SUBMITTED COMMENTS OF
AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

Request for recommendations on overhauling the U.S. tax code

July 14, 2017

UNITED STATES SENATE

COMMITTEE ON FINANCE

Request for recommendations on overhauling the American tax system

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AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

This statement is submitted by the American International Automobile Dealers Association[1] (AIADA) in response to the request by Chairman Orrin Hatch for recommendations on improvements to the American tax system. Established in 1970, AIADA is and continues to be the only association whose sole purpose is to represent America's international nameplate automobile franchises that sell and service vehicles in the U.S. Our mission is to increase awareness in Washington, D.C., and around the country of our members' contributions to their communities and the American economy, and to preserve and promote a free market for international brand automobiles in the United States.

In cities and towns across our country, dealers of international brands operate 9,600 franchises and employ 577,000 Americans with a payroll of 32 billion dollars. Together they account for an additional 527,000 indirect jobs. In 2016, those same franchises sold 8.4 million vehicles, or 59 percent of total U.S. market share. International nameplate auto dealers did not stop there; in 2016 they spent an overwhelming $4.8 billion on advertising and sold $54 billion in parts and services. International nameplate auto dealers are a large, visible, and vital cog in our nation's economy, and they rely on the competitive pricing of their products to maintain and grow their businesses.

AIADA's dealer members represent the retail side of the international auto manufacturing industry, which has also invested heavily in the United States. International automakers have invested $75 billion in U.S. operations and have more than doubled their production in the U.S. over the past 15 years, producing 47 percent of all vehicles built here in America. In 2016 alone, 5.5 million vehicles were built by the American employees of international nameplate manufacturers in the U.S., of which 925,000 were exported to over 140 countries worldwide. International automakers directly and indirectly employ 1.29 million Americans and exports of

[1] AIADA represents America's international nameplate automobile franchises that sell and service the following brands: Acura, Aston Martin, Audi, Bentley, BMW, Ferrari, Genesis, Honda, Hyundai, Infiniti, Jaguar, Kia, Land Rover, Lexus, Maserati, Mazda, Mercedes, MINI, Mitsubishi, Nissan, Porsche, Rolls Royce, Smart, Subaru, Toyota, Volkswagen, and Volvo. These retailers have a positive economic impact both nationally and in the local communities they serve, providing more than 500,000 American jobs. Visit AIADA online at www.aiada.org.

international autos alone supported 265,000 US jobs. AIADA highlights all this information to ensure that the committee members are aware of the economic impact of international auto dealers and automakers in the United States.

Border Adjustment Tax

As an industry, we are very concerned with the proposed border adjustment tax provision found in the House of Representative's "Better Way" tax reform proposal. If passed into law, the 20 percent tax on all goods and services crossing the border into our country would hit international nameplate dealers and manufacturers hard – ultimately devastating American workers, American consumers, and the American economy.

Under the current tax system, both imported and domestically produced products are treated equally. When an American and foreign firm sell in another country, they both pay a corporate tax and a value added tax (VAT). American and foreign firms selling a product in the U.S. both pay just a corporate tax – the difference is that the American firm pays a 35 percent rate, while a foreign company might only pay a 17 or 20 percent rate. If American firms are at a disadvantage, it is due to the exorbitant American corporate tax rate, not a need to border adjust taxes.

In an increasingly global economy, it would be ill-advised and short-sighted to attempt to classify products, particularly automobiles, into categories of imports and exports and therefore pick winners and losers. Many Americans are employed as a result of the international nameplate automobile industry, including the 577,000 employed by international nameplate automobile dealers, and many more Americans benefit from being able to purchase quality products at affordable prices that result from this integrated supply chain.

The automobile industry is so globally integrated that many automobiles traditionally thought of as "foreign" brands are actually built right here in the U.S. and with more U.S. parts than the traditional American brands. Not one car sold in America contains 100 percent domestically produced content. Therefore, the 20 percent import tax will increase the price on all new vehicles, not just so-called foreign vehicles.

The proposed border adjustment tax would significantly impact new car sales through higher prices, reduced demand, restricted choice, and new obstacles for customers seeking auto loans. In fact, should the proposed border adjustment tax be implemented, a recent study conducted by the Center for Automotive Research[2] pegs the average price increase at about $2,000 per

[2] CAR's mission is to conduct independent research and analysis to educate, inform and advise stakeholders, policy makers, and the general public on critical issues facing the automotive industry, and the industry's impact on the U.S. economy and society. http://www.aiada.org/sites/default/files/CARS%20Study.pdf

vehicle. Given today's average new car price, loan rates, and terms as reported by Cox Automotive[3], AIADA estimates that the payment for the average car buyer could increase by nearly $100 per month, an increase that would cause many consumers to be priced out of the car market all together. Another report by Deutsche Bank says we should expect an increase of $2,300 per vehicle, reducing U.S. demand by 1.2 million units per year in the short term and 0.5 million units in the long term[4]. That is a striking decrease in sales and would cause a dramatic downstream impact on not just dealership operations, but the American economy as a whole.

