TAX REFORM

AND THE EQUIPMENT MANUFACTURING INDUSTRY

AEM

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⋆ INTRODUCTION ⋆

Congress is faced with a once-in-a-generation opportunity to enact major reforms that lowers the tax rate, recognizes the global economy, and incentivizes investment and job creation. In short, reforms that will transform the American economy from a low-growth to a high-growth economy. This goal is shared by the equipment manufacturing industry, as this paper makes clear.

The Association of Equipment Manufacturers (AEM) arrived at the following top-line priorities for comprehensive tax reform after extensive consultation with its member companies, including a survey that solicited AEM member company executives' perspectives and priorities for tax reform. And while the various tax reform options considered by Congress have continually changed during the course of the year, industry priorities have remained the same.

As Chair of AEM's Tax Policy Working Group, I am pleased to share the following report with you. It is my hope that the findings will make clear the industry's priorities for comprehensive tax reform. Those priorities are:

- Providing tax relief to equipment manufacturers by lowering the topline tax rates for both C-Corporations and S-Corporations (pass-through businesses)
- Simplifying the costly and complex tax code facing manufacturing businesses
- Enact *permanent* tax reform, which would offer the most meaningful impact for equipment manufacturers
- Balancing provisions that encourage manufacturers and their customers to make capital investments
- Eliminating estate taxes, especially for multigenerational, family-held businesses

To be clear, there are other aspects of the tax code that impact equipment manufacturers both as an industry and as individual businesses. AEM's membership range from small, family-owned businesses to large, publicly traded, multinational corporations, but even across this diverse range of businesses, there is broad agreement that the nation's tax code must be simplified and the tax rates lowered.

The current debate over tax reform is a moment of truth for elected officials in Washington. This is their moment to show the American people that they are serious about reforming the tax code to once again encourage manufacturing in America. AEM and its member companies will continue to make the case for comprehensive and permanent tax reform on behalf of the 1.3 million men and women of the equipment manufacturing industry.

Bruce C McFee

Bruce McFee
Chairman and CEO | Sullivan-Palatek, Inc.

The equipment manufacturing industry supports nearly 1.3 million jobs, either directly or indirectly, and contributed $159 billion to the nation's GDP in 2016. The industry accounts for just over 5 percent of the nation's manufacturing output and 7 percent of the nation's manufacturing workforce. As such, any tax reform measure that impacts the industry also impacts a large segment of the economy.

In 2016, equipment manufacturers paid an estimated $25 billion in local, state and federal taxes. For tax reform to succeed at maintaining or creating new jobs, lawmakers must take the objectives and interests of equipment manufacturers and other similarly-situated industries into account when formulating potential tax reform legislation.

The national discussion about the importance of restoring American manufacturing, led in part by President Trump, helps to frame the political imperatives that drive tax reform efforts. While any overhaul of the tax code will impact all corners of the U.S. economy, the future of U.S. manufacturing is at the center of the political discussions, and no industry reflects this sentiment more than the equipment manufacturing industry.

Most economists would agree on certain fundamental problems in the current business-tax structure: the statutory-tax rate on business income is among the highest in the world; treatment of income earned overseas by U.S. businesses is arguably punitive; the tax code is generally not amenable to investment; and many feel the code encourages corporations to excessively use debt to finance their operations.

With the 2018 mid-term elections a little under a year away and tax reform the most important legislative priority for Congress, the business community faces an important question: If Congress is able to pass comprehensive tax reform, then what sort of changes to the U.S. tax code would the equipment manufacturing industry support.

★ INDUSTRY OVERVIEW ★

The Association of Equipment Manufacturers (AEM) is the principal industry group representing the interests of the off-road, heavy machinery industry in the United States and Canada. AEM's 950 member companies range from large, publicly-traded original equipment manufacturers (OEMs) like Caterpillar, Inc., Deere & Company, AGCO Corporation, and Terex Corporation to privately-held manufacturers like the Vermeer Corporation, Sullivan-Palatek, and Kinze Manufacturing.

While many of its members are conventional C-corporations, a substantial minority are pass-through businesses for the purposes of tax treatment. The equipment manufacturing industry generated $15.4 billion in federal taxes in 2016 on total direct and indirect sales activity of $361.2 billion. The industry paid over $10 billion in state taxes as well.[1]

The equipment manufacturing industry also depends heavily on global trade and access to international markets. According to the global research firm IHS-Markit, about 30 percent of machinery produced by equipment manufacturers in the United States is eventually intended for export. Some AEM member companies that are based in the United States maintain international manufacturing operations.

