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THE HOFFMAN GROUP

Certified Public Accountants & Consultants

Phone: 443.320.4101 www.hoffmancpas.com Fax: 1.410.630.5001

10055 Red Run Boulevard, Suite 130 Owings Mills, MD 21117

Expanded depreciation deductions

How can you benefit from tax reform?

In December 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA) into law. This is the most comprehensive tax reform package in over three decades, and it will have a major impact on how much income taxes manufacturers and distributors will pay in 2018. And there's good news: In addition to lowering business tax rates, the new law significantly expands the tax breaks for capital expenditures.

As a result, you may be able to save big tax dollars on purchases of fixed assets and property improvements that you make before the end of this year. Here are the details.

Section 179

If you need new plant equipment, want to upgrade your accounting software or decide to remodel your office, it can provide a sizable tax break. Generally, you must "capitalize" these purchases — in other words, spread the deductions for capital expenditures over several years.

But there are two tax breaks that allow you to accelerate these deductions for tax purposes: Section 179 and bonus depreciation. Although these deductions have been available in various amounts over the years, they've been expanded by tax reform.

First, the TCJA permanently increased the Sec. 179 expensing limit for qualifying fixed asset purchases from $510,000 in 2017 to $1 million in 2018 and beyond. However, this break is phased out for qualifying purchases over $2.5 million in 2018 (up from $2.03 million in 2017). Going forward, these amounts will be indexed for inflation.

Sec. 179 expensing for fixed asset purchases is phased out on a dollar-for-dollar basis for purchases that exceed the threshold amount. So, no Sec. 179 deduction is available if your total investment in qualifying property is above $3.5 million for 2018.

What types of assets qualify for Sec. 179? Examples of assets that are eligible include machinery, equipment, vehicles and furniture. The TCJA also expands the leasehold improvement property that's eligible for Sec. 179 to include roofs, HVAC equipment, and fire protection and security systems.

With the permanent extension of the increased Sec. 179 expensing limit, you can now plan your annual capital expenditure budget with more certainty. Say you're thinking of spending up to $1 million this year on qualifying fixed assets such as those listed above. If so, you might want to make purchases and place the assets in service before the end of the year.

Bonus depreciation

The second expanded tax break for capital expenditures is bonus depreciation. Under the old rules, businesses were allowed to deduct 50%

of qualified property additions in the first year of service for 2017.

Under the TCJA, companies are now allowed to *fully* deduct capital expenditures made after September 27, 2017, and no later than December 31, 2022.

Unlike Sec. 179, bonus depreciation isn't subject to any spending limits or phaseout thresholds. In addition, the new law expands the break to include new *and used* property, removing one of bonus depreciation's former disadvantages compared to Sec. 179 expensing.

Unfortunately, the bonus depreciation breaks will sunset, starting in 2023, as follows:

- 80% for qualifying property placed in service after December 31, 2022, and before January 1, 2024,
- 60% for qualifying property placed in service after December 31, 2023, and before January 1, 2025,
- 40% for qualifying property placed in service after December 31, 2024, and before January 1, 2026, and
- 20% for qualifying property placed in service after December 31, 2025, and before January 1, 2027.

For certain property with a longer production period and certain aircraft, the beginning and end dates in the list above are increased by a year.

Qualifying property generally includes Modified Accelerated Cost Recovery System (MACRS) property with a recovery period of 20 years or less, computer software and qualified improvement property. In addition, special rules apply to vehicle purchases and certain real property.

In the past, some corporations chose to accelerate their alternative minimum tax (AMT) credits instead of taking bonus depreciation for assets they acquired. However, that option is no longer available under the new law, because the TCJA repeals the corporate AMT.

Got company cars?

Many small and midsize manufacturers provide company cars for their owners and salespeople. However, the deduction for luxury passenger automobiles is limited for federal income tax purposes. Under the new tax law, the limits for vehicles placed in service after December 31, 2017, are:

- $10,000 for the first year the asset is placed in service,
- $16,000 for the second year,
- $9,600 for the third year, and
- $5,760 for the fourth and later years.

These amounts are indexed for inflation annually after 2018. For vehicles for which bonus first-year depreciation is claimed, the maximum additional first-year depreciation allowance remains at $8,000.

Need help?

The potential tax savings with Sec. 179 expensing and bonus depreciation are significant, but the rules can be complicated. Consult with your tax advisor for more details on how you can take full advantage of these taxpayer-friendly opportunities to grow your business. ■

Loaning money between a business and its shareholders

It's common for owners of privately held manufacturing and distribution firms to loan money to and borrow money from their companies. The IRS looks closely at such transactions to determine whether they are truly loans, or actually compensation, dividends or contributions to equity. An inaccurate classification of payments to shareholders can have adverse tax consequences.

