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EQUIPMENT LEASING AND FINANCE ASSOCIATION

# The Implications of Tax Reform on the Equipment Leasing and Finance Industry

ELFA Webinar

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# Presenters

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# Webinar Structure

- This webinar is designed to provide participants with an overview, of H.R. 1 (the "Act"), the major tax legislation signed into law on December 22, 2017.
- A preliminary directional analysis of many of the provisions impacts on the equipment leasing and finance industry will also be provided
- Many of the implications of the new tax law are still undetermined, and in some cases unknown, the goal of this webinar is to provide you a road map, not point to point directions.
- Please submit your questions utilizing the chat feature, and we will periodically answer select questions during the presentation.

# Topics

Topics Covered in this webinar will include:

- Corporate rate reduction
  - Fiscal year issues
  - Deferred tax assets
  - AMT elimination
  - NOL carryforwards
  - Tax indemnification clauses
- Taxation of pass-thru entities
- Interest deductibility limits
- 100% bonus depreciation for new and used equipment
- Section 179 Changes
- Section 1031 (LKE) Changes
- Accounting Issues
- Energy tax credits
- A request for input

# Corporate Rate Reduction

- Corporate rate drops from 35% to 21% effective 1/1/18
  - Fiscal year taxpayers have a pro-rated rate (based on days) for the remainder of their fiscal year
    - March 2018 (275/365 x 35% + 90/365 x 21%) = approx. 31.55%
    - June 2018 = approx. 28.06%
    - September 2018 = approx. 24.53%
- Corp Alternative Minimum Tax (AMT) is eliminated
  - Under prior law, C Corps paid higher of tax @ (35% x taxable income) or (20% x AMT income)
  - AMT over statutory tax = a Deferred Tax Asset (DTA)
  - DTA creditable towards future periods when AMT was not due
  - Resulted in AMT Deferred Tax Asset carryforward (prepayment)
    - Applied against 2018 – 2020 regular tax obligation
    - Carryforwards that do not reduce 2018-2020 eligible for 50% refund from 2018-2020 and 100% in 2021

# Corporate Rate Reduction (Cont.)

- Net Operating Loss Carryforwards (NOLs):
  - NOLs can no longer be carried back and can now be carried forward indefinitely but can only be used to offset 80% of taxable income.
  - Previously, net operating loss carryforwards were able to be carried back 2 years and forward 20 years
  - Example:
    - ABC has tax loss of $20 MM in 2017 creating $20 MM NOL carryforward
    - ABC has taxable income of $10 MM expected in 2018;
    - ABC can only use $8 MM; is taxed on $2 MM and carries forward $12 MM
    - $12 MM NOL carryforward creates a $2.52 MM (i.e. $12 MM x 21%) deferred tax asset

# Corporate Rate Reduction-Tax Indemnification Clauses

- Many lease agreements include tax indemnification clauses stating that lessor has entered the agreement on the basis of certain tax deductions, credits and other tax benefits
- Lessee may indemnify the lessor for any losses of such benefits due to their actions as well as a change in law
- Indemnification will provide the same after-tax net economic yield which was originally anticipated by the lessor

# Corporate Rate Reduction

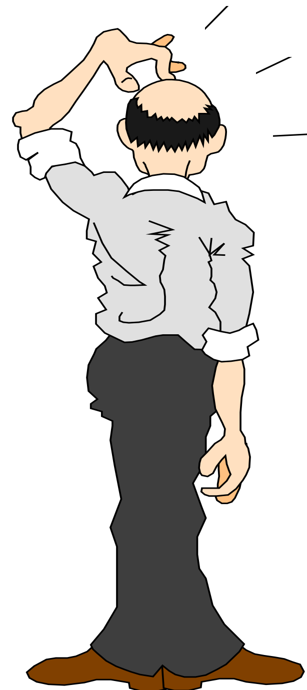
- Identifying opportunities:
  - Prospective lessees with Deferred Tax Assets from Net Operating Losses (NOLs) or AMTs because it will take them longer to utilize them now at the lower rate
  - Fiscal year lessees/lessors will be subject to temporarily higher tax rates until their new fiscal year starts
  - Future cost of some tax-exempt loans will likely increase because any expenses which are deducted against tax-exempt income will have a lesser tax effect, possibly making some tax leases (i.e. 5-year or less QTE asset leases) more attractive