Other companies that are members of AEM (Mahindra, Kubota Tractor Corporation, Volvo Construction Equipment, etc.) are North American divisions of multinational corporations who maintain manufacturing operations in the United States. Companies maintain a variety of supply chains, as well; companies employ a variety of methods for sourcing raw materials and components as inputs–sometimes from suppliers overseas.

★ THE SURVEY ★

To help gauge how various tax reform proposals might affect the equipment manufacturing industry, AEM sent a questionnaire to approximately 250 of its member company executives[2] in May 2017. Fifty-six companies responded either in whole or in part — an above-average rate for such surveys. Seventy percent of respondents were C-corporations, and the sample contained a mix of large and small companies that are representative of the broader AEM membership. Roughly 50 percent are publicly traded. All but one respondent identified their company as an importer/exporter.

The 29 respondents that answered questions relating to company characteristics have an average sales total of $2.4 billion, nearly a quarter of which is outside the U.S. Their average total assets amount to $2.8 billion, 18 percent of which are outside the U.S. These firms have, on average, 8,600 employees worldwide and carry roughly $320 million in debt.

The survey posed 40 total questions. The topics ranged from specific information about the individual companies to their views on proposed changes to the tax code. Most of the proposed changes addressed in the survey were based on components of A Better Way for Tax Reform plan..

[1] The ratio of profits/revenue from this exercise is 7.5%; The average effective marginal tax rate for the manufacturing industry (which equals profits/net income) is 22%, according to the U.S. Treasury.

[2] The fifty-six AEM member company executives who completed the survey included presidents, CEOs, CFOs, and COOs.

Respondents were asked to rate their support for various proposed changes to the tax code on a scale of 1 to 5, with a score of 5 indicating enthusiastic support, and a score of 1 indicating complete opposition to a proposal. Respondents were also asked to list their top two priorities, in order of importance, for any tax reform legislation that might be enacted this by the 115th Congress.

⋆ SURVEY RESPONSES ⋆

Respondents generally approve of changes that will reduce their taxes and oppose reforms that will raise revenue to pay for tax-cutting measures. But an interesting consensus also emerged.

AEM members rated the importance of a lower business tax as ***the most important tax reform priority***. Over 80 percent of respondents (both C-corporations and pass-throughs) said lower business taxes were the top priority, and scored it at an average of 4.5/5. The second most-common priority chosen by respondents was a simplified tax code. These two priorities were far and away the most desired changes.

This suggests that, for most equipment manufacturing companies, a reduction in the tax rate would provide the most significant benefit in terms of alleviating the government burden on business activities. The responses also indicate that many businesses would prefer a stripped-down, simplified tax code that doesn't seek to encourage some activities while discouraging others.

⋆ FULL EXPENSING AND INTEREST DEDUCTIBILITY ⋆

The deductibility of capital expenses is of particular importance to the equipment manufacturing industry for two key reasons. First, manufacturing businesses are by nature more capital-intensive than most other sectors. Second, the equipment manufacturing industry itself sells products that represent major capital investments for its customers. A major piece of farm or construction equipment typically has a price tag well into the high six figures; at the high end, products like cranes easily stretch into the seven-figure range.

The equipment manufacturing industry also relies heavily on the ability of businesses to borrow. Manufacturers borrow from lenders for a variety of reasons -- to finance expansions to their businesses (both in terms of workforce and capital expenditures), to complete mergers and acquisitions, and to maintain appropriate cash flow (among other reasons).

Surprisingly, that is why both pass-throughs and C corporations were somewhat ambivalent about the full expensing of capital investment. The companies in this survey did not appear to value full expensing as highly as a lower tax rate; the average importance rate placed on full expensing was 4/5.

Companies were also asked about their support for a move to full expensing for capital equipment *combined with* the elimination of interest deductibility. The two were joined together in the survey because it is believed Congress will consider the two jointly as well — first because the cost of a move to full expensing would almost surely have to be offset by a major corporate tax pay-for such as eliminating interest deductibility, and also because a tax code with expensing and interest deductibility creates a negative effective marginal tax rate on capital expenditures.

Respondents rated the importance of such a change rather low: 3.6/5. This is significant, given that the equipment manufacturing sector has more capital investment than most other sectors.

