

# THE LIKELY IMPACT OF TAX REFORM ON CAPITAL EXPENDITURES: WHAT TAX REFORM CAN DO FOR YOUR TAXES (AND THE ECONOMY)

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## **The impact of tax reform stands to be both larger and more durable than many observers realize.**

One could argue that no industry deserved tax reform more than construction. In 2016, *Construction Dive* published an article detailing a U.S. Department of Treasury report. The report determined that construction firms paid the highest tax rate of any industry. While the average tax rate across all industries was 23 percent prior to reform, the construction industry encountered an average tax rate of 30 percent. This is especially remarkable for an economic segment largely comprised of small firms that are also flow-through tax entities.<sup>1</sup> There were many forces at work, including the increasingly pervasive impact of the alternative minimum tax.

But that was then, and this is now. The Tax Cuts and Jobs Act of 2017 rendered significant changes to the current tax structure. For individual filers, it cut the top income tax rate from 39.6 percent to 37 percent, shifted tax brackets to lower taxes for many Americans, doubled the standard deduction, and otherwise simplified the tax compliance process for millions of taxpayers.<sup>2</sup>

While the headline-maker was the reduction in the top C corporation tax rate from 35 percent (one of the most elevated rates in the advanced world) to 21 percent, the new tax law also eliminated the alternative minimum tax — a boon for many Americans, including many small construction firm owners.<sup>3</sup> No wonder that business confidence has remained elevated despite the specters of tariffs and trade wars.<sup>4</sup>

Nevertheless, as impactful as each of these aspects of tax reform will be, the most important element of tax reform may be among the least well-publicized. As indicated by the Internal Revenue Service, businesses can immediately expense more under the new law. Specifically, “a taxpayer may elect to expense the cost of any section 179 property and deduct it *in the year* (emphasis added) the property is placed in service. The new law increased the maximum deduction from \$500,000 to \$1 million. It also increased the phase-out threshold from \$2 million to \$2.5 million.”<sup>5</sup> This creates additional resources for construction firms to purchase new equipment, helping to produce much needed productivity enhancements in the process.

Section 179 of the U.S. Internal Revenue Code permits a taxpayer to elect to deduct the cost of property on their income taxes as an expense rather than requiring the cost of the property to be capitalized and depreciated.<sup>6</sup> Ultimately, all this means is that a taxpayer can better defray tax liabilities if a piece of property is defined as fitting within the four corners of Section 179. Accordingly, any expansion in the definition of Section 179 would induce more tax savings and more business investment.

Last year's tax reforms do just that. They expand the definition of Section 179 property in ways that are rather advantageous to the construction contractor community. Qualified improvement property, which means any improvement to a building's interior, now falls within the boundaries of Section 179. However, improvements do not qualify if they are attributable to:

1. the enlargement of the building;

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<sup>1</sup> Slowey, K., “Report: Construction pays highest tax rate of any industry,” *Construction Dive* (April 18, 2016). Available at: <https://www.constructiondive.com/news/report-construction-pays-highest-tax-rate-of-any-industry-1/417562/>.

<sup>2</sup> Timm, J.C., “Trump signs tax cut bill, first big legislative win,” *NBCNews* (Dec 22, 2017). Available at: <https://www.nbcnews.com/politics/politics-news/trump-signs-tax-cut-bill-first-big-legislative-win-n832141>.

<sup>3</sup> *Ibid.*

<sup>4</sup> “United States Nfib business optimism index,” *Trading Economics*. Available at: <https://tradingeconomics.com/united-states/nfib-business-optimism-index>; Gale, W.G. and Krupkin, A., “Navigating the new pass-through provisions: A technical explanation,” *Brookings* (Feb 12, 2018). Available at: <https://www.brookings.edu/research/navigating-the-new-pass-through-provisions-a-technical-explanation/>.

<sup>5</sup> “New rules and limitations for depreciation and expensing under the Tax Cuts and Jobs Act,” *IRS.gov* (April 2018). Available at: <https://www.irs.gov/newsroom/new-rules-and-limitations-for-depreciation-and-expensing-under-the-tax-cuts-and-jobs-act>.

<sup>6</sup> *Ibid.*

2. any elevator or escalator; or
3. the internal structural framework of the building.

That said, roofs, HVAC fire protection systems, and alarm/security systems are now deemed to be Section 179 property. These changes apply to property placed into service during taxable years beginning after December 31, 2017.<sup>7</sup>

In addition, the new law expands the bonus depreciation percentage from 50 percent to 100 percent for qualified property acquired and placed into service after September 27, 2017, and prior to January 1, 2023.<sup>8</sup> All of these changes expand the incentive to invest in equipment, which in turn accelerates economic growth and stimulates demand for construction services.

The expanded incentive to invest is not lost upon wily marketers. One Ford dealership's website summarizes relevant benefits of the new law, explaining in straightforward fashion how small businesses can write off as much as \$1 million by investing in new equipment, including in Ford trucks and vans.<sup>9</sup>

While it is difficult to know what percentage of Ford pickup trucks are sold to those engaged in the provision of construction services, the percentage is likely to be nontrivial. The most ubiquitous pickup truck is the Ford F-series, a line of light- and medium-duty pickup trucks. These trucks are often purchased for reasons pertaining to work as opposed to personal use. According to the most recently available sales reports, Ford's sales of F-series vehicles are higher than they were a year ago.<sup>10</sup> This is remarkable for three reasons:

1. Conventional wisdom held that overall vehicle sales for the current cycle peaked as many as two years ago.
2. The year 2017 was a terrific year for Ford F-series sales in its own right.<sup>11</sup>
3. Fuel prices have risen significantly over the past year, which would have the tendency to induce people to purchase smaller vehicles, all things being equal.