# Taxation of Pass-Thru Entities

- Partnerships, S-Corps & sole-proprietorships (pass-thru entities) are not taxed at entity level; taxable income is passed through to owners
- Previously, corporate rate was generally higher than individual rate so individuals were not disadvantaged; now individual rates top @37%; corporate rate @ 21%
- New provision is meant to bring the effective tax rate on pass-thru income closer to the corporate rate @ 21%
- Benefit is a deduction equal to 20% of eligible taxable income, subject to limitations
- Effective individual maximum rate approximately 29.6% (i.e. 37% x (100% - 20% deduction) for qualifying entities
- Once certain income thresholds are reached, any businesses involving performance of services are excluded from pass-through benefit, including health, accounting, law, consulting, athletics, actuarial, performing arts, financial services, brokerage services or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.
- Not excluded are engineering and architecture firms
- Eligible businesses with limited W-2 expenses may prefer owning to leasing due to a rule increasing the pass-through deduction by 2.5% of original cost (i.e. without regard to depreciation) of its equipment & real estate

# Questions?

Reminder: Type your questions into the chat box during the presentation. We will respond to questions once more during the presentation, and then at the end as time permits.



# Limit on Interest Deductibility

- For tax years beginning after Dec. 31, 2017, the Act imposes a new limit on nearly all net "business interest"
  - Net Business Interest Expense Deduction = "business interest expense" (i.e., interest paid or accrued on indebtedness properly allocable to a trade or business) – "business interest income"

- There is a disallowance of a deduction for net interest expense in excess of 30% of the business's "adjusted taxable income" (ATI)
  - For purposes of this limitation, ATI is determined in a manner similar (but not identical) to EBITDA for taxable years 2018 through 2021
  - Beginning in 2022, ATI is determined in a manner similar to EBIT (i.e., depreciation and amortization reduce the adjusted taxable income limit the 30% is applied to)

- Disallowed Interest Deductions
  - carried forward indefinitely and treated as interest in later taxable years

# Limit on Interest Deductibility (Cont.)

- Leasing Opportunities
  - Taxpayers running into this limit will favor leasing over borrowing, as rent paid under a true lease is not interest subject to the limitation
  - Use leases structured with "Section 467 loans" to create interest income to offset interest expenses that would therewith be disallowed
- Taxpayers Excluded from Interest Limitation
  - Small businesses: average annual gross receipts for the 3-year period ending with the prior year not in excess of $25MM
  - Regulated public utilities and electric cooperatives
  - Costs of floor plan financing for inventory are excluded from the limitation

# 100% Bonus Depreciation (Full Expensing)

- The Act allows taxpayers to expense the full cost of new and used equipment placed in service after September 27, 2017 and before January 1, 2023
- Thereafter, the immediate deduction falls by 20% per year for property placed in service on or after January 1, 2023 and before January 1, 2027 (80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and no bonus depreciation in 2027 and thereafter)
- Certain property with longer production periods and certain aircraft are entitled to an extra year with respect to each deadline above
- Most states are unlikely to conform to federal bonus depreciation regime

# 100% Bonus Depreciation – Special Rules

- Applies to new and used property so long as the property was not previously used by its owner or a related party
- An equipment user can sell equipment it has been using for years to a lessor and lease it back, and the lessor can claim 100% bonus depreciation
- Lease syndications – purchaser/new lessor must acquire property subject to lease within three-months of seller/original lessor placing it in service. Sales of leased equipment being more restricted than non-leased equipment may be an unintended consequence of this Act
- Industry is studying whether a lessee purchasing equipment at the end of the lease is eligible for 100% bonus depreciation or not
- Three-month sale-leaseback rule was eliminated because it is no longer needed as used property is generally qualified
- 100% bonus depreciation is not available if there was a "binding written contract" to acquire the properties before September 28, 2017 – need to carefully analyze
- The "Pickle" tax-exempt use property rules still apply – no bonus or other accelerated depreciation if leased to government, non-profit or foreign person or if used outside the United States

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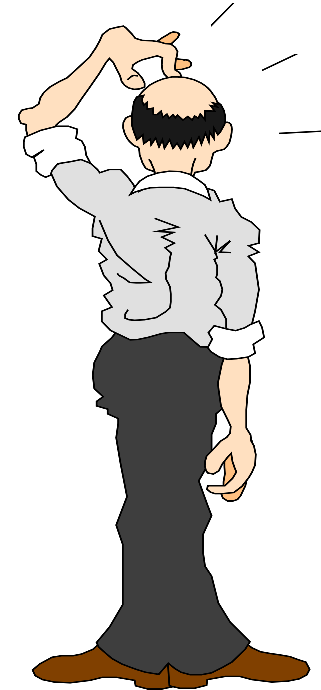

