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Tax Reform Eliminates Tax Benefits of Business Vehicle Trade-Ins

You often want to use tax code Section 1031 to avoid paying taxes on your existing property when acquiring replacement property.

As under prior law, you may continue to use Section 1031, but on real property only.[1] Your ability to use a Section 1031 tax-deferred exchange on personal property, such as your business vehicle, airplane, equipment, and collectibles, is gone.[2] Tax reform killed it.

Your new inability to use a Section 1031 tax-deferred exchange for personal property means that you no longer treat a business vehicle trade-in as a non-taxable event. Now, it's a taxable event.

But having a taxable event does not necessarily mean that you are going to pay more taxes. There's more than one nifty silver lining for many business taxpayers in this lost ability.

Silver Lining Number 1: Creating Cash

If you pay self-employment taxes, you usually come out ahead if you use the "sell and buy" strategy rather than the trade-in strategy (Section 1031 exchange).

With the sell-and-buy strategy, you save self-employment taxes because

- you don't pay self-employment taxes on the sale of your existing business vehicle, and
- you deduct depreciation and Section 179 expensing on your new vehicle (even when you use IRS mileage rates, you benefit).

Example. Sam sells his old zero-basis business vehicle for $17,000 and creates a $17,000 gain ($17,000 - zero). On this gain, Sam does not pay any self-employment taxes. The gain is a Section 1231 gain that Sam reports on his IRS Form 4797. The gain never gets to Sam's Schedule C or his Schedule SE.

On the purchase of his new vehicle for $41,000, Sam, who makes about $125,000 a year, saves at his actual self-employment tax rate of 14.13 percent.[3]

Under the old law, Sam could have traded in his old vehicle for the new, and his cost to purchase the new vehicle would have been $24,000 ($41,000 - $17,000). The $24,000 is going to produce less self-employment tax savings than the $41,000.

Thanks to tax reform and silver lining number one, Sam can no longer avoid saving money on his self-employment taxes with the sell-and-buy strategy.

Silver Lining Number 2: Finding Tax Losses

Let's stay with those taxpayers who file their business income and deductions on Schedule C of their 1040 forms or are otherwise considered self-employed, such as some partners in partnerships. These are the only taxpayers who can use the optional IRS mileage rates to deduct their vehicles.

The 2018 mileage rate is 54.5 cents a mile.[4] Inside each 54.5-cent mile that you deduct, you have 25 cents for depreciation.[5]

Example. You buy a 2018 vehicle for $37,000 and use it 100 percent for business. (We are using 100 percent because it makes for easy math and a clear picture of what happens.) You drive the vehicle 10,000 miles. Your depreciation is $2,500 (10,000 x 25 cents) and your adjusted basis is $34,500 ($37,000 - $2,500).

If you sell this vehicle for $25,000, you have a $9,500 tax-deductible loss ($25,000 - $34,500).

Because of tax reform, if you trade in this vehicle and the dealer gives you $25,000 on the trade, you also have a $9,500 tax-deductible loss.

Frankly, before tax reform, many Schedule C taxpayers who were using IRS mileage rates traded in their vehicles and missed the loss deductions entirely. And, sadly, this was true not only at the time of the trade but often throughout the life of that Schedule C taxpayer. In other words, these Schedule C taxpayers died and never realized their rightful tax loss deductions.

Now, because of tax reform and silver lining number two, mileage rate users are no longer going to overlook and miss out on their tax loss deductions.

Of course, there's the other group of self-employed people who have gains on their trade-ins and will now have to pay taxes on those gains. But this group likely should have been doing that anyway. Remember, people in this group are now going to save money on their self-employment taxes as explained in silver lining number one.

Silver Lining 3: Spending Less for Vehicles

Owners of S and C corporations don't generate any self-employment tax savings on the sales and purchases of new vehicles. They just have gains and losses.

If you operate as a corporation and the sale or trade-in of your existing vehicle is going to produce a big taxable gain, why do it? Before tax reform, when you could avoid taxes with the trade-in, you could easily justify the newer vehicle. Not so after tax reform.

We expect those who would have traded in vehicles to avoid taxes on gains to trade less because of tax reform. And their cost of vehicles is going to go down because they will own fewer vehicles over their lifetimes.

The reason this saves money is that vehicles generally go down in value, so with fewer vehicle purchases, your costs go down slower and you keep more of your money. You can thank tax reform for silver lining number three: losing less money on vehicles and spending less money on vehicles.

What to Know about Your Current Business Vehicle

Do you know what your business basis is in your vehicle (original cost, plus improvements, minus depreciation)? You should.

You see, when you sell this vehicle, you compare basis with selling price to find your gain or loss. (And remember, because of tax reform, you may no longer trade in to avoid tax gains on the sale of your vehicle.)

To form a strategy, you need to know if you have a gain or a loss.

A True and Enlightening Story

Jeff has been in business for 15 years. During that time, he has owned six cars and always traded in when getting his replacement cars. His original car cost him $33,000. Since the original, Jeff has given car dealers $100,000 to make his trades. As you read this, Jeff has invested $133,000 in cars ($33,000 + $100,000).

His depreciation deductions (mileage rates or actual) total $42,750, so his adjusted basis with 100 percent business use is $90,250. Let's say he can sell his current car for $14,000. With 100 percent business use, Jeff has a tax loss of $76,250 ($90,250 - $14,000).

If Jeff's business use is 80 percent, then his tax loss is $61,000 ($76,250 x 80 percent).

Trade-ins are what made Jeff's tax loss huge. Jeff's story is not unusual. This is especially true with businesspeople who use IRS mileage rates and think that's the end of it. They mistakenly don't consider the depreciation that's built into the mileage rates.

Jeff's story is a true story. And it could have been a truly sad story, because Jeff had no clue that he was missing his tax loss deductions. He simply thought that the IRS mileage rate deduction was all he had to know about his vehicle deductions. He did not know that depreciation was a component of the IRS mileage rate.

Jeff could have died and missed all his vehicle tax losses. Thankfully, we found him and helped him realize his tax deductions, as you see above.

And now with tax reform, Jeff has to recognize gain or loss on every trade. But here's the big question: Would Jeff know that there's a gain or loss in the mileage rates, or would he continue to wrongfully think that the mileage rates simply take care of his car deductions?

Takeaways

The loss of personal property Section 1031 exchanges creates silver linings for the following people:

1. Schedule C taxpayers and certain partners in partnerships, because (a) they do not pay self-employment taxes on the gains from sales of their old vehicles, (b) but they do save self-employment taxes with the deductions on the new vehicles. The self-employed group includes single-member LLCs who did not elect corporate treatment, 1099 recipients, proprietors, and certain partners in partnerships.

2. IRS mileage rate users who simply did not know that their mileage rate vehicles could produce a deductible loss. Now, tax law requires mileage rate users to calculate gain or loss when they trade in vehicles.

3. All business owners who now have to look at a taxable gain on a trade-in. Many of these owners will simply say no to paying taxes and keep the vehicle longer. They will save more money on vehicles because most vehicles decline in value.

Make sure you know your basis in your vehicle, right now. If you wait, you likely are not going to know your basis later, either. And that means you could do something you won't like with your vehicle.

And finally, remember Jeff. Don't be like Jeff.

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1 IRC Section 1031(a)(1).
2 Ibid.

3 On Schedule SE, where you compute the self-employment tax, you take 92.35 percent of your Schedule C income and then apply the 15.3 percent self-employment tax. This gives you a net savings of 14.13 percent (15.3 percent x 92.35 percent).

4 Notice 2018-3.

5 Ibid.