like-kind exchanges will be allowed for real property only in 2018 and beyond, not personal property. This is a tremendous blow to dealers with rental operations and will be perceived as a detriment by dealership customers. For example, a farmer trading in a combine and getting a $100,000 trade-in value with no remaining tax basis on that equipment would have to pay tax on a $100,000 gain. However, the cost of the new vehicle could offset the gain through the increased expensing provisions.

LIFO

Despite threats to eliminate LIFO, those inventory rules remain in place. No changes are issued in the Act, which is great news for dealerships.

Net operating loss (NOL) deduction

NOLs are now limited to 80 percent of the taxable income with the remaining 20 percent carrying forward indefinitely. This only applies to losses generated after January 1, 2018, with prior NOLs still eligible to offset one hundred percent of the dealer's taxable income.

Entertainment expenses

Entertainment expenses that were previously subject to a 50 percent deduction limit are now fully nondeductible. Meals with associated business purposes still have the 50 percent allowance. Another change has to do with employer-provided meals that typically were one hundred percent deductible as deminimus fringe benefits. These are now limited to a 50 percent deduction limit and will be fully nondeductible after 2025.

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Lower rates on pass-through entities

That Act allows for a 20 percent deduction of pass-through business income – S corporations, partnerships, proprietorships – for non-service businesses. Service businesses, such as accountants, attorneys, physicians, etc., are subject to different limitations and might not be eligible for the deduction. Dealerships are not service businesses.

Once taxable income exceeds certain thresholds, the deduction is limited to the lesser of 20 percent of qualified business income or the greater of 50 percent of the total wages of the business, not to include guaranteed payments or independent contractors; or 25 percent of wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all tangible personal property. The IRS will look hard at reasonable compensation to ensure that dealers are not shifting income to qualify for the limits.

The deduction is then compared to 20 percent of the dealer's taxable income net of any capital gains. The deduction is then the lesser of these amounts.

Trusts and estates are eligible for the deduction with W-2 income apportioned between the beneficiaries and the fiduciary.

Another new component to these rules is an aggregate loss limitation on pass-through business income. The amount of business losses deductible in any one year beginning in 2018 are limited to $500,000 regardless of what the net loss may be in total. The excess of net losses over $500,000 are added to the NOL carryover as discussed above.

Electric vehicle credits

Under the Act, the current credit of up to $7,500 for hybrid or electric vehicles is retained. This is good for customers, but can benefit dealers if these types of vehicles are sold to non-profit or government entities. For those sales, the credit can revert to the dealer if requirements are properly met.

Affordable Care Act mandate

The mandate to purchase health care insurance is repealed along with the related subsidies, but dealers would still be responsible for Medicaid surtaxes and the additional .9 percent Medicare tax on wages as well as on earned income over $250,000.

Estate and gift tax exemption

The estate and gift limits have been effectively doubled for 2018 and indexed for inflation beyond that. The limits project to be approximately $11.2 million for 2018.

These are the key issues of the Tax Cut and Jobs Act that apply to dealers and dealerships. Please contact the HBK Dealership Group with your questions or for more information.

Rex Collins is a Principal at HBK CPAs and Consultants. He directs HBK's National Dealership Industry Group, which provides tax, accounting and operational consulting exclusively to dealers. Rex can be reached at 317-504-7900 or at rcollins@hbkcpa.com.

Nick Demetrios is a Principal in the Youngstown, Ohio office of HBK CPAs & Consultants. He is a member of the HBK Tax Advisory Group and has experience with individual, partnerships and corporate tax compliance and research issues.

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