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Tax reform implications on equipment financing

Equipment acquisition strategies for the future

Obtaining the equipment your business needs to grow and stay competitive remains an imperative. Tax reform could change how these acquisitions affect your business.

The 2017 tax overhaul positioned businesses for growth and profitability. Leading-edge technology, timeliness, and scalability all play important roles in an organization's decision to acquire assets. However, there has never been a single, best answer to the question of how to pay for equipment.

Enter tax reform. While corporations have historically identified successful go-to strategies to take advantage of equipment-related tax legislation, the playing field has changed. From 100% expensing to the elimination of the corporate alternative minimum tax (AMT), the new rules require a fresh analysis. Let's take a look at important considerations from the top down.

Equipment finance: An effective acquisition tool

The Tax Cuts and Jobs Act of 2017 (TCJA) won't change the tried-and-true benefits of leasing that have always supported business growth. Equipment financing continues to provide:

- Enhanced cash flow, allowing you to avoid large out-of-pocket costs and effectively manage cash from operations
- Unparalleled flexibility and asset-management features, including options to keep equipment in place for the long haul or upgrade to the latest technology
- Preservation of credit lines to support day-to-day business operations rather than long-term capital needs

Key takeaways

Equipment financing can be used as a strategic tool.

Tax reform could impact your business.

From 100% expensing to the elimination of the corporate AMT, the tax rules require a fresh analysis.

Continued tax savings

Most equipment offers depreciation benefits. Historically, the most common equipment financing options—loans, non-tax leases, and tax leases—allowed the equipment owner to deduct equipment depreciation expenses from taxable income, which significantly lowered their tax liability. Fortunately, the TCJA doesn't eliminate this benefit.

However, selecting the option that optimizes your business's tax strategy is key. Traditional thinking went something like this: Full corporate tax payers benefited most by retaining equipment tax ownership in order to take depreciation directly. Loans and non-tax leases worked best for these businesses. Businesses that weren't full tax payers commonly found more benefit from shifting the equipment's tax ownership to a third-party financing source in return for a lower financing rate. In this scenario, tax leases often worked best.

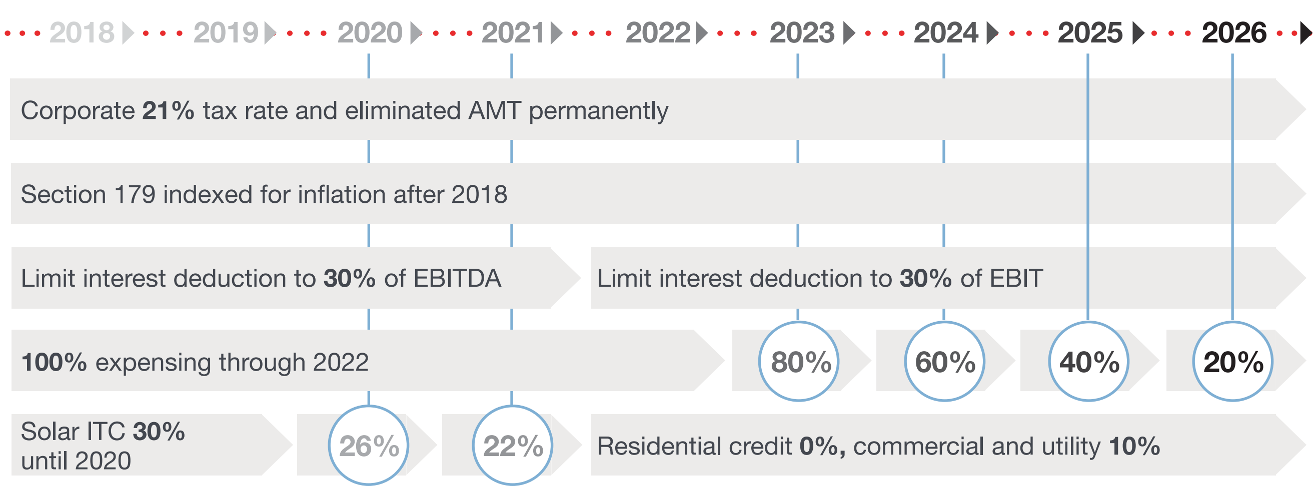
Historic changes with major impact

The centerpiece of the TCJA—a reduction in the maximum corporate tax rate from 35% to 21%—dramatically reduced tax liability for many businesses. Additionally, the range and size of available corporate tax deductions has expanded. The combination of these two changes begs an important question for most businesses: How many deductions can realistically be absorbed going forward?

Determining the tax deductions and credits that will best benefit your business will be time well spent. Together, your financial advisor and equipment finance provider can help you determine the right equipment acquisition strategy for your business in 2019 and beyond.

A reduction in the maximum corporate tax rate has dramatically reduced tax liability for many businesses.

