Crowe Horwath.

Smart decisions. Lasting value.™

Tax Reform: Key Considerations for Dealerships

January 22, 2018

Presented By
Joe Magyar, CPA
Natalie Frenier, CPA

The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.

Individual Income Tax Provisions

Individual Income Tax Changes

- Many itemized deductions are limited or eliminated
- Standard deduction increased
- Child tax credit increased
- Itemized deduction limitation is repealed
- **<u>Individual provisions generally sunset on Dec. 31, 2025</u>**

Individual Income Tax Changes

	Current Law	New Law
Tax rate	Top rate of 39.6 percent beginning at $480,050 for married filers and $426,700 for single filers.	Top rate of 37 percent beginning at $600,000 for married filers and $500,000 for single filers.
Standard deduction	$12,700 for married filers and $6,350 for single filers.	$24,000 for married filers and $12,000 for single filers.
Personal exemptions	$4,050 per individual and dependent.	Repealed.
Child tax credit	Partially refundable credit of $1,000 per child younger than age 17, with a phaseout starting at $110,000 of income for married filers, $55,000 for single filers.	Credit of $2,000 per child younger than age 17, with a phaseout starting at $400,000 of income for married filers, $200,000 for single filers. Up to $1,400 per child is refundable.

Individual Income Tax Changes

	Current Law	New Law
Affordable Care Act taxes	3.8 percent tax on net investment income and 0.9 percent tax on wages and self-employment income.	No changes.
Shared responsibility payment (individual mandate penalty)	Penalty imposed on individuals who do not maintain health insurance.	Repealed effective Jan. 1, 2019.

Individual Income Tax Changes

	Current Law	New Law
Mortgage interest deduction	Interest deductible on up to $1 million of acquisition indebtedness on primary residence plus one additional residence and $100,000 of home equity indebtedness.	Interest deductible on up to $750,000 of acquisition indebtedness incurred on or after Dec. 15, 2017. Eliminates deduction for home equity interest.
State and local tax deduction	Deduction allowed for state and local taxes.	Itemized deduction for up to $10,000 of state and local taxes.
Charitable contributions	Deduction allowed for charitable contributions. Cash contributions limited to 50 percent of adjusted gross income.	Deduction retained. Limit increased to 60 percent of adjusted gross income for cash contributions.
Casualty losses	Itemized deduction allowed for casualty losses.	Itemized deduction limited to casualty losses from a presidentially declared disaster area.

Individual Income Tax Changes

	Current Law	New Law
Unreimbursed employee expenses	Allowed as an itemized deduction.	Repealed.
Deduction for tax preparation services	Allowed as an itemized deduction.	Repealed.
Medical expenses	Deductible if in excess of 10 percent of adjusted gross income.	Retained. Expenses deductible through 2019 if in excess of 7.5 percent of adjusted gross income. Deduction returns to 10 percent threshold in 2020.
Miscellaneous itemized deductions, including tax preparation fees and investment management fees	Deductible if in excess of 2% of adjusted gross income.	Repealed.
Investment interest expense	Deductible to the extent of investment income.	No change.

Individual Income Tax Changes

	Current Law	New Law
Alimony	Deductible to payer, taxable income to recipient.	No deduction to payer and not taxable income to recipient. Effective for any divorce or separation agreement entered into on or after Jan. 1, 2019. Can elect to have the provisions apply to agreements entered into before Jan. 1, 2019, by modifying the agreement. Permanent change – does not sunset.
Moving expenses	Deductible if incurred in connection with work-related relocation.	Repealed.

Tax Reform – Estate, Gift, and GST Taxes

- Lifetime exclusion increased from $5 million to $10 million per person for estates of decedents dying and gifts made after Dec. 31, 2017, and through Dec. 31, 2025

- Because of inflation indexing, the 2018 amounts will go from approximately $5.6 million to $11.2 million per person

- Returns to $5 million per person on Jan. 1, 2026

- No changes to estate and gift tax rates

State Tax Implications

- Expect states to generally conform to broader federal base.
  - Approximately 40 states begin their individual computation with AGI or federal gross income.
  - 4 states begin with federal taxable income – may see less conformity from these states.

- 21 states have their own estate/inheritance taxes; states will need to either:
  - Adjust existing law, without federal estate tax to piggyback onto
  - Repeal and replace estate tax income with other sources

Corporate & General Business Tax Provisions

Corporate & Business Provisions

- Corporate tax rates – reduced to 21 percent starting in 2018, from a top rate of 35 percent.
- AMT repealed.
- Fiscal year clients will have a transition with blended tax rates.
- Evaluating the relative benefits of C-corp vs. S-corp will be an important planning consideration. Clients will generally have until March 15 to make this decision after considering all relevant facts and circumstances.