# Section 179 Changes & Implications for Customers

- Section 179 benefits the small business customers many equipment finance companies serve, but doesn't directly apply to larger taxpayers
- Section 179 has marketing value for equipment finance companies promoting CSAs, EFAs and loan-type agreements to small businesses
- New 100% bonus depreciation rules make Section 179 less relevant, at least until 2023 when bonus depreciation begins to ramp back down
- Some small business taxpayers may have special circumstances that don't allow them to take advantage of 100% bonus depreciation; In these cases Section 179 may remain as a possible benefit
- Take care to avoid providing tax advice. Customers should seek guidance from tax professionals familiar with their specific business circumstances

# Section 179 Changes & Implications for Customers

Key changes to Section 179 under the Act:

- The maximum amount a qualifying taxpayer can expense goes from $500,000 ($510,000 for tax year 2017, after indexing) to $1,000,000
- The phase-out threshold amount goes from to $2,000,000 ($2,030,000 for tax year 2017, after indexing) to $2,500,000
- Both amounts will be indexed for inflation for tax years after 2018

# Changes to Section 1031 (Like-Kind Exchange)

- The Act amends Section 1031 to make tangible personal property ("TPP") ineligible for like-kind exchanges
- Real property continues to be eligible, but Section 1031 will no longer bring direct benefits for equipment finance companies
- For most taxpayers, the benefits of reduced tax rates and 100% bonus depreciation outweigh the loss of Like-Kind Exchange
- TPP sold on or after January 1, 2018 is no longer eligible for Section 1031 treatment (except for reverse exchanges)
- TPP sold on or before December 31, 2017 can be matched with 2017 or eligible 2018 replacement property following rules in effect prior to the Act

# Changes to Section 1031 (Like-Kind Exchange)

- Taxpayers should take care when determining 2017 matches, to ensure they maximize tax benefits
- When available, matching 2017 sales with 2018 purchases (as opposed to purchases made from 9/28/2017 to 12/31/2017) will maximize the benefits of 100% bonus depreciation at the higher 2017 tax rates
- Taxpayers should keep LKE programs intact until all eligible matches are completed (including the 2018 matches described above) and program-related legal agreements are unwound
- Be cautious before making changes to IT systems for tax depreciation and gain/loss recognition for assets with LKE-related deferrals; Some systems may not have the ability to handle the “layered basis” tracking required by LKE rules
- Emerging issue of conformity between federal and state LKE rules; Some states may continue like-kind exchange for state income tax

# Tax Accounting Issues

- Revaluation of Deferred Tax Assets & Liabilities

  - Deferred tax assets (DTAs) or liabilities (DTLs) recorded using a 35% rate must be adjusted downward using a 21% rate
  - Deferred tax assets typically from AMT, NOLs, rents taxed in advance of book income
  - Deferred tax liabilities typically from bonus depreciation in excess of book depreciation
  - Since creation of DTAs or DTLs were at 35% and flowed through Tax Provision line, they are adjusted through Tax Provision line
  - DTL adjustment results in a credit (reduction) to the Tax Provision
  - DTA adjustments result in a debit (increase) to Tax Provision

# Tax Accounting Issues (Cont.)

- DTLs often used as part of transaction funding
  - Equity; Internal debt; Deferred taxes (mostly liabilities)
  - With reduction of DTLs, the internal debt financing existing portfolios will increase and thus cost more
- Sec 451- Taxable year of inclusion
  - Requires “tax–book” conformity when books report income in advance of tax income
  - Rent is an excluded item and Conference Report footnote 872 stated that “*this does not require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in the taxpayer’s applicable financial statement*.”
  - Seems to be applicable to certain aspects of debt including OID, late payments fees, cash-advance fees and interchange fees.
  - Analysis “to be continued”! Discuss with your accountants!

# Renewable Energy Tax Credits

- Solar investment tax credit (ITC) continues to be 30% with phase down to 10% from 2019 to 2023 based on the “start of construction” date

- Wind production tax credit (PTC) continues to be a ten-year stream at 2.4 cents per kWh for projects that started construction in 2016 or earlier
  - For projects that “start construction” in 2017, the PTC is 80% of 2.4 cents, 60% in 2018, 40% in 2019 and then expires
  - The PTC for new and operating projects continues to be eligible for inflation adjustments that since 1992 have increased it 60% (1.5 to 2.4 cents)

- Tax credits for other energy technologies remain lapsed

- Base Erosion Anti-Avoidance Tax (BEAT) will limit taxpayer who make significant tax deductible payments to foreign affiliates from fully using energy and other tax credits – impact on tax equity market is TBD

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