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Return on Investments

Better MRO Asks Experts to Weigh In on Tax Reform Opportunities for Manufacturers

Tam Harbert | Mar 13, 2018

What You Need To Know

The biggest benefits can be divided into two broad categories: direct savings from tax cuts and investment incentives through changes in expensing, depreciation and accounting which experts say can be planned for over the next three to five years.
Tax attorneys and accountants reveal that S corp revenues pass to the owners, who then pay tax based on their individual rates. The new law lowered the highest individual tax rate to 37 percent from 39.6 percent.
Companies can deduct 100 percent of the cost of equipment in the year it was purchased and put into service, including used equipment, which can reduce taxable income significantly and encourage capital spending, experts say.
Nearly 70 percent of respondents in a National Manufacturing Association study report that tax reform would encourage their companies to increase capital spending.

To best take advantage of the new tax laws benefits—either in direct savings or investment incentives, manufacturers will want to assess their unique situations and then set strategic plans, suggest tax experts. Here's what they say you need to know.

The U.S. Tax Cuts and Jobs Act, which cut corporate rates from 35 to 21 percent, is expected to generate tax savings of as much as $261.5 billion for the manufacturing industry, empowering companies to invest in capital equipment and create more jobs, according to the ***Penn Wharton Budget Model***. Although some of its provisions are temporary, manufacturers now know what to expect for at least a few years, says Omar S. Nashashibi, founding partner of The Franklin Partnership LLP and head of government relations for One Voice, the advocacy program of the Precision Metalforming Association and the National Tooling and Machining Association.

"I recognize that some provisions will expire but compared to what manufacturers have had over the last several decades, we call that stability," says Nashashibi. "Clients now have a window to plan capital expenditures over the next three to five years."

A Tax Reform Cheat Sheet: Important Provisions and Dates for Manufacturers

Provision: Corporate Tax Rate Reduction

Summary: Reduces top corporate tax rate from 35 to 21%.

Effective Date: Dec. 31, 2017

Provision: Corporate Alternative Minimum Tax

Summary: Repeals the corporate AMT and the election to accelerate AMT credits in lieu of bonus depreciation.

Effective Date: Dec. 31, 2017

Provision: Pass-Through Tax Treatment / Section 199A

Summary: Raises the deduction available to pass-through filers to 20%.

Effective Date: Dec. 31, 2017

Provision: Limitations on Interest Deductibility

Summary: Revises Section 163(j) and expands its applicability to every business, including partnerships.

Effective Date: Dec. 31, 2017

Provision: Repeal of Domestic Production Activities Deduction (Section 199)

Summary: DPAD was a tax incentive for businesses that manufactured property at least partially within the United States.

Effective Date: Dec. 31, 2017

Provision: Research Tax Credit

Summary: Net value was effectively increased by 22% (from 65% to 79% of incremental qualified spending).

Effective Date: Dec. 31, 2017

Provision: R&E Tax Deduction

Summary: Companies will be required to write-off research expenses over a longer time period.

Effective Date: Dec. 31, 2021

Provision: Carryback Net Operating Losses

Summary: Companies may not use an NOL to offset income in any prior year and may offset only 80% of taxable income (after NOL) in carryforward year.

Effective Date: Dec. 31, 2017

Provision: Immediate Expensing of Certain Capital Expenditures

Summary: Companies will be able to fully expense certain capital expenditures, including acquisitions of used property, in 2018.

Effective Date: Applies until 2022 for purchases made after Sept. 28, 2017.

*Source: "How Tax Reform Will Impact Manufacturing" from **BDO**, December 2017*

John Livingstone, a tax principal at PwC for U.S. industrial products, agrees. The changes in capital equipment depreciation and expensing, in particular, should be considered strategically. "We now have a more attractive expensing provision that will last longer," he says. "That provides a more affordable way for investing in capacity, upgrading, automating and digitizing where appropriate."

The biggest benefits for manufacturing and metalworking companies can be divided into two broad categories: direct savings from tax cuts and investment incentives through changes in expensing, depreciation and accounting.

