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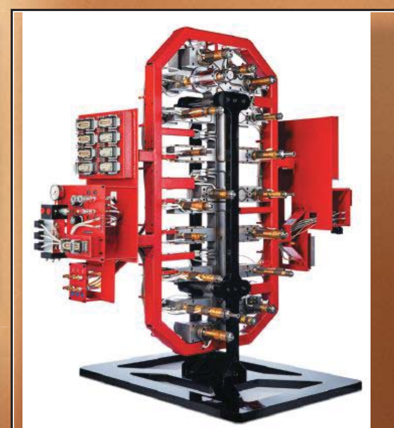
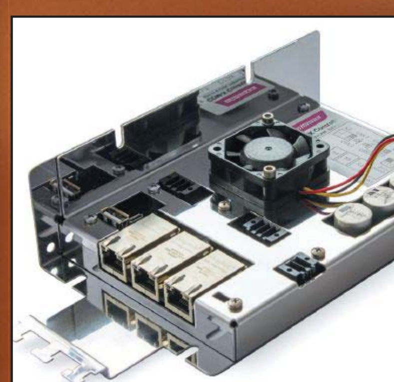


INSIDE



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TAX IMPACTS MACHINERY PURCHASES

New law includes benefits for makers, buyers of machinery and equipment

By Lisa Jo Lupo

THE FIRST MAJOR tax change in more than 30 years creates an interesting opportunity for machinery and equipment users at NPE2018. It could mean that more lookers walking the aisles become buyers.

The new Tax Cuts and Jobs Act includes a number of benefits for manufacturers and purchasers of both new and used machinery and equipment — from reduced tax rates for businesses to increased first-year deductions on capital expenditures.

The law's bonus depreciation could change companies' approaches to equipment purchases.

"Right off the bat, that's the one that hits people right between the eyes when it comes to equipment," said George Muhoray, VP at Customers Commercial Finance.

BONUS DEPRECIATION

The bonus depreciation provision allows an immediate first-year deduction of 100 percent on capital purchases through 2022 — up from the 50 percent deduction of recent years. The bonus depreciation, which can be taken only one time, is available as an alternative to regular depreciation; businesses can opt to take one or the other.

Michael Devereux, Mueller Prost LC

Applicable on equipment purchases made from Sept. 27, 2017, and after, the bonus-depreciation rate drops by 20 percent annually from 2023 through 2026 (i.e., 80 percent deductions in 2023, 60 percent in 2024, etc.), explained CPA Michael Devereux, who is a partner and director of manufacturing, distribution and plastics industry services at Mueller Prost, a financial services firm.

There are some caveats to the provision. For example, the deduction is taken the year the machinery or equipment is placed in service. Thus, if the order is placed in late 2018 but the machine is not delivered or set up and used until January 2019, the expenditure cannot be deducted until 2019. This is especially important for items purchased in late 2022, which, if not in use until 2023, would be only 80 percent deductible.

But that five-year window is an improvement, because in the past the bonus depreciation rate was determined one year to the next, Muhoray said. "There's now more definity to it. It's pro-business, it's pro-productivity. One of the benefits of equipment in the plastics industry is that the equipment is so productive that you don't need to add as many people. But if you make the pie bigger, more equipment is being added, and there's more business to go around, you're hoping that that means more jobs and more opportunity, whether it be on the production side or the equipment-sales side."

USED MACHINERY AND EQUIPMENT

The new law also allows the write-off of eligible used machines and equipment that are "new to the taxpayer," Devereux said. "This is a brand-new concept related to bonus depreciation. Before, the asset had to be new. This allows you to get bonus depreciation on used equipment, unless it's not new to you." That is, he explained, if you're leasing equipment, then decide to purchase it — it's not new to you, so you don't get bonus depreciation.

"The fact that it includes used equipment with no time clause on it makes the used equipment market a bit more vibrant because now I've got this 100-percent bonus depreciation that I can extend to equipment I buy on the secondary market," Muhoray said. "So, if I'm selling that equipment I'm more in an apples-to-apples comparison when I'm going against new equipment."

While new equipment dealers may see this as adding competition for them, it needs to be seen through the eyes of the end user, he said. "We're all here to service the end user, the client. So, the flexibility it gives them is, to me, the biggest outcome of all this. Beyond the absolute productivity aspects of a machine, there are financial implications that factor in and can make it easier for people to buy and sell equipment."

Devereux also sees private equity and companies involved in mergers and acquisitions (M&A) benefiting from the provision. For example, if Molder A buy the assets of Molder Z, but not the stock, Molder A gets bonus depreciation on all the eligible assets. "This provision has never, ever existed," Devereux said, adding that even many M&A advisors are unaware of it.

QUALIFIED IMPROVEMENT PROPERTY

The new deduction also may apply to a relatively new category of assets called qualified improvement property, Devereux said. While not applicable to structural add-ons to a plant, this category does apply to improvements that are required to accommodate new equipment, or

Continued

OTHER SIGNIFICANT CHANGES

By Lisa Jo Lupo

WHILE THE BONUS depreciation provision will likely have the greatest impact on equipment and machinery purchases, other provisions of the new tax law that can have significant effect include changes to the following:

• **Section 179.** New aspects of this provision allow for immediate expensing up to a certain amount, said CPA Michael Devereux, who is a partner and director of manufacturing, distribution and plastics industry services at Mueller Prost, a financial services firm. Generally, for small to midsize companies, it increases the deduction limit from $500,000 to $1 million. But, he added, "the ability to write off your equipment right out of the gate is limited by a phaseout of the benefit." That is, once you buy more than $2.5 million of eligible assets, the benefit starts to phase out dollar for dollar up to $3.5 million, at which point it is completely phased out.

