Crowe LLP
Independent Member Crowe Global

401 East Jackson Street, Suite 2900
Tampa, Florida 33602-5231
Tel +1 813 223 1316
Fax +1 813 229 5952
www.crowe.com

TCJA Guidance

Areas of Concern for Motor Vehicle Dealers
Prepared for NADA by Crowe

I. Section 199A – 20% Pass-through and Sole Proprietorship Deduction for Qualified Business Income

a. The Basics

Starting January 1, 2018, business income from a pass-through entity to an individual (and other taxpayers except corporations) and income from a sole proprietorship (but not wages) may be eligible for a 20% deduction against income taxed at regular income tax rates.

The deduction is limited to the larger of 50% of the wages paid by the business, or 25% of the wages paid by the business plus 2.5% of the basis in certain property.

Examples

	Example 1	Example 2	Example 3	Example 4
1. Business Income	$500,000	$2,000,000	$2,000,000	$2,000,000
2. 20% Initial Deduction	$100,000	$400,000	$400,000	$400,000
3. Wages Paid	$600,000	$600,000	$600,000	$1,000,000
4. 50% of Wages - Limit	$300,000	$300,000	$300,000	$500,000
5. Property Basis	$5,000,000	$5,000,000	$11,000,000	$5,000,000
6. 2.5% of Property Basis	$125,000	$125,000	$275,000	$125,000
7. 25% of Wages	$150,000	$150,000	$150,000	$250,000
8. Total of 6. & 7. - Limit	$275,000	$275,000	$425,000	$375,000
9. Deduction Allowed	$100,000	$300,000	$400,000	$400,000

b. Qualified Trade or Business

The deduction is 20% of business income from a qualified trade or business. The Internal Revenue Code (IRC) has several definitions of what constitutes a trade or business. Section 162 allows deductions for a trade or business. Section 446 provides the accounting methods for each separate trade or business. Section 1411 applies to net investment interest which, generally, is not derived from a trade or business. Section 1402 defines what income from a trade or business is subject to self-employment tax, etc. Section 469 generally equates passive income with a lack of active participation in a trade or business but allows for grouping of activities (rental with other trade or business activities) if they constitute an appropriate economic unit. Some of these provisions provide for grouping of activities and are interdependent.

For example, a taxpayer may be allowed to (or required to) group activities that may not be defined as a trade or business (e.g., leasing activities) with other activities that are defined as a trade or business (e.g., manufacturing). The combined activities may meet the definition of a trade or business.

Since the 20% deduction applies to each separate trade or business, the deduction could be very different if it is calculated for each separate trade or business rather than on a combined basis. Under the IRC provisions in effect before 2018, depending on the particular facts and circumstances, businesses could be organized as separate legal entities and be treated as a combined group under Section 469 and treated as separate trades or businesses under Section 446. Even under Section 446, the business activities of an entity in different locations or economic units could be treated either as separate businesses or as a single business depending on the facts and circumstances.

The situation becomes even more complex with multi-tiered entities that may or may not be disregarded and may or may not be under common control.

i. PROBLEM

Existing businesses were formed and organized based on the tax laws in existence prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA). The new law contains provisions that, on their face, will adversely affect many businesses because they are not organized in a way that takes full advantage of the 20% deduction. On the other hand, some businesses whose current structure would maximize the benefit of the 20% deduction might be negatively impacted by overly broad aggregation or grouping rules. The IRS has indicated that it will issue guidance that addresses these areas, which is essential since taxpayers require additional information to determine appropriate next steps.

ii. RECOMMENDATION #1

To help reduce the necessity to reorganize their businesses and reduce taxpayer burden in complying with the TCJA, it is recommended that the IRS allow taxpayers to group or regroup business activities that they control using the same rules that were in effect when TCJA was enacted, be given the opportunity to regroup if future IRS guidance for implementation of TCJA so indicates, and to calculate the 20% deduction on a consolidated basis for each group. The rules should embrace the concept that an appropriate economic unit would be treated as a trade or business even if it includes trade or business activities and rental activities. Taxpayers should also be given the opportunity to elect to regroup under IRC Section 469 to be consistent with the grouping for IRC Section 199A. These provisions will help make the intended reduction in tax easier to determine and make the process more closely aligned with the benefits provided to corporations who merely use their new lower tax rate.