C-corp vs. S-corp/Partnership

DON'T RUSH THE DECISION

- Carefully consider all impacts of making pass-through vs. C-corp decision.
- Examples of criteria to be considered:
  - Intent to distribute profits
  - Potential of future sale of business
  - State tax implications
  - Ability to retain current accounting methods if going from pass-through to C corporation
  - Interaction with other business interests such as real estate and management companies
  - Financial statement tax provision
  - Impact on succession planning
  - Future tax law changes/political climate
- Check-the-box elections & S-corp elections can be made through March 15.
- Elections to revoke S-corp status and/or QSub elections can generally be made by March 15.

Depreciation & Cost Recovery

Bonus Depreciation

- 100% bonus depreciation for assets acquired from Sept. 28, 2017 through Dec. 31, 2022
- Bonus depreciation not available for real estate unless it is qualified improvement property
- Allows for bonus depreciation on used property
- Phases out bonus deprecation from 2023 through 2027
- 50% bonus depreciation on new property acquired and placed in service before 9/28/2017
- Transition rule for new property acquired before 9/28/2017 and placed in service after 9/27/2017 (binding contract)

- Bonus depreciation not available for property used in the following trade or business:
  - Trade or business that has had floorplan financing indebtedness (auto dealers) starting 1/1/2018. Dealership property acquired and placed in service between 9/27/2017 and 1/1/2018 is eligible for the new 100% bonus depreciation.

- Industry elections:
  - Electing real estate trade or business must depreciate nonresidential real estate, residential real estate, and QIP under the ADS regime – 40 years for buildings and 20 years for qualified improvement property. They also lose bonus depreciation on qualified improvement property. Electing real estate businesses still get bonus depreciation on personal property and land improvements.

Depreciation & Cost Recovery

- Provides 15-year depreciable life for qualified improvement property (QIP)
  - Eliminates qualified leasehold, qualified retail, and qualified restaurant property

Section 179 Expense

- Section 179 expense threshold increased to $1 million with phaseout at $2.5 million
- Expands the definition of qualified real property eligible for Section 179 expensing to any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems
- Property used in trade or business entities with floorplan indebtedness may qualify for Section 179 expense

Depreciation & Cost Recovery

Depreciation Limits for Luxury Automobiles

- Increases depreciation limits to:
  - Year 1 $10,000
  - Year 2 $16,000
  - Year 3 $ 9,600
  - Year 4 & after $ 5,750

Like-Kind Exchanges

- Like-kind exchanges repealed except for real property not held for sale.
- Deferred exchanges (forward and reverse) in progress as of Dec. 31, 2017, can be completed as like-kind exchanges.

Interest Expense Limitation

- Deduction for net interest expense limited to 30% of adjusted taxable income.
- Net interest expense is the excess of interest expense over interest income.
  - For partnerships and S-corps, interest income does not include portfolio interest.
- Dealership floorplan interest is an adjustment in the calculation.
- Adjusted taxable income is similar to EBIDTA through 2021:
  - Taxable income
  - PLUS interest expense
  - PLUS depreciation, amortization, and depletion
  - PLUS NOLs
- Adjusted taxable income is EBIT beginning in 2022:
  - Taxable income
  - PLUS interest expense
  - PLUS NOLs

Interest Expense Limitation

- Amounts in excess of 30% limitation would carry forward indefinitely.

- Generally applies on an entity-by-entity basis, including pass-through entities:
  - Owners of pass-through entities will be required to track carryforwards of excess interest.
  - Tiered pass-through entities have additional complexity.

- Does not allow the excess 30% limitation of one business to shelter the disallowed amount of another business.

- Consolidated group is one entity. Separate entity computations may still be required for state returns.

- Does not apply to:
  - Floorplan financing indebtedness
  - Real estate trades or businesses that elect to take ADS depreciation in lieu of bonus depreciation
  - Businesses with average gross receipts of less than $25 million for the prior three years – attribution rules apply

Interest Expense Limitation

Example – Corp A	2018-2021	Starting in 2022
• Taxable income without interest expense	$1,500,000	$1,500,000
• Plus depreciation, amortization, and depletion	$ 500,000	$ 0
• Adjusted taxable income	$2,000,000	$1,500,000
• 30% limitation	$ 600,000	$ 450,000
• Interest expense incurred	$ 750,000	$ 750,000
• Disallowed amount carried forward to future years	$ 150,000	$ 300,000

Net Operating Losses

- 80% limitation on use of NOLs generated in 2018 and later years.

