Letters to Editor

How Much Does that New Machine Really Cost?

After reading Fred Young's editorial, "Reinvesting in New Equipment Pays Dividends" (*Gear Technology* – November/December 2007), I was compelled to throw in my two cents regarding the tax aspects of equipment purchases, aspects to which Mr. Young alluded.

Without engaging in a debate over the appropriateness of current federal income tax rates or the tax system itself, I think we can all agree that taxes affect our businesses in a significant way. As such, any intelligent decisions we make regarding our businesses, including decisions related to the purchase of new equipment, must take into account the tax consequences involved.

The tax treatment of capital expenditures will differ from one business to another, depending on factors such as the organizational structure of the business (LLC, corporation, S corporation, etc.), the taxable income of the company and the dollar amount spent on equipment in a given year. The main thing to keep in mind, regardless of these factors, is that depreciation deductions will most likely allow a profitable company to recoup a sizeable portion of the money spent on equipment through reduced income taxes. The tax savings from these deductions could very well amount to 28–35% of the money spent on capital investments.


VOICES

Reinvesting in New Equipment Pays Dividends

Frederic M. Young, president, Forest City Gear Corporation

Spending money (on new machinery) to make money has worked well for Forest City Gear.

Recently, I was approached by a colleague who is a manufacturer outside the gear industry. He was impressed by Forest City Gear's ability to continually acquire new manufacturing equipment, and he wanted to know more about our capital investment strategies. I responded to my colleague by e-mail, but I thought the readers of *Gear Technology* would be equally interested in some of my comments.

Our strategy over the years has been to buy new equipment to gain the experience of higher productivity and quality. Generally speaking, we end up expanding our size range and technology with each new machine, allowing us to pursue jobs for which we may not have been competitive previously.

A further benefit is the marketing gain you realize when customers see all the new toys on your floor. Your employees will take more pride in their work, and with each new acquisition, there is an opportunity for additional employee training on state-of-the-art equipment, allowing you to produce faster.

We receive cross-pollination when training with the setup guys who come in to install new equipment, as they have been exposed to benchmark shops all over the world and have been challenged to conquer very difficult work at their individual customers' locations.

You should have more uptime on newer equipment and should not have any significant maintenance expenses. Because we have been purchasing so much new equipment for so long, our depreciation allows us to continue to buy lots of new stuff courtesy of the depreciation tax advantage.

Finally, over time, we have developed quite a list of potential buyers for our surplus equipment, selling it to customers, competitors or trading it in against newer equipment. Usually you are better off if you can sell it yourself versus trade-in, as your vendor has to buy low enough to allow him to warranty and bury sales expenses.

We also get a fair amount of work steered in our direction by the folks from whom we purchase our equipment.

As I am fond of saying, your customers want you to have the

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Tax deductions associated with the purchase of manufacturing equipment are typically taken over a period of seven years, but there are provisions within the federal tax code which allow certain companies to depreciate equipment much faster. For smaller companies who spend less than $510,000 on equipment in a year, a deduction for the full purchase price may be available in the year of purchase. This "accelerated depreciation" is due to a special tax law provision (Section 179), which allows a company to deduct up to $128,000 of equipment purchases immediately—so long as the company spends less than $510,000 during the year on qualifying equipment acquisitions. These numbers are for tax years ending in 2008.

To illustrate the significance of these tax deductions, assume a small company spends $120,000 on equipment in 2008. If that company qualifies to use the accelerated depreciation provisions of Section 179, and the company pays tax at the typical corporate income tax rate of 35%, the federal tax savings in the year of purchase will amount to $42,000. In essence, the company's out-of-pocket cost for the equipment is $78,000 rather than $120,000 ($120,000 purchase price, minus $42,000 in tax savings). This example is also true for S corporations and LLCs, which pay no federal income tax. For these companies, the tax savings are passed through to the owners, reducing the amount of cash distributions needed from the company to cover the owner's tax bill for the year. This drastically alters the cash flow and financing analysis related to such a transaction. If the company does not qualify under Section 179, those tax savings still exist, but they are just spread over the span of several years, typically seven.

Mr. Young, in his editorial, points to a variety of factors contributing to his capital expenditure philosophy. He notes decreased setup times, more efficient run times, higher quality gears and a higher volume of production without proportionately higher direct labor costs. These are all factors related to advancements in technology, and I would imagine these factors are understood by anyone in the gear manufacturing business. However, other factors mentioned by Mr. Young—most notably the tax factors—may be overlooked by a business owner when making the decision to acquire new machinery. I suspect many smaller businesses, those without the benefit of a tax or finance department, make these decisions based solely on sticker price, with no consideration given to the impact of their decision on the company tax returns. The result could be faulty decisions based on incorrect financial assumptions.

I was glad to see Mr. Young mention the role of tax strategy in his capital investments analysis. It is apparent that he understands these considerations are not inconsequential footnotes to this discussion, as many business owners may believe them to be. Of course, state taxes, property taxes and a company's specific income tax situation will all impact this analysis, and experience tells me it is beneficial for a business owner to consult with a CPA (or other qualified tax advisor) whenever kicking around the idea of making a significant capital acquisition. Getting tax advisors involved early in the decision making process will ensure the broadest range of options and strategies, as many of these strategies require action before the equipment is even placed in service.

Does this mean we should all run out and spend $1 million on new equipment in order to save taxes? Of course not—it would be foolish to suggest spending $1 million to save a potential of $350,000 in taxes over seven years. What this does mean is that when faced with the decision of whether your organization should be purchasing equipment, for reasons unrelated to taxes, the anticipated cash flow and financing projections should take into account the substantial impact of income tax deductions. When the tax savings from depreciation deductions are taken into account, business owners may realize they have a lot more buying power than they originally thought.

Matt McBride,
Chief Financial Officer,
Riverside Spline & Gear, Inc.

You stated you "have no solution to these problems, only concerns," but I think you have already contributed to the solution. I believe that those currently in positions of influence or power need to speak out, and you have. Nothing can ever change if we don't even think or talk about it, and change never happens without a little pain. Everyone in this country with an education knows Social Security is a problem, but it is very difficult to discuss. No one wants to be the heel to take away Grandma's or Mom's SS check. No one wants to offend friends or associates by questioning their perceived entitlements. Talk alone will of course never change anything; the questioning of the current status quo and soul searching by those of intelligence when a problem is thrust into their conscience must be the start. I hope you are a very lucky man and live long enough to see this problem resolved.

Regards,
Tom Schmitt,
Schmitt Design, Crystal, MN

Speaking Up Does Make A Difference

Dear Mr. Goldstein,

I wanted to thank you for your editorial in the November/ December issue of *Gear Technology*. As a younger man who wonders what will happen when I retire, it is refreshing to see someone who is near the age of retirement question the current system. It is extremely discouraging to pay that 15% tax and think that there won't be anything left for me when I need it.

As you point out, the tax burden on younger families is a real problem. We can not realistically rely on Social Security, yet when we are paying 40% of our income in taxes, it is extremely difficult to save for retirement. I recently heard a statistic that one out of every five workers is employed by the government. That implies that the other four workers are paying that government employee's salary. Sure, everyone has a different income, but since government employees are paid relative to local salaries or wages with the GS system, it is probably fair to say that on average, 25% of the non-government employees' salary goes to pay that government salary. That seems pretty close to the reality of my taxes.