iii. RECOMMENDATION #2

Alternatively, taxpayers should be allowed to arrange their financial affairs with the availability of comprehensive and complete guidance as to the application of federal tax law based on their individual situation. To provide taxpayers with this opportunity, the IRS should allow taxpayers the option of making changes in their financial structure until the extended due date of their 2018 federal tax return and have those changes be effective as of the beginning of their 2018 tax year. Additionally, any substantive changes to this guidance should take effect prospectively.

c. <u>W-2 Wages</u>

The Act includes a limit for the 20% deduction that is based, in whole or in part, on wages paid by the business, specifically W-2 Wages "with respect to the qualified trade or business."

Many businesses contract with separate payroll agents to provide a variety of alternatives to traditional W-2 employee arrangements. These agent companies include employee leasing companies (ELC), professional employer organizations (PEOs), etc. Some PEOs are certified by the IRS (CPEOs) and perform in a manner that is consistent with a co-employer arrangement.

The IRS regulations provide this guidance regarding the meaning of employment-related services:

> *Provider of employment-related services* means a person that provides employment tax administration, payroll services, or other

employment-related compliance services to clients, including, but not limited to, collecting, reporting, and paying employment taxes with respect to wages or compensation paid by the person to individuals performing services for the clients. A provider of employment-related services includes, but is not limited to, a CPEO.

Additionally, some multi-faceted businesses organize as separate legal entities but use one entity as a common paymaster for all related entities.

In all of these situations, services are being provided by people who work each day at one company but the name of a different company, PEO, ELC, or payroll agent appears on their W-2s.

IRC Sections 3511 and 7705 were enacted in 2014 (i) acknowledging that these arrangements between clients and companies that provide employment-related services are allowable under current law, (ii) authorizing the IRS to establish the CPEO program, and (iii) relieving CPEO clients of liability for federal tax deposits that were paid by the client to the CPEO but were not deposited by the CPEO.

IRC Section 199 similarly allowed a deduction based in part on W-2 wages. Treasury Regulation 1.199-2 addresses the issue of companies using payroll agents by providing that wages paid by an entity other than the common law employer (payroll agent) may be taken into account by a taxpayer who is the common law employer even though the payroll agent is listed on the Form W-2.

i. PROBLEM

How will the IRS apply the term "W-2 Wages with respect to the qualified trade or business" under IRC Section 199A? One interpretation could be that only the company whose name is shown on the W-2s may use those wages as a basis to calculate the limitation for the 20% deduction. Another interpretation could be that when a W-2 is issued by a payroll agent, whether a common paymaster, ELC, or (C)PEO, the only business that may use the W-2 wages amount for an employee would be the company that benefitted from the services of the employee. It would be manifestly unjust for the payroll agent (ELC, PEO, etc.) to be able to use the W-2 wages paid to those employees who actually worked for the client as a basis for the provider's 20% deduction.

ii. RECOMMENDATION #3

To clarify what appears to be the clear intent of the Act, the IRS should provide guidance explaining that the term "W-2 Wages with respect to the qualified trade or business" means the W-2s for workers of a business and not the payroll agent.

d. <u>Specified Service Trades or Businesses</u>

As stated above, the deduction is 20% of business income from a qualified trade or business including pass-throughs and sole proprietorships but does not apply to W-2 wages paid to an employee. However, certain businesses may not qualify for the deduction depending on the type of business activity and the level of income.

The businesses that may not qualify are trades or businesses involving the performance of services:

- in the fields of health, law, …accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners, or
- in the area of securities and investments generally.

While there is an opportunity for a deduction for these businesses at lower income levels, the deduction begins to phase-out for single taxpayers at $157,500 of taxable income ($315,000 joint) and is completely eliminated at $207,500 for single taxpayers ($415,000 joint).

Some auto dealership groups with multiple stores and locations establish separate management companies that provide administrative services and leadership to the stores and receive management fees from the stores. The management company may be limited to the dealer/owner or may have a full staff of professionals including accountants, human resource professionals, attorneys, etc. If such a management company were a pass-through or a single member LLC owned by another pass through entity or an individual, would its income qualify for the 20% deduction?