Some companies told us they did not value expensing simply because their companies would not receive financial-statement benefits in terms of their recorded tax expenses and effective tax rate. This is because the timing benefits of full expensing would be accrued as a deferred tax liability. In addition, one company reported that equipment investments depreciate quickly, and another responded that they already had tax losses, so rapidly deducted capital expenditures was worthless to them.

There are several other interesting trends among the responses to questions on full expensing. Sixty-one percent of respondents (19 of 31) said that their companies would increase investment as a result of full expensing (ignoring interest-deductibility limits). In addition, 71 percent of respondents said that full expensing (absent of other considerations) would lead them to increase sales projections. However, when asked about the Better Way's combination of full expensing and limiting interest deductibility, only 24 percent of respondents said they would increase sales projections.

Respondents seemed to divide into two camps when asked about eliminating the deductibility of interest on its own. 48 percent of respondents said the provision would be harmful or very harmful to their companies and only 22 percent said that they would reduce their company's level of debt as a response to the higher cost of financing their company via borrowing. However, 41 percent of respondents also assigned such a change a 3 out of 5, indicating a fair level of ambivalence.

★ COMPLIANCE COSTS ★

Numerous respondents complained about the compliance costs inherent in the tax code, and half of all pass-through respondents indicated that fixing this--combined with addressing the uncertainty from year to year--was a high priority for them. One-third of all C-corporations reported this as well, which is surprising since it is hard to imagine any politically feasible tax reform effort that would achieve meaningful simplification.

The specific complaints about complexity differed quite a bit: One pass-through said that it was complexity at the state and local level that made it difficult for them to operate in multiple states, and another said the time and resources devoted to tax compliance takes the company's resources away from more productive tasks. Another found compliance so complicated that it found it impossible to fully grasp the tax implications of certain business strategies, which led them to make investment decisions that were--after taxes--inferior to what they had foregone.

★ INHERITANCE TAXES ★

While the responses of C-corporations and pass-throughs were virtually identical in their emphasis on lowering business-tax rates, the two cohorts differed in some important ways. Approximately one-third of pass-through companies listed estate-tax reform as one of their top two priorities; by contrast, and as expected, none of the C-corporations selected estate-tax reform as a top priority. A number of C-corporations expressed a strong preference for moving toward a territorial tax system; none of the pass-through businesses selected moving to a territorial tax system.

Under current law, the estate tax applies under specified circumstances to transfers of wealth when a person dies. An additional tax — the so-called "gift tax" — may apply to generation-skipping transfers, such as a gift from a grandfather to a grandchild. The Better Way plan would repeal both the estate and gift taxes. It would also eliminate the "step up in basis" rule, which provides inheritors with the fair-market value of inherited property on the date of the decedent's death. Such taxes are important primarily for private, closely held businesses, and no publicly traded entities expressed interest in these provisions.

Privately held companies, however, seemed ambivalent about wholeheartedly embracing the Better Way for Tax Reform plan to the treatment of inheritance taxes. This is likely because it is difficult to assess which would be more harmful for family businesses: maintaining the current estate tax or eliminating the "step up in basis" rule. Several respondents indicated that they felt estate-tax issues should be dealt with separately, rather than as part of an overall tax reform package, because of their complexity and the possibility that they would delay other tax reform provisions.

The estate tax is of particular importance to the agricultural community, which matters to many AEM members as they constitute a substantial portion of its members' customer base. Since many agribusinesses are family-oriented and pass between generations, the estate tax is of pronounced importance to these customers of equipment for long-term financial planning for their businesses.

AEM also has its share of family-owned businesses, and several indicated their own preference for a tax reform that included a path for them that allowed the business to remain in the family through the next generation without them having to pay a nearly-punitive tax rate.

⋆ VISIONS OF TAX REFORM ⋆

Finally, the survey asked participants to rank their top three preferences among five different visions for tax reform, which are described thusly:

1) Reagan/Camp style reform, consisting of

- Lower corporate, business and individual tax rates
- A broader tax base (i.e. elimination of many deductions)
- Longer depreciation schedules.

2) The Better Way for Tax Reform plan, consisting of:

- A 20% corporate tax rate
- A lower top tax rate on individuals and pass-throughs
- Full, immediate deductibility of all investment (expensing)
- Elimination of the deductibility of interest
- A border adjustment tax on exports and imports

3) Stripped-down tax reform consisting of:

- A steep rate reduction on corporate and pass through tax rate
- Elimination of deferral for foreign earnings--i.e. a worldwide tax but with a very low rate.