Receivables and payables

Loans *from* shareholders to the business are common with a start-up or a business that's in a high-growth phase of development — after all, manufacturing firms are asset-intensive and often require large amounts of capital at these stages. Rather than apply for a line of credit or loan from a conventional lender, it's sometimes easier just to front any shortfalls from the owner's personal funds. These are generally reported as a liability on the company's balance sheet (similar to a term loan).

Conversely, businesses that have evolved into the "cash cow" phase may have extra cash on hand to loan money *to* shareholders. For example, the proceeds may be used to fund the owner's personal expenditures, such as providing a down payment on a vacation home, paying tuition bills for the owner's family members or funding a start-up venture for a retiring owner. These are generally reported as an asset on the company's balance sheet (similar to a receivable).

The IRS may be critical of shareholder loans and argue that payments made to shareholders should be reclassified as salary (which incurs payroll taxes) or as an equity transaction. For example, the IRS might say the payments from a C corporation are actually dividends, which are taxable to the owner personally as ordinary income.

Distributions from pass-through entities (such as partnerships and S corporations) generally aren't taxable to the extent that the owner has a positive tax basis in his or her ownership interest. (An owner's tax basis is essentially a function of capital contributions, pro rata earnings and distributions.)

6 factors to consider

When the IRS doesn't see eye-to-eye with a taxpayer, the U.S. Tax Court may be called on to determine whether payments made to shareholders qualify as bona fide loans. Here are six factors that the court usually considers:

1. The size of the loan,

2. The company's earnings and dividend-paying history,

3. Provisions in the shareholders' agreement about limits on amounts that can be advanced to owners,

4. Loan repayment history,

5. The shareholder's ability to repay the loan, based on his or her annual compensation, and

6. The shareholder's level of control over the company's decision making.

Perhaps most persuasive is whether you've executed a formal, written note that specifies all of the repayment terms. Arm's length loan contracts typically provide the interest rate, a maturity date, any collateral pledged to secure the loan and a repayment schedule.

Interest charges

If your business loans more than $10,000 to a shareholder, you must charge what the IRS considers an "adequate" rate of interest. If not, payments to shareholders may be subject to a complicated set of below-market interest rules. Each month the IRS publishes its applicable federal rates (AFRs), which vary depending on the term of the loan.

If you fail to charge interest or charge a rate that's lower than the AFR, the IRS requires you to impute interest. These calculations can be complicated. The amount of incremental imputed interest (beyond what the company already charges the shareholder) depends on when the loan was set up and other loan terms.

Borrow (and lend) with care

Consult with a tax advisor to ensure that you're treating payments to and from shareholders properly. Loans may be inadvertently reclassified, leading to costly tax consequences, if you fail to follow the tax rules. ■

Compilation, review or audit: Select the right level of assurance

The term "assurance" refers to how much confidence lenders and other stakeholders have that a company's financial statements will be reliable, informative and in conformity with U.S. Generally Accepted Accounting Principles (GAAP) or another financial reporting framework. Higher levels of assurance require more in-depth procedures performed by the CPA when evaluating a company's financial statements. Here's how the three levels of assurance — compilations, reviews and audits — measure up.

No assurance

Compiled financial statements provide *no* assurance that they're free from material misstatement or that they don't require material changes to conform to GAAP. Here, an accountant simply puts management's data into a financial statement format that conforms to GAAP (or another framework). Footnote disclosures and cash flow information are optional in compiled financial statements.

AICPA *Statement on Standards for Accounting and Review Services (SSARS) No. 21* recently reduced the length of compilation reports. Instead of the previous standard three-paragraph statement, compilation reports are now only one paragraph long, unless the company follows a special-purpose framework (such as income tax basis or cash basis). In those cases, an extra paragraph is needed.

There's another type of service that accountants offer that provide *no* assurance: Prepared financial statements follow many of the same guidelines as compiled financials. The basic difference? Preparation statements don't require the CPA to include a report; instead, they simply contain a disclaimer on every page that no level of assurance has been provided.

Accountants have been preparing financial statements for years, but SSARS 21 now provides official guidance for accountants to follow. Prepared financial statements are often used by owners who formerly

relied on management-use-only financial statements, which have been eliminated under SSARS 21.

Limited assurance

Reviews provide *limited* assurance that the statements are free from material misstatement and conform to GAAP. They start with internal financial data. Then, the accountant applies analytical procedures to identify unusual items or trends in the financial statements. He or she will also inquire about any anomalies and evaluate the company's accounting policies and procedures.