It is conceivable that the pace of truck sales, whether at GM, Ford, Dodge, Toyota, or Honda, will pick up even more as the recovery persists and as the end of the year approaches. An early August article published in *Construction Equipment Guide* featured a survey conducted by the Associated Equipment Manufacturers and Equipment Dealers Association. The survey indicated a consensus among dealers that tax reform was, in fact, driving up demand.<sup>12</sup>

Trey Gooze, president and chief operating officer of Yancey Bros, a Georgia-based Caterpillar equipment dealer, adds that "the law created incentives for business to invest and gave business owners additional confidence that the economic outlook would remain favorable in the near term. ... The biggest driver for increased equipment sales is more jobs where they can profitably deploy the equipment. Caterpillar equipment is an investment, and our customers expand their fleet when they have visibility on their ability to profitably deploy that fleet."<sup>13</sup> The article also quotes Jay Baldwin, president of Reliable Contracting Company (based in Gambrills, Maryland), who states that the new tax structure "is going to be of great value. One hundred percent depreciation in year one, things like that make a lot of difference."<sup>14</sup>

Alex Carrick, an economist at ConstructConnect, also thinks the new tax plan has been a boon for companies that lease equipment, saying, "Jobs in that sector have been skyrocketing. Rental of machinery and equipment is one of the real standouts in respect to levels of employment."<sup>15</sup>

Benefits of the new tax law do not flow purely to those selling new equipment, however. The new law also extends tax breaks to purchasers of used equipment. A July article published in *Accounting Today*, a public accounting trade magazine, reports that used equipment sales have increased significantly since the year's onset.<sup>16</sup> It is likely that these purchases cannibalize sales of new equipment, at least to a certain extent.

From the perspective of economic growth, this is potentially problematic. Eric Toder, a fellow at the D.C. based Urban-Brookings Tax Policy Center, states that "buying new equipment is investment. [Buying used equipment] is not a net

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<sup>7</sup> *Op. cit.* note 5.

<sup>8</sup> *Ibid.*

<sup>9</sup> "About the Section 179 tax deductions," Bonnell Motors Inc. Available at: <https://www.bonnellford.com/about-the-section-179-tax-deductions.htm>.

<sup>10</sup> "July 2018 sales," Ford Motor Company. Available at: [https://s22.q4cdn.com/857684434/files/doc\\_news/2018/08/July-2018-Sales-Final.pdf](https://s22.q4cdn.com/857684434/files/doc_news/2018/08/July-2018-Sales-Final.pdf).

<sup>11</sup> Howard, P.W., Full-size pickup sales growth continues: 'The F-series is killing it,' *Detroit Free Press* (Nov 21, 2017). Available at: <https://www.freep.com/story/money/cars/2017/11/21/ford-f-150-pickup-truck/847963001/>.

<sup>12</sup> Lambertson, G., Tax reforms' impact on the construction industry, *Construction Equipment Guide* (August 10, 2018). Available at: <https://www.constructionequipmentguide.com/tax-reforms-impact-on-the-construction-industry/41505>.

<sup>13</sup> *Ibid.*

<sup>14</sup> *Op. cit.* note 12.

<sup>15</sup> *Ibid.*

<sup>16</sup> Matthews, S., Tax bonanza for old machines could hinder Trump's growth goal, *Accounting Today* (July 10, 2018). Available at: <https://www.accountingtoday.com/articles/tax-bonanza-for-old-equipment-could-hinder-trumps-growth-goal>.

investment to the economy. It is moving capital from one owner to another.”<sup>17</sup> The House Ways and Means Committee specifically extended tax reforms to used equipment because they sought to support small businesses and farmers who may not have sufficient resources to invest in new equipment.

Arguably, something similar happened nearly a decade ago in the aftermath of the 2008 financial crisis. In an effort to prop up struggling U.S. auto manufacturers, the government passed a law supplying tax breaks for purchases of new efficient cars and trucks. The program, affectionately (or derisively) named Cash for Clunkers, bolstered vehicle sales over the short term. In the medium to long term, however, the influx of used cars (from drivers who had previously purchased tax subsidized cars) partially negated the overall increase in consumer spending.<sup>18</sup>

Still, the impact of tax reform stands to be both larger and more durable than many observers realize. This represents one reason to be optimistic about U.S. economic prospects in 2019. Even so, at some point, the demand for new equipment will be largely satiated, meaning that even tax reform will not be enough to support perpetual economic growth.

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<sup>17</sup> *Ibid.*

<sup>18</sup> Hoekstra, M., Puller, S.L., and West, J., Cash for corollas: When stimulus reduces spending, *American Economic Journal: Applied Economics* 9, no. 3 (July 2017): 1–35. Available at: <https://www.aeaweb.org/articles?id=10.1257/app.20150172>.