As discussed above, if the IRS allows taxpayers to group or regroup their businesses and aggregate them, the income of the management company would, presumably, be combined with the dealership income that would qualify for the 20% deduction. What if the IRS decides that the computation is to be conducted for each individual trade or business? Would the fact that the management company was performing services for auto dealerships to profit from the sale and servicing of new and used vehicles be attributable to the management company? If not, would the IRS determine that the management company was merely a consulting business that meets the definition of a "Specified Service Trade or Business?"

In most cases, the taxable income of the owner will be at a level where no deduction will be allowed if the business is classified as a specified service trade or business.

Auto dealership management companies are different from most specified service businesses since they are not usually standalone businesses. Rather, their services are provided for the benefit of controlled or, at least, related auto dealerships. The management services focus on effectively managing the operations of several, if not many, auto dealerships selling new and used vehicles, parts, services, accessories and related products to both individual and commercial customers.

i. PROBLEM

If the IRS determines that auto dealership management companies are standalone specified service trades or businesses, they will not be able to deduct any portion of the 20% Section 199A amount that will be allowed to the same type of business where management and operations are combined into one company. Most of these dealers will not qualify for any of the favorable exceptions based on income.

ii. RECOMMENDATION #4

To clarify that the intent of the TCJA was not to penalize businesses for their organizational structure, the IRS should provide guidance that auto dealership management companies are not to be considered as specified service trades or businesses.

e. <u>LIFO Recapture</u>

Motor vehicle dealerships that use LIFO are required to recapture the accumulated LIFO benefits as income in the year when they liquidate their LIFO inventory. If such a sale occurs at the end of a year, the taxpayer's Section 199A deduction would be limited based on a full year's worth of wages. If the sale occurs earlier in the year, the wages for the purpose of the limitation would be only a fraction of the yearly wages.

i. PROBLEM

Dealers who sell their LIFO inventory early in the taxable year and report significant LIFO recapture income will be severely affected by having the Section 199A wage limitation based on a fraction of a year's wages for that trade or business.

ii. RECOMMENDATION #5

The IRS should provide that LIFO taxpayers who sell their businesses during a taxable year may utilize the wages of that business during the 12-months prior to the sale for purposes of determining the wage-based limitation computations.

II. Section 168(k)(9)(B) Bonus Depreciation and Section 163(j)(1)(C) Floor Plan Interest Expense Deduction and Like Kind Exchange

a. Bonus Depreciation

The TCJA generally allows a taxpayer to deduct 100% of the cost of qualifying property as additional first-year depreciation. Qualifying property is generally new and used tangible property used in a trade or business with an applicable recovery period of twenty years or less and placed in service in the taxable year.

The Act also places a new limitation on the deductions by a business for interest expense that is generally 30% of the taxpayer's adjusted taxable income for the year. However, the Act also provides an exception and allows dealers a deduction for their floor plan interest. As a tradeoff for this deduction, the property used in these business does not qualify for the bonus depreciation deduction.

IRC Section 168(k)(9)(B) provides:

> The term "qualified property" shall not include any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section.

IRC Section 163(j)(1)(C) provides:

> The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of the business interest income of such taxpayer for such taxable year, 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus the floor plan financing interest of such taxpayer for such taxable year.

Some dealers may have a small amount of floor plan interest or lower amounts of other interest and prefer to forgo using the additional floor plan limits in favor of the bonus depreciation deduction. The reference to IRC Section 168 above, by using the word "if," gives the impression that deducting interest under the additional allowance for floor plan interest may be optional and, if a dealer forgoes that additional allowance, the bonus depreciation would be deductible.

However, the reference to IRC Section 163 does not contain the word "if" and makes a matter-of-fact statement - "plus the floor plan interest for the year" - indicating that if there is floor plan interest, it is deductible with no options.