Lower Taxes for Every Manufacturer and Owner

The relatively straightforward 14 point tax cut for C corporations grabbed the headlines. The benefit calculation for S corporations, the most common structure for small and midsized manufacturers, is more complicated. A 2018 survey from One Voice, found 58 percent of companies with an average of 72 employees use the S corp designation [for more details, see our sidebar, "A Snapshot of the Middle Market"].

As pass-through entities, S corporations get taxes reduced on two levels, says Brian Kitchen, tax director at Kreischer Miller, which counts many mid-size and small manufacturers among its clients. S corp revenues pass to the owners, who then pay tax based on their individual rates. The new law lowered the highest individual tax rate by 2-plus points, to 37 percent from 39.6 percent. And certain pass-through entities including manufacturers will be able to deduct 20 percent from their income before applying tax.

Some S corp owners are considering becoming C corps to get the bigger tax rate reduction, but it's not so straightforward, Kitchen notes. Many of his clients plan to hand over the business to the next generation or sell it at some point. "I've been getting text messages from clients asking if they should switch to a C corp," he notes. "But I recently had a three-hour meeting going over with a client what it could mean. It's really important for people to understand not only the immediate potential tax savings, but also the long-term consequences."

A Shot of Adrenaline for Capital Investment

The law significantly expanded expensing and depreciation of capital investments. Limits on Section 179 expensing were raised from $500,000 to $1 million. In addition, companies can deduct 100 percent of the cost of equipment in the year it was purchased and put into service, including used equipment, which can reduce taxable income significantly. That not only encourages capital spending by manufacturers, but also juices the revenues of the manufacturers that make manufacturing equipment or components, Livingstone says.

Notably, this is one of the few provisions that are retroactive and can be applied to 2017 taxes. "If you acquired capital equipment last year after Sept. 27, you can expense 100 percent of it on this year's taxes," says Jim Brandenburg, tax partner at Sikich. Take that 2017 deduction if you can, he says, since it will be more valuable at 2017 rates than it will be at the lower 2018 rates.

A Snapshot of the Middle Market

Corporate Structures:

- 58.33% sub S corps
- 29.76% C corps
- 9.52% LLC
- 1.19% ESOP
- 1.19% sole proprietor

Few would **change structure** because of the new law: Only 7% said they would consider changing to a C corp if the top pass-through rate was 20%.

Most use **depreciation to the max**: 91% said they used bonus/accelerated depreciation when purchasing equipment.

Average **spending on new heavy equipment**/machinery in 2017: $870,386

Source: Survey by One Voice, an advocacy program of the Precision Metalforming Association and the National Tooling and Machining Association, December 2017.

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> Tax Principal, U.S. Industrial Products, PwC

There was also a provision that will benefit smaller players specifically. The new law raised the revenue limit for qualifying to use cash accounting from $10 million to $25 million, notes Kitchen. That means more companies are freed from using the accrual method of accounting, which requires them to pay taxes on accounts receivable and prevents them from expensing inventories.

In combination, these changes should prompt a wave of investments. In a survey by the National Association of Manufacturers, nearly 70 percent of respondents said tax reform would encourage their company to increase capital spending and two-thirds suggested that it would enable them to expand their businesses. Nearly 60 percent said that they would hire more workers. The cash infusion could also spur a wave of mergers and acquisitions. Small, niche companies might become acquisition targets of larger manufacturers, says Bryan Ball, vice president and group director of supply chain and global supply chain management practices at Aberdeen Group.

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A solid strategic plan should enable companies to make the most of the temporary provisions. The expansion and acceleration of depreciation will be phased out starting in 2022. Individual tax rates are scheduled to rise to previous levels in 2026. The 20-percent deduction for pass-through revenue also ends then. Then again, things can be changed by future Congresses, so plan strategically, but act sooner rather than later.

And don't forget to use a trusted tax advisor to help you. Although tax reform delivers many benefits for manufacturers, simplicity isn't one of them. "You'll pay less in taxes, but you won't be filing your taxes on a post card," says Nashashibi.