- 2018 – NOLs can offset 100% of taxable income.

- Beginning in 2019:
  - NOLs incurred in 2017 and prior tax years can offset 100% of taxable income.
  - NOLs incurred in 2018 and later years can only offset 80% of taxable income.

- Generally no carryback allowed.
  - Two-year carryback retained for taxpayers engaged in the trade or business of farming.

- Indefinite carryover of NOLs generated starting with the 2018 tax year.

Credits

- Most credits retained.

- New credit – *Family & Medical Leave Act* wages:
  - Credit for up to 25 percent of wages paid under FMLA.
  - Credit only available for voluntary payments of wages. No credit if state or local laws mandate payment of wages for FMLA.

Credits

AMT Credit Carryforward

- Credit for prior-year minimum tax still available
- Credit partially refundable in 2018, 2019, and 2020
- Balance of credit refundable in 2021

General Business Credit Carryforwards

- The legislation appears to allow the carryforward of unused credits subject to taxable income limitations
- Repeals deduction for unused credits

Other Items

- Disallows any deduction for:
  - Entertainment and recreational expenses, including amounts paid for an entertainment facility
  - Social club membership dues
  - De minimis fringe benefits provided to employees that are primarily personal in nature
  - Qualified parking and transportation fringe benefits
  - On-premises athletic facilities
  - Deduction for meals provided at the convenience of the employer, beginning in 2026
  - Contributions made for university athletic seating rights (formerly an 80% deduction)

- The 50% deduction for trade/business food and beverage is retained in general until 2026.

- The new law now applies the 50% limit to certain meals provided by employers that were 100% deductible, until 2026:
  - Meals provided at a qualified on-premise dining facility
  - Meals provided on premise for the convenience of the employer – e.g., Saturday meals

- Holiday parties are still 100% deductible.

State Tax Implications

- 25 states and D.C. automatically conform to the IRC
- 21 states conform as of a fixed date; state legislation required to adopt changes
- Expect states will decouple from key areas, such as full expensing of depreciable assets

F&I Captives

- Domestic P&C insurance companies benefit from lower 21% rate.
  - Includes:
    - 831(b) Investment Income
    - Controlled Foreign Corporation (CFC) with domestic election

- Non-Controlled Foreign Corporation (NCFC)
  - Definition of U.S. Shareholder
    - Changed to voting rights OR value of the foreign entity (prior law only voting rights)
    - If U.S. Shareholders own 25% or more treated as a CFC
  - Passive Foreign Investment Company (PFIC)
    - Change in Insurance Company Exemption
    - Being classified as a PFIC may eliminate the deferral benefits of an NCFC

Pass-Through Entity Tax Provisions

Pass-Through Entity Provisions – Overview

New 20% deduction for a portion of pass-through income

Sunsets on Dec. 31, 2025

- Step 1
  - Tentative deduction is 20% of pass-through income not to exceed the greater of:
    - 50% of W-2 wages paid by the business
    - 25% of W-2 wages paid by the business plus 2.5% of the initial tax basis (not reduced by depreciation) of qualified property
      - Wage/capital limitation does not apply if owner’s 1040 taxable income is less than $315,000 ($157.500 single) unless a specified service business
      - Exemption from wage/capital limitation phases out over next $100,000 of taxable income ($50,000 single) and wage/capital limitation fully applies after taxable income reaches $415,000 ($207,500 single)
- Step 2
  - Deduction allowed is lesser of:
    - Tentative deduction computed in step 1
    - 20% of taxable income on the owner’s 1040 in excess of capital gain income

Pass-Through Entity Provisions – Overview

- Calculation is with respect to each trade or business.
  - Does Section 469, including grouping, control the definition of trade or business?
  - Is a rental activity including Schedule E property a trade or business. Does it matter if a triple net lease?
- Service Businesses – Favorable treatment not allowed above income threshold.
  - Finance companies and leasing companies should be eligible for favorable tax treatment.
  - The treatment of other non-financial services businesses is not clear at this time, e.g. management companies.
- Net operating loss provisions:
  - 20% deduction limited to cumulative taxable income after loss carryforwards. Appears to limit loss carryforwards to losses incurred in 2018 and later years.
- Effective tax rate is 29.6% assuming full 20% deduction using highest tax bracket of 37%.