It may have been the intent to provide a benefit to certain taxpayers who pay significant floor plan financing interest without realizing that not all taxpayers who pay smaller amounts of floor plan financing interest would be penalized by this provision.

i. PROBLEM

If the additional limits allowed for deducting floor plan interest are optional, can dealers elect to use only the general limits for interest deductibility and forgo any additional deduction in favor of deducting bonus depreciation?

ii. RECOMMENDATION #6

To clarify the clear intent of the TCJA, the IRS should provide guidance that dealers may annually choose between deducting interest using the non-floor plan interest limits or deduct bonus depreciation.

b. <u>Floor Plan Interest Expense Deduction</u>

The TCJA allows taxpayers to deduct floor plan financing interest while placing limits on deductions for most other types of business interest. Floor plan financing interest is allowed for only certain motor vehicles including a boat, farm machinery or equipment, and any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.

Truck and RV dealerships generally sell both self-propelled and towable vehicles either separately or in combination. Boat dealerships generally sell boats and trailers for boats. The floor plan accounts for these businesses may have both self-propelled and towable vehicles financed through a single account.

Farm implement dealers sell both self-propelled and towable devices and generally have both on the same floor plan account.

The interest on the farm implement floor plan account appears to be fully deductible as floor plan financing whereas at least a portion of the interest for truck, RV and boat dealerships' floor plan interest financing may not qualify since some of the items financed do not appear to meet the definition of a motor vehicle.

There is no indication that, in drafting the TCJA, Congress intended to treat farm implement dealers more favorably than truck and RV dealers.

i. **PROBLEM**

Farm implement dealers appear to be allowed to deduct towable implements whereas truck and RV dealers do not appear to be entitled to deduct floor plan interest for trailers.

ii. **RECOMMENDATION #7**

To establish parity between farm implement dealers and truck and RV dealers, the IRS should provide guidance that truck trailers and RV trailers also qualify as motor vehicles and are included in the favorable floor plan financing treatment. This treatment would be particularly appropriate when a dealer sells both motorized vehicles and trailers that are financed in the same floor plan account.

c. <u>Individual Deduction for Interest on Debt Involving Partnerships & S Corps</u>

The TCJA limits the deduction for business interest to 30% of adjusted taxable income for the year. When an individual finances the purchase of an ownership interest in a pass through entity, the interest that is properly traceable to the ownership under prior law would be deducted by the owner on Form 1040 Schedule E against the income from the entity.

Under the TCJA, all business interest deductions are subject to limitation based on adjusted taxable income. It appears that in some situations, the pass through entity would be required to calculate a limitation on its interest deduction and another computation may be required at the ownership level. Since the owner of the pass through entity incurred interest on the debt involving the entity, it is unclear (i) whether the interest paid by the owner would be included with the entity's limitation computation or in a separate computation at the owner's level, and (ii) exactly how those computations would be made. The Act also provides for a threshold exemption when gross receipts are under $25 million.

i. **PROBLEM**

What is the proper procedure to compute the interest limitation when there is interest expense at the pass through entity level and interest on debt to purchase at the ownership level and the owner is involved in one or more similar arrangements? Additionally, how is the $25 million threshold to be applied?

ii. **RECOMMENDATION #8**

The IRS should provide guidance that the owner of a pass through entity that is involved in an active trade or business is also considered to be involved in the same active trade or business and can deduct the interest on the acquisition debt to the extent that there is excess capacity for the deduction at the entity level.

d. Section 168(e)(3)(E) 15-Year Property

Under the TCJA, Qualified Improvement Property means an improvement to the interior of a nonresidential building if the improvement is placed in service after the date the building was placed in service but does not include an enlargement or structural framework of the building.

IRC Section 163(e)(3) provides the class life of certain property and, while IRC Section 168(e)(6) defines Qualified Improvement Property, there is no reference to its class life. The TCJA Conference Report (Business Reform, B. Cost Recovery, 4. Applicable recovery period for real property) indicates that the TCJA provides for a general 15-year MACRS recovery period for Qualified Improvement Property. However, there is no reference to the recovery period for Qualified Improvement Property in IRC Section 168(e)(3)(E), 15-year property.

i. PROBLEM

There is no statutory language establishing the recovery period for Qualified Improvement Property.