The concern of affordability is not new to the auto industry. As the regulatory burden of manufacturing autos has increased with time, so has the cost of the vehicles. At the same time, household income has remained fairly stagnant. Cox Automotive found that while the current average price of a new car has increased by 35 percent in the past 20 years, household income only increased by 3 percent. A border adjustment tax would make an already bad situation worse.

The impact of the proposed border adjustment tax would be felt throughout the entire dealership. In addition to the increase in the cost of the vehicle, servicing and repairing a car would also increase. Analysts predict that the cost of gasoline would rise approximately 30 cents per gallon[5]. Consumers least able to afford the added cost will be the most impacted. Customers need safe cars and trucks to transport their families and get to work. They don't need a new consumer tax increasing the costs of nearly all their necessities.

Estate Tax

The majority of automobile dealerships are family-owned businesses, some of which have been in the family for generations. These businesses bear the brunt of the federal estate tax. While recent efforts to 'fix' the tax, such as raising the exemption and capping the rate, have been a step in the right direction, only full repeal of the tax will truly set us on the course to incentivize growth and encourage small business investment in the economy.

A common misconception is that the estate tax impacts only wealthy estates, but because it is a tax on capital, it is particularly harmful to small family businesses, such as auto dealerships.

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[3] Cox Automotive is a leading provider of products and services spanning the automotive ecosystem. No matter the stage of the auto buying or selling process, we have a solution for clients of any size.

[4] Deutsche Bank Research is responsible for macroeconomic analysis within Deutsche Bank Group and acts as consultant for the bank, its clients and stakeholders. They analyze relevant trends for the bank in financial markets, the economy and society and highlight risks and opportunities. DB Research delivers high-quality, independent analysis and actively promotes public debate on economic, fiscal, labor market and social policy issues.

[5] The Brattle Group, Border Adjustment Import Taxation Impact on the U.S. Crude Oil and Petroleum Product Markets, http://www.brattle.com/system/publications/pdfs/000/005/384/original/FINAL_Border_Tax_Paper_2016_12_16.pdf?1481912863

Capital is needed by dealerships to survive, to create new jobs, and to pay higher wages. For tax year 2017, upon the death of the dealer principal, surviving heirs must pay taxes of up to 40 percent of the estate's value above the current $5.49 million exemption. To pay these unreasonably high taxes, heirs often must sell the business, break it up, or liquidate their assets.

An auto dealership is a highly-leveraged, full service operation with all parts of the business integrated. Contractual arrangements with automakers can require franchised dealers to provide, and buy outright, new cars, services, equipment, and parts. For those inheriting a dealership, there are few assets of significant value that can be sold without adversely impacting the dealership as a whole. And unfortunately, paying the estate tax by selling off dealership assets is no guarantee that the business can continue to operate.

Some AIADA members spend over $100,000 a year on estate tax planning, funds that otherwise could be invested in business growth. The estate tax results in dealers diverting capital from business investment, costing jobs and threatening the ability of families to pass businesses on to the next generation of owners. As the Committee looks for ways to accomplish its objective of removing impediments to economic growth, repealing the estate tax should be at the top of that list.

LIFO

Last In, First Out (LIFO) is a method of inventory valuation which allows dealerships and other businesses to record the last units purchased as the first units sold and has been an accepted and established accounting method in the United States for 80 years. LIFO is considered a more accurate accounting method for industries that often experience rising inventory costs – such as auto dealerships – because it allows them to avoid the realization of phantom profits caused by inflation. Many dealerships have been on LIFO properly and legally for decades, creating years of LIFO reserves.

While some previous tax reform proposals have suggested that the use of LIFO should be disallowed and existing LIFO reserves "recaptured," this would fly in the face of one of the goals of tax reform, which is to allow businesses to fully and immediately expense any investments it makes, including inventories. Additionally, since LIFO is not a tax expenditure it should not be considered a source of revenue for reform.

The recapture of a company's LIFO reserve is a retroactive tax that would cause a company to be taxed as though it had sold all its assets, would have gotten no money from the sale, but would be taxed as if it had. Essentially, taxation of LIFO reserves would be a tax on something that isn't really an asset.

Obtaining the cash necessary to pay the punitive tax could force significant changes to ongoing operations, such as reduced employment, delayed expansion, and cancelled or postponed investments. For some dealerships without the ability to raise the funds necessary to pay the tax through cost reductions, repeal would force them out of business entirely – the LIFO reserve could exceed retained earnings or net worth, in which case the dealer would have to liquidate, and also might still owe tax. This is one of the reasons why some previous proposals to eliminate LIFO have allowed companies to pay taxes on their LIFO reserve over a number of years.

According to a report by the Tax Foundation[6], sudden changes in federal tax policy make businesses fearful that other arbitrary adjustments may happen in the future, and increase risk and uncertainty, which reduce the willingness to invest. Any changes to policy related to LIFO should be weighed with great consideration of the real-world consequences for businesses, such as car dealers, and their employees that have been using this method for decades under a different set of understood rules.