Tax reform timeline



100% expensing

For the better part of the last decade, bonus depreciation has reigned supreme, offering an additional 30% to 50% cost recovery—in addition to standard Modified Accelerated Cost Recovery System (MACRS) depreciation—on new equipment in the year it was placed in service. For equipment placed in service after September 27, 2017, and before January 1, 2023, however, the tax reform bill eliminated the bonus feature. Instead, those who invest in qualified equipment during that time can simply expense 100% of the equipment cost in the first year of ownership.

This unprecedented benefit is a huge windfall for businesses with sufficient taxable income to claim it. That said, the benefit of such a write-off has less impact in a 21% corporate tax environment than in a 35% tax environment; therefore, more businesses might be unable to absorb all the depreciation benefits available to them. As a result, even full taxpayers could now find that a tax lease allows them to monetize otherwise unused depreciation benefits and, therefore, provides the lowest after-tax cost to acquire equipment.

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Note that the temporary increase in expensing allowance now also applies to pre-owned equipment purchases. Additionally, the 100% expensing benefit will begin to phase out in 2023, by offering an 80% bonus (in addition to regular MACRS deductions), which will then be lowered by 20% each tax year thereafter. Thus an 80% bonus applies in 2023, 60% in 2024, and so on.

Interest expense deduction

The TCJA now places limits on deductions related to interest accruals and payments made on debt in a given tax year. Unfortunately, this could negatively affect heavy borrowers and those investing in business growth and expansion activities. Equipment leasing could help to offset the pain, however, because rental payments arising from a lease are not included in this calculation.

Alternative minimum tax

The repeal of the corporate AMT gives many organizations something to celebrate. In the past, those paying AMT seemed to automatically benefit from a tax lease equipment acquisition strategy, as capital asset depreciation was an AMT preference item. This meant that equipment depreciation benefits were effectively neutralized and had little value for AMT payers. With AMT's repeal, now is the time to reassess all available equipment finance options with your financial advisor.

Net operating loss carryforwards

Net operating loss (NOL) treatment has changed as well. NOLs generated in 2018 or later can no longer be carried back (with certain natural disaster exceptions), but can now be carried forward indefinitely. In the past, tax leasing was especially beneficial for organizations with expiring NOL credits, to ensure they could fully optimize both depreciation and NOLs.

The time sensitivity of NOL use is likely to moderate in the future, allowing businesses to consider a wider set of equipment acquisition options.

Investment tax credit (ITC)

Particularly in the area of clean energy investments, the ITC has offered many businesses an affordable means to achieve greener, energy-efficient power generation. After much debate, the tax reform legislation did not modify ITCs currently available for solar, wind, and other forms of alternative energy. For instance, solar energy systems placed in service before 2020 are generally eligible for a 30% ITC, and available tax credits will still phase out slowly after 2020.

As with the tax reform changes addressed earlier in this paper, businesses will want to review with financial advisors their ability to absorb a large investment tax credit before buying clean energy equipment outright, or using debt to finance the system.

If the business doesn't have sufficient tax appetite, the project could be acquired via a tax lease, in which case a third-party financing source becomes the tax owner, and the (borrowing) business receives the tax benefit indirectly, in the form of a lower financing payment.

Agriculture equipment

Since 2018, most machinery and equipment used in a farming business has had a shorter recovery period under the MACRS depreciation system. These items, which were previously seven-year property, became five-year property as of 2018. Looking beyond the temporary increase in expensing available, these changes permanently accelerate the recovery period for many agribusinesses, thereby increasing the annual depreciation available for the equipment owner.

The Tax Cuts and Jobs Act of 2017 won't change the tried-and-true benefits of leasing.

Section 179

Traditionally, Section 179 allowed businesses with limited capital acquisitions to expense 100% of the cost of new and preowned equipment in the first year of ownership. Owners could expense up to $500,000 in cost, so long as the business's total equipment investment for the year did not exceed $2 million. For investments totaling more than $2 million, the deduction declined on a dollar-for-dollar basis.

The TCJA permanently increased the deduction to $1 million beginning in 2018, on an equipment investment limit of $2.5 million. Section 179 has always applied to new build and pre-owned equipment purchases—previously a significant distinction from bonus depreciation. However, the new tax reform changes to Section 179 are both permanent and now applicable to a broader set of assets, including HVAC and ventilation systems, fire protection and security systems. Consult with your tax advisor to determine if Section 179 can benefit your business this year.

Weighing the benefits

Remember, equipment financing can be used as a strategic tool. It allows you to not only acquire and employ assets immediately, but also to develop a plan to achieve long-term goals. Whether your company's objective is to enhance cash flow or optimize tax savings—or both—an in-depth analysis of your equipment acquisition strategy is necessary. Assessing your business's current and future asset needs in the form of a Lease vs. Buy Analysis will help determine whether a lease or loan is the best alternative for your organization.

To develop the most profitable acquisition strategy, consult with an equipment financing expert. Now more than ever, it's imperative to seek a professional with a tenured history in lease structuring, in-depth knowledge of the equipment specific to your business, and an understanding of your organizational goals.

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