ii. RECOMMENDATION #9

The IRS is aware of this error and, if corrective legislation is not practical, it should examine whether it possesses authority – and, if such authority exists, it should exercise its authority – to correct this error.

e. Like Kind Exchange

The Act eliminates the benefit of like kind exchange (LKE) for all property except real property. Under prior law, LKE allowed taxpayers, like those who purchased fleets of vehicles, especially heavy-duty trucks, to trade-in their existing vehicles in exchange for new vehicles and defer the gain on the trade-ins. Since these businesses were trading up for new vehicles, LKE made it possible for them to improve their over-the-road fleet of vehicles and provide economic stimulus for both truck dealers and manufacturers.

i. **PROBLEM**

For some taxpayers, the elimination of LKE and the resulting taxable gain will be offset by the 100% bonus depreciation deduction. For other taxpayers, 100% bonus depreciation is either not allowed (e.g., dealers with floor plan interest) or other factors prevent the partial or complete offset of the gain.

Under the TCJA, there will be a tax penalty for such upgrades and, consequently, it is likely that economic activity for new trucks will be reduced. This hardship could be softened by allowing certain taxpayers to transition to the new rules over a period of time.

Additionally, this provision will create economic hardship for some dealers who replace their lease and rental fleets annually, as they will lose the ability to deduct bonus depreciation when replacing their current fleet with 2018 vehicles and thereby incur a 40% recapture in 2018.

ii. RECOMMENDATION #10

It is recommended that the IRS provide that for sales of personal property through December 31, 2023, a taxpayer may elect to recognize the gain of property previously acquired through both like-kind exchanges and short-term lease and rental fleets over a five-year period beginning in the year of the disposition.

III. Section 274 Business Meals

The TCJA disallows business deductions for entertainment, amusement or recreation, club dues, and the costs for the use of a facility. The 50% deduction for these items is no longer allowable. Deductions for 50% of food and beverages associated with business continue to be allowed for employee meals for work travel, etc.

What is unclear under the change is whether the presence of some element of entertainment or recreation disallows the 50% deduction, such as when a business meal occurs during a sporting event, etc.

Under prior law, business expenses for recreational, social, and similar activities (including the cost for the use of facilities) were not subject to the rules that generally applied to entertainment and travel costs, including the rule that only allowed a 50% deduction, as long as the primary benefits were not for highly compensated employees and owners. Rather, the cost for these activities were and appear to remain 100% deductible.

Businesses frequently hold sales events for customers from the general public, targeted potential customers, or existing customers. These events include food and beverage, demonstrations, and other activities (some directly related to the business and some more general) and are intended to attract the desired attendees. The cost of these events should be fully deductible as primarily sales events and not entertainment.

a. PROBLEM

The new provision disallowing all entertainment expenses should not be construed in an overly broad manner, and the IRS should provide specific guidance clearly identifying what may and may not be deducted. Without such guidance, taxpayers will be uncertain as to how they should plan and structure these types of activities.

b. RECOMMENDATION #11

The IRS should provide clear guidance that:

- Business meals in a clear business setting, even though during an entertainment event, qualify for the 50% deduction;
- Recreational, social, and similar events, including holiday parties and picnics either on- site or off-site, continue to be 100% deductible; and
- Sales events, even though they include meals and entertaining activities, are 100% deductible.

IV. International – Reinsurance Companies

Auto dealers are concerned that their foreign insurance companies may be subject to several adverse provisions contained in the TCJA such as those that would cause their foreign companies to become passive foreign investment companies that incur higher taxes. Also of concern is the application of the Act to the redemption of undistributed foreign earnings and profits and whether the tax on global low-taxed income will apply.

a. PROBLEM

The need for timely guidance is essential as taxpayers have a limited period of time to take appropriate action during 2018 to minimize the negative effect of any adverse guidance by the IRS.

b. RECOMMENDATION #12

The IRS should either defer the effective date of the relevant TCJA provisions to a later tax year or (i) provide an option for taxpayers to make financial and organizational decisions up until the extended due date of their 2018 returns, and (ii) make the effective date of those decisions back to the beginning of 2018. This will allow taxpayers and their advisors the time necessary to react to the guidance and plan accordingly.