4) European-style tax code, consisting of

- A top business tax rate of 15%
- border-adjustable VAT and

5) No change at all.

The Camp plan won this "beauty contest" by a fair margin, which may be attributed to the lack of enthusiasm among participants for a border adjustment tax. However, the Better Way plan is more popular than a low-rate worldwide-tax regime (with no deferral), despite the fact that, at a rate of 15 percent, the U.S. statutory rate would be below nearly all of the country's trading partners, thus making the impact of a worldwide tax regime moot. If the foreign entity has a higher tax rate than the U.S., then the money will not be taxed a second time when it is repatriated to the U.S.

The popularity of the Camp plan is prescient, as the late-July announcement by the "gang of six" regarding tax reform eschewed the BAT and generally embraced a Camp-like approach.

★ ★ ★ CONCLUSION ★ ★ ★

Leaders in Congress have introduced varying proposals for addressing these issues. Most notably, House Speaker Paul Ryan and Ways and Means Committee Kevin Brady introduced a draft proposal they call their "Better Way for Tax Reform" plan. This proposal has received mixed responses from the business sector, and the House Ways & Means Committee is currently drafting new tax reform legislation.

The plan would impose sharply lower tax rate on both corporations and privately held "pass-through" businesses. It would also alter the current worldwide "deferral" method of taxing foreign-sourced income, shifting instead to a territorial tax regime. In addition, it would allow businesses to immediately deduct capital investments, rather than gradually doing so over the life of an investment.

While nearly all businesses cheered these proposals, many balked at the accompanying revenue-raisers in the plan. Chief among these "pay-fors" was a border-adjustment tax (BAT) that would have generated an estimated one trillion dollars in the next decade. That provision has been dropped from consideration, however.

The chief methods for generating revenue on the corporate side currently under discussion entail ending interest deductibility and phasing out various other unnamed tax expenditures. Not surprisingly, the business community has been somewhat divided on these measures; those whose business models would not be greatly affected by the revenue raisers have supported the reforms, while those who would bear the brunt of the cost have complained.

Equipment manufacturers in the United States face numerous obstacles: another survey revealed that the low unemployment rate has led many manufacturers to complain that it is difficult to find skilled workers, and the substandard infrastructure in many parts of the country works against manufacturers, who rely on dependable deliveries to manage their supply chain and maximize productivity. A 2015 study estimated that a large part of the decline in manufacturing production in the last decade owes to poor infrastructure.

The survey suggests that the tax code is yet another barrier that makes business complicated and more difficult for equipment manufacturers. And manufacturers look favorably upon some of the reforms under consideration, which they think would help the industry compete globally.

The most notable finding is that the equipment manufacturing industry prioritized a lower business tax rate over all other changes to the tax code, and that companies are inclined to support limitations to deductibility of interest payments and the expensing of capital investments if the resulting tax revenue was used to lower the corporate- and business-income tax rates significantly. It may be inferred that this is likely true for other capital-intensive industries as well.

As with any major legislative reform, a revised tax reform package will require trade-offs by Congress. It is likely that the scope of what has been deemed a "fundamental" tax reform will eventually narrow as the concerted opposition to most proposed methods of increasing tax revenues to pay for proposed reforms harden. Should that occur, the corporate tax code will be extremely difficult to alter. Tax reform efforts should therefore be targeted toward reducing the statutory corporate tax rate.

Prepared by:
Ike Brannon, PhD, President, Capital Policy Analytics
Michelle Hanlon, PhD, Howard W. Johnson Professor of Accounting, MIT

The Association of Equipment Manufacturers (AEM) is the North American-based international trade group providing innovative business development resources to advance the off-road equipment manufacturing industry in the global marketplace. The equipment manufacturing industry supports 1.3 million jobs across the United States, and in 2016 generated $159 billion for the U.S. economy. AEM membership comprises more than 950 companies and more than 200 product lines in the agriculture, construction, forestry mining and utility sectors worldwide. AEM is headquartered in Milwaukee, Wisconsin, with offices in the world capitals of Washington, D.C.; Ottawa, Canada; and Beijing, China. The preceding report was produced in conjunction with Capital Policy Analytics, an economic research firm based in Washington, D.C.

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