Pass-Through Entity Provisions

- 20% deduction does not apply to:
  - Capital gains
  - Dividends
  - Portfolio interest
  - Foreign income

Qualified Property

- Qualified Property is:
  - Tangible property (personal and real) eligible for depreciation – does not include land.
  - Used to produce qualified business income.
  - Held at the end of the year and has not reached the end of it's depreciable period.
    - Depreciable period is defined as the longer of:
      - The last day of the last full year in the applicable recovery period that would apply to the property under section 168
      - 10 years

Qualified Property

- Example of 2018 calculation

Asset	Date Acquired	Cost	Life	Acc Dep	Adjusted Basis	Qualifying Amount 12/31/2018	Comments
Land	1/1/2005	1,000,000	n/a	n/a		0	Not depreciable
Building	1/1/2005	25,000,000	39	(8,333,000)	16,667,000	25,000,000	
Building Addition	1/1/2015	4,000,000	39	(410,000)	3,590,000	4,000,000	
Equipment #1	1/1/2005	5,000,000	5	(5,000,000)	0	0	more than 10 years old
Equipment #2	1/1/2010	5,000,000	5	(5,000,000)	0	5,000,000	
Equipment #3	1/1/2015	7,000,000	5	(4,200,000)	2,800,000	7,000,000	
Intiital Basis of Qualified Property						41,000,000	
2.5% of Qualifiyng Property (add to 25% of wages)						1,025,000	

Pass-Through Entity Provisions – General Rule

- Under the new law, the deduction is the lesser of:
  - 20% of income but not in excess of the greater of:
    - 50% of W-2 wages paid by the business
    - 25% of W-2 wages paid by the business plus 2.5% of the initial tax basis (not reduced by depreciation) of qualifying tangible property

	LLC/S-Corp A (Dealership #1)	LLC/S-Corp B (Dealership #2)	LLC/S-Corp C (Real Estate Entity)
Gross Income	$60,000,000	$60,000,000	$2,000,000
Wages Paid	$(1,000,000)	$(5,000,000)	$0
Other Deductions	$(54,000,000)	$(50,000,000)	$(1,500,000)
Taxable Income	$5,000,000	$5,000,000	$500,000
Initial Tax Basis of Qualifying Tangible Property	$800,000	$2,000,000	$3,000,000
20% of Taxable Income	$1,000,000	**<u>$1,000,000</u>**	$100,000
50% of Wages Paid	**<u>$500,000</u>**	$2,500,000	$0
25% of Wages plus 2.5% of Tangible Property	$270,000	$1,300,000	**<u>$75,000</u>**
Pass-Through Deduction Allowed	$500,000	$1,000,000	$75,000

Pass-Through Entity Provisions – Multiple Pass-Through Entities

- Assume K-1 #1 and K-1 #2 are qualified trades or businesses
- Pass-through entity deduction can't exceed 20% of taxable income

	Individual A	Individual B	Individual C
K-1 #1	$500,000	$500,000	$500,000
K-1 #2	$400,000	$400,000	$(400,000)
W-2 Income	$0	$150,000	$150,000
Adjusted Gross Income	$900,000	$1,050,000	$250,000
Itemized/Standard Deductions	$(50,000)	$(50,000)	$(50,000)
Taxable Income Before Pass-Through Deduction	$850,000	$1,000,000	$200,000
Pass-Through Deduction – K-1 #1	$(100,000)	$(100,000)	$(100,000)
Pass-Through Deduction – K-1 #2	$(80,000)	$(80,000)	$0
Pass-Through Deduction Cap – 20% of Taxable Income	$(170,000)	$(200,000)	$(40,000)
Pass-Through Deduction	$(170,000)	$(180,000)	$(40,000)
Taxable Income	$680,000	$820,000	$160,000

Pass-Through Entity – Loss Carryforwards

- Pass-through entity loses $4 million in 2018
- Pass-through entity makes $5 million in 2019

	2018	2019
K-1 Income	$(4,000,000)	$5,000,000
Loss Carryforward		$(4,000,000)
Income Eligible for Pass-Through Entity Deduction	$0	$1,000,000

Pass-Through Entity – Loss Limitations

- Only $500,000 ($250,000 single) trade or business losses can offset other income of an individual
- Includes losses from pass-through entities
- Unused losses become NOLs

	Current Law	New Law
Wages	$750,000	$750,000
Interest Income	$50,000	$50,000
Trade or Business Loss	$(600,000)	$(600,000)
Trade or Business Loss Allowed	$(600,000)	$(500,000)
Taxable Income	$200,000	$300,000
NOL Created	0	$100,000

Questions?

Thank you!

Joe Magyar
Partner
+1 813 209 2435
joe.magyar@crowehorwath.com

Natalie Frenier
+1 614 469 1279
natalie.frenier@crowehorwath.com