• **Interest deductions.** Another new provision limits the interest-expense deduction to the sum of the company's business interest income and 30 percent of its adjusted taxable income. This applies only to companies with a three-year average greater than $25 million in annual gross receipts; companies below this can still fully deduct the interest associated with debt service. Devereux gave the example of a company having loan-interest expenses of $110,000 and interest income of $10,000, leaving a net interest expense of $100,000. If that company's adjusted taxable income for that year was $100,000, it could deduct only $30,000 of this (30 percent of $100,000). The excess of $70,000 then can be carried forward indefinitely. "What they're trying to do is to put debt and equity on a level playing field," Devereux said. "Before tax reform, and still to this day a little bit, the tax law favors debt opposed to equity."

• **Corporate tax.** The corporation tax reduction to 21 percent is beneficial to companies, but it also essentially reduces the bonus depreciation deduction. For example, Devereux said, if you bought a $100,000 machine under the old law, it qualified for bonus depreciation of 50 percent, so you could write off $50,000; multiplying that by the corporate tax rate of 35 percent equals $17,500. If the same company writes off $100,000 today, it will realize a saving of $21,000 — the amount it would have paid at the current 21 percent tax rate, had the equipment been ineligible for depreciation. "So, yes, there is an added benefit, but the difference of $17.5 [thousand] to $21,000 isn't as great as everyone is making it out to be," Devereux said.

• **Amortization for research expenses.** There also are some negative aspects of the law, Devereux said, "Although for manufacturing, it's kind of hard to find them." One of these is a provision that starts in 2022 that requires businesses to capitalize and amortize research expenditures over a five-year period; if the research is performed outside the U.S., it has to be amortized over a 15-year period. Currently, these expenditures can be written off in Year 1 and don't have to be capitalized — though they can be.

• **Domestic production deduction**. Also, under the new law, the domestic production activities deduction has been eliminated. In the past, companies received a 9 percent deduction on taxable income associated with U.S. manufacturing, but the new manufacturing provisions have replaced this deduction.

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that are considered as "part of" new equipment. For example, if you need to upgrade the electrical infrastructure to accommodate new equipment, "you can classify that as a qualified improvement property and write the whole thing off in the year purchased."

Devereux believes lawmakers intended for this asset category to be eligible for bonus depreciation. For purposes of regular depreciation, he believes they intended to recognize it as a 15-year class life property category. But its class life didn't make it into the final bill. "We are hoping it gets fixed in a technical corrections bill," he said.

Devereux said the provision does not apply directly to building structures or real estate. But you can segregate the costs of a building project, based on the designated class lives of the property and associated equipment and infrastructure. Generally, commercial buildings are depreciated using the straight-line method over a 39-year period, but you can segregate the components or systems within the building that have shorter depreciable lives. As an example, Devereux cited overhead cranes or special foundations needed to support the weight of heavy machinery. "That's actually part of the equipment," he said. "So we segregate our clients' costs out, because you get that bonus depreciation on any class life of 20 years or less."

With the new 100-percent deduction, Devereux said, "I can see it increasing capital purchases because of the ability to write it off." However, he added, "you don't necessarily want to make that decision based on tax law alone." The primary questions to ask should be, "Do I need it?" and "Can I get a return on the investment?"

"Don't let the ability to write something off essentially make your decision for you," he said. "If it makes sense, then purchase it, and the tax benefits come along with it. But if you don't need it, I'd say don't purchase it."

FINANCING AND NPE2018

Muhoray agreed, stating that companies have been given the incentive to purchase equipment from a tax perspective, but they have to consider their business needs and whether they have the business and the underlying fundamentals to purchase equipment. "Just because I get a big tax benefit out of doing so, of itself, doesn't necessarily mean I'm going to do it," he said. "I'm sure a lot of guys are sharpening their pencils right now to figure out what's what."

In fact, he added, "We plan on making leasing a bigger part of our business. A lot of people in the plastics industry have come to the realization that they're not in the equipment-ownership game, they're in the product-making game." If these companies can make their debt component smaller, it can put them ahead of the game.

Although some companies want to own their equipment to build equity, Muhoray said, leasing can be a good alternative to the cost of owning equipment.

However, he said, "from a lending and leasing perspective, we haven't seen a jump in requests. The chatter is absolutely there, but I think people are still digesting."

"If people aren't relying on their tax advisors, they'd better be now more than ever."

GEORGE MUHORAY
Customers Commercial Finance

Speaking before the start of NPE2018, Muhoray thinks that people may be simply waiting for the trade show, which he sees as "coming at an incredibly interesting time." He said many are likely thinking, "'I don't really have to do anything this second, I can wait until NPE and order at one place and use that as the jumping-off place."

THE BIG PICTURE

"You have to put it all into perspective of what else is going on," Muhoray said. Interest rates are increasing, so leasing can be a way to lower the overall cost of borrowing because the leasing company takes on the tax benefits of owning the equipment and passes that on in the lease rate.

"There are a lot of things that will play out here, and it may take more than this initial couple months for people to get their arms around it," he said. "If people aren't relying on their tax advisors, they'd better be now more than ever."

Overall, Devereux expects an influx of machinery and equipment purchases. "I am bullish on tax reform when it comes to manufacturing," he said. "It is going to be extremely beneficial, and I think it will make us more competitive in the world market."

But, Devereux said, the new law won't be the only factor juicing equipment sales. "I would attribute that at least equally, if not more, to the economy doing well. It's all part of it. The tax law is impacting people's buying decisions, but their business needs are really driving it — and businesses are doing well; they're growing.

"The market's doing better," he added. "U.S. manufacturing is just going gangbusters. I realize NPE is a worldwide show, but it is heavily attended by U.S. manufacturers."

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