Pass-Throughs

Auto dealerships organize themselves using many different tax code classifications. They can operate as C corporations, S corporations, sole proprietorships, partnerships, and limited liability corporations (LLCs). Many dealers have chosen to operate as S corporations or pass-through entities for years, allowing them to pay taxes at the individual income tax rates. Operating as a pass-through entity also allows them certain tax preferences such as deductions, credits, and exclusions that make it possible for them continue to service the communities where they reside. These dealerships have long term employees and customers that rely on them for sales and service.

As the Committee works to bring together a comprehensive tax reform package, AIADA encourages them to consider those small businesses that operate as pass-through entities. We understand lowering the corporate tax rate is a priority and AIADA supports this goal. However, it most go hand in hand with lowering the individual tax rates and therefore preserving the tax treatment for the pass-through business model. Maintaining the use of a number of tax preferences such as the LIFO accounting method and accelerated depreciation are vital to the success of auto dealerships that operate as pass-through entities.

Interest Deductibility

As the Committee begins to consider comprehensive tax reform it is important to consider the way an auto dealership functions and finances its business. Auto dealers assume the majority of

[6] The Tax Treatment of Inventories and the Economic and Budgetary Impact of LIFO Repeal, The Tax Foundation

the risk in the sale of automobiles. They own, and therefore finance, every car in the dealership, every part in their service department, the dealership facility, and the land on which it sits. All of this means that the ability to deduct interest is a critical part of a successful business.

Without the ability to deduct interest the cost of financing a dealership would be unmanageable. It would be nearly impossible to afford the inventory necessary to run the dealership. Additionally, monies dealers would use to reinvest in their businesses and their community would be greatly limited. We urge the Committee to consider these concerns when forming their tax package.

Recommendations

The automotive industry in the U.S. is constantly evolving, and international nameplate automobile manufacturers and dealers are designing, building, and selling more vehicles across the U.S. than ever before. In the process, they are redefining the meaning of an "American" car. International nameplate dealers are growing their investment in the American economy and communities in a variety of ways and today provide the majority of America's auto retailing jobs and vehicles for American consumers, selling 59 percent of the new cars purchased by American consumers in 2016.

AIADA and its 9,600 American auto dealers strongly support a pro-growth comprehensive tax reform bill, but we believe it can only be accomplished without the inclusion of the border adjustment tax provision being discussed in the House. The border adjustment tax would have unintended consequences that would cause harm to our dealerships, their employees, and their customers.

Additionally, in order to truly spur investment, the federal estate tax should be fully and permanently repealed to provide certainty and fairness, and stop penalizing growing family-owned businesses. And finally, great care should be taken when considering any significant changes to long-standing tax policies, such as LIFO, the treatment of S corporations for tax purposes and interest deductibility, which allow auto dealerships and other small businesses, to continue investing in their operations, growing, and creating American jobs.

We look forward to working with the Chairman and the Committee as they move forward on crafting the comprehensive tax reform legislation our country needs.

CENTER FOR AUTOMOTIVE RESEARCH

Border Adjustment Tax: Estimated Impact on U.S. Vehicle Prices

Overview

This analysis highlights the immediate impacts of implementing a border adjustment tax on U.S. vehicle prices.

- The border adjustment mechanism is being considered as an integral part of the major corporate tax reforms that are expected to be introduced in the 115th Congress.
- Border adjustment is being considered as a way to generate sufficient tax revenues to offset the impact of lowering the overall corporate tax rate.
- The border adjustment mechanism functions by excluding cash-inflow from overseas (export revenue) and cash- outflow to foreign countries (import costs) in the taxable profit calculation.
- Automakers and suppliers that sell and manufacture in the United States are part of a highly globally-integrated industry.
- The automotive industry would see significant changes to their tax base under a border adjustment; the tax would be highly disruptive to U.S. vehicle sales and production.

Methodology

- This analysis is based on confidential financial data received from automakers representing over 50 percent of U.S. light vehicle sales.
- This analysis holds exchange rates constant, and examines only a price response to the implementation of border adjustment.
- The estimates are based on the impact of the proposed border adjustment tax on imported vehicles as well as parts used for vehicle production in the United States.
- This analysis estimates a price increase with no change in unit sales or domestic production—both of which would be affected by a price increase of this magnitude.

Findings

In response to the border adjustment:

- U.S. light vehicle prices would increase 5.6 percent in immediate response to border adjustment.
- Since the current U.S. average transaction price for new vehicles is $34,968 (Kelley Blue Book, 2017), average per vehicle price increases are estimated at $1,970.
- Assuming U.S. sales at 17.5 million vehicles in 2016, the light vehicle price increase represents $34.6 billion in higher costs to consumers.
- The $1,970 price increase resulting from the proposed border adjustment masks the turbulence and churn in the market which would significantly impact models, segments, and even entire companies.

http://mediaroom.kbb.com/2017-02-01-New-Car-Transaction-Prices-Remain-High-Up-More-Than-3-Percent-Year-Over-Year-In-January-2017-According-To-Kelley-Blue-Book

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