Reviewed statements require footnote disclosures and a statement of cash flows. But, the accountant isn't required to evaluate internal controls, conduct substantive testing and confirmation procedures, or physically inspect assets.

SSARS 21 calls for review reports to contain emphasis-of-matter (and other-matter) paragraphs when CPAs encounter significant disclosed (or undisclosed) matters that are relevant to stakeholders.

Reasonable assurance

Audits are seen by many as the "gold standard" in financial reporting. They provide *reasonable* assurance that the statements are free from material misstatement and conform to GAAP.

Though there's no level of assurance that provides an absolute *guarantee* against material misstatement or fraud, a lot of work goes into preparing audited financial statements. In addition to performing analytical procedures and conducting inquiries, auditors:

- Evaluate internal controls,
- Verify information with third parties (such as customers and lenders),
- Observe inventory counts,
- Physically inspect assets, and
- Assess other forms of substantive audit evidence.

Public companies are required by the Securities and Exchange Commission to have their financial statements audited. In addition, many lenders require larger private companies to be audited. But audits aren't necessary for everyone.

Moving up (and down) the assurance chain

Choosing the right level of assurance comes down to: 1) the complexity of your operations, 2) the abilities of your in-house personnel to accurately report financial results that conform to GAAP, and 3) your stakeholders' expectations. Though larger companies have more sophisticated finance and accounting departments, the nature of their transactions and their reliance on outside financing often necessitate an audit.

Over time, manufacturers may decide to change their level of assurance. For example, a growing firm might upgrade from a review to an audit to attract public company financing. Or a stable midsize firm might decide to downgrade from an audit to a review, and then hire a CPA to perform certain agreed-upon procedures to evaluate accounts receivable and inventory on a quarterly basis. Discuss these options with your CPA to find the level of assurance that suits your business's current needs. ■

How to put financial statements to work for your business

Spring is the time of year that calendar-year-end businesses receive financial statements that conform to U.S. Generally Accepted Accounting Principles (GAAP) and prepare tax returns. This year, take your financial data beyond compliance and use it to develop a comprehensive business plan. Also, assess how your business measures up over time and against the competition. Here's how financial statements can be used to be proactive, not reactive, to changes in the manufacturing industry.

Forecasting the future

Historical financial statements are often the starting point for planning for the future. Comprehensive business plans include forecasted balance sheets, income statements and statements of cash flows.

Many items in your forecasts will be derived from revenue. For example, variable expenses and working capital accounts are often assumed to grow in tandem with revenue. Other items, such as rent and management salaries, are fixed over the short run.

These items may need to increase in steps over the long run. For example, a company may eventually need to expand its factory or purchase equipment to grow if it's currently at (or near) full capacity.

By tracking sources and uses of cash on the forecasted statement of cash flows, management is able to identify when cash shortfalls may happen and plan how to make up the difference. For example, the company might need to draw on its line of credit, request additional capital contributions, lay off workers, reduce inventory levels or improve its collections. In turn, these changes will flow through to the company's forecasted balance sheet.

Benchmarking results

Historical financial statements can also be used to evaluate the company's current performance vs. past performance or industry norms. A comprehensive benchmarking study includes the following six elements:

1. Size. This is usually in terms of annual revenue, total assets or market share.

2. Growth. This shows how much the company's size has changed from previous periods.

3. Liquidity. Working capital ratios help assess how easily assets can be converted into cash and whether current assets are sufficient to cover current liabilities.

4. Profitability. This section evaluates whether the business is making money from operations — before considering changes in working capital accounts, investments in capital expenditures and financing activities.

5. Turnover. Such ratios as total asset turnover (revenue divided by total assets) or inventory turnover (cost of sales divided by inventory) show how well the company manages its assets.

6. Leverage. Identify how the company finances its operations — through debt or equity. There are pros and cons of both.

How does your company measure up against other manufacturers? Contact your CPA for help benchmarking performance or creating forecasts from your GAAP financials. ■

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10055 Red Run Boulevard
Suite 130
Owings Mills, MD 21117

We Know Manufacturing

With increasing regulations, technological changes and heightened competition, manufacturing companies are faced with a myriad of challenges in getting their products to clients in a fast and cost-effective manner. Staying abreast of the constantly changing rules in the industry makes it difficult to remain profitable. The Hoffman Group is experienced in helping manufacturers develop profit enhancing solutions to improve the bottom line and anticipate marketplace changes. We become a part of your management team to help develop and implement strategic decisions.

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hoffmancpas.com 443.320.4101 info@hoffmancpas.com