INSIGHTS FROM THE BDO AUTO DEALERSHIP PRACTICE

POTENTIAL TAX BENEFITS OF CAPITAL INVESTMENTS FOR AUTO DEALERSHIPS

BDO Driving Profits
NEWSLETTER

Auto dealers are navigating unprecedented market conditions, and most are experiencing an improved bottom line and healthier cash flow. Many dealers delayed making major capital improvements or significant purchases of personal property during the pandemic due to the volatile circumstances and concerns around potential shutdowns. Now that we've entered what many consider the post-pandemic era, dealers are in a position to put their working capital to good use.

Dealers should work with their tax advisors as they contemplate significant capital improvement projects such as facility upgrades or the installation of electric vehicle infrastructure. Interior renovations to existing buildings may be considered "qualified improvement property" (QIP), which must be depreciated straight-line over 15 years and are eligible for bonus depreciation (100% through 2022). The changes to the business interest expense limitation calculation for taxable years beginning after January 1, 2022, may have a substantial impact on the amount of depreciation expense immediately available for dealers when placing improvements in service.

As a refresher, the business interest expense limitation was introduced through the 2017 Tax Cuts and Jobs Act (TCJA). A taxpayer's business interest expense deduction is limited to the sum of business interest income, floor plan financing interest and 30% of adjusted taxable income (ATI). For taxable years starting before January 1, 2022, depreciation, amortization and depletion were added back to taxable income when computing adjusted taxable income for purposes of this calculation. Therefore, accelerated depreciation has not had any bearing on the amount of deductible business interest expense. Beginning in 2022, adjusted taxable income **will include** deductions for depreciation and amortization.

Most, if not all, dealerships use floor plan financing. For such dealers, an exception was created to allow them to fully deduct their floor plan interest expense if they are unable to do so when applying the standard 30% of ATI test. If the dealer can deduct all of its business interest expense without using the floor plan interest exception, bonus depreciation can be utilized.

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However, if a floor-planning dealer is unable to fully deduct its business interest expense (including floor plan interest) when applying the 30% of ATI test, bonus depreciation is unavailable for that taxable year. What does this mean for dealers in 2022? If a floor-planning dealership makes a significant depreciable investment, it is now more likely to be limited on the availability of bonus depreciation beginning in 2022.

Despite these changes, there are ways to maximize the tax benefits of capital improvements. If a related entity owns the real estate used by an auto dealer, and the lease is structured in a way that allows for the landlord to pay for and capitalize the improvements, it may be advantageous for the real estate entity to capitalize the project. Since the real estate entity does not have floor plan interest expense, it would be allowed to deduct bonus depreciation on eligible property. The real estate entity may be subject to a business interest limitation because of the accelerated depreciation; however, the benefits of this approach may outweigh the limitations.

If the real estate is owned by an unrelated third party and the dealership capitalizes the improvements, there may still be an opportunity to take advantage of accelerated depreciation, but potentially to a lesser degree. Taxpayers can elect out of bonus depreciation by class of property, which means a taxpayer could potentially take bonus depreciation on 15-year QIP property and elect out of bonus depreciation on five- and seven-year property.

The nonrefundable federal EVI tax credit for commercial property that was used to help offset up to 30% (maximum of $30,000) of the total costs of purchase and installation of EV equipment expired on December 31, 2021. EVI is considered five-year energy property for federal tax purposes and is considered a separate class of property for bonus elections. Many observers anticipate that this credit will be extended; if it is, the credit is not included in the add-back.

Additionally, the tangible property regulations (TPR) must be kept in mind. The TPR provide clear guidance on distinguishing capital improvements from deductible repairs and discuss the proper treatment of retail store refresh or remodel projects. Depending on the scope of a project, a portion of the overall investment may be considered a "refresh" under these rules, which would be treated as a repair or maintenance expenditure rather than a capital asset. This determination is based on the facts and circumstances of the specific project. Along with QIP, expansions to existing buildings are not considered a "refresh."

While the changes to the business interest expense limitation may impact which entity capitalizes improvements or ultimately how much depreciation can be taken in year one, with proper tax planning there may be ways for dealerships to reap the tax benefits of such improvements.

HOW BDO CAN HELP

Because significant capital investments can put a strain on cash, you should review whether you're taking full advantage of available tax deductions to help offset the initial cash outflow. BDO has a wealth of experience helping dealerships like yours determine an appropriate strategy under your specific circumstances. We can help you navigate the complex depreciation and interest limitation rules to improve savings.

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BDO is a valued business advisor for auto dealerships, bringing a wealth of experience on traditional and emerging accounting, tax, and advisory issues. The firm's Auto Dealerships industry practice works with a variety of companies across the dealership sector, including automotive, motorcycle, marine, RV, rental equipment and more. We help dealerships of all sizes achieve their desired business outcomes.

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