MANUFACTURER

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Learning the ABCs of the QBI deduction for pass-through entities

Midyear tax planning
Is it time to switch accounting methods?

Vendor fraud: Know the warning signs

Got operating problems?
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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

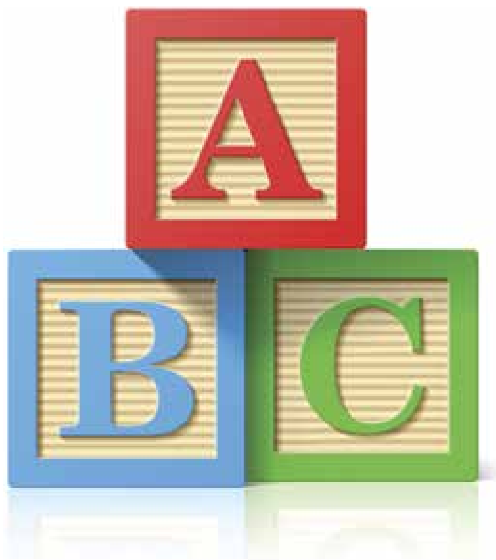
Learning the ABCs of the QBI deduction for pass-through entities

The Tax Cuts and Jobs Act (TCJA) permanently lowers the federal income tax rate for C corporations to a flat 21%, starting in 2018. But manufacturers that operate as sole proprietorships and "pass-through" entities aren't eligible for this reduced tax rate. Instead, they may be eligible for a "qualified business income" (QBI) deduction for 2018 through 2025. Will this special tax break bridge the disparity between the rates for C corporations and pass-through entities?

Why are pass-through entities popular in manufacturing?

Many small and midsize manufacturers have set up shop as sole proprietorships or one of the following types of pass-through entities:

- Partnerships,
- Limited liability companies (LLCs) that are treated as sole proprietorships or partnerships for tax purposes, and
- S corporations.



These business structures allow a business to avoid double taxation. That is, income from C corporations is taxed when it's earned, and again when a C corporation pays dividends or shares are sold. By comparison, income from sole proprietorships and pass-through entities is reported on an owner's personal tax return and taxed just once at the owner level at standard rates.

How are rates changing under the TCJA?

C corporations are still subject to double taxation under the new tax law. But the TCJA substantially lowers the income tax rate and eliminates the alternative minimum tax (AMT) for C corporations, starting in 2018.

However, *individual* income tax rate cuts are less significant and only temporary (from 2018 through 2025) under the new tax law. In addition, individual AMT still exists under the TCJA, although the exemption amount and phaseout thresholds have been temporarily increased, so fewer individuals will owe AMT for 2018 through 2025 than under prior law.

The new law also creates a new QBI deduction for sole proprietorships and pass-through entities. The rules for this special deduction are complex, and the IRS plans to issue additional guidance to explain how it works.

What's QBI?

For tax years beginning after December 3, 2017, the QBI deduction will be available to noncorporate owners of qualified businesses, including individuals, estates and trusts. For manufacturers, the deduction generally will equal 20% of QBI, subject to certain restrictions.

On an individual owner's tax return, this deduction is essentially treated the same as an allowable itemized deduction — but the taxpayer doesn't need to itemize to claim the QBI deduction.

QBI is defined as the noncorporate owner's share of items of taxable income, gain, deductions and loss from a qualified business, without making AMT adjustments. QBI doesn't include investment-related items (such as capital gains and losses, dividends, and interest income), reasonable owners' compensation and guaranteed payments from a pass-through business to its owners.

The QBI deduction and applicable limitations are determined at the *owner* level. Each owner must track his or her share of qualified items of income, gain, deductions and loss from the qualified business, as well as his or her share of W-2 wages paid by the entity.

What are the restrictions?

There are no additional restrictions on the QBI deduction unless an unmarried owner's taxable income exceeds $157,500 or $315,000 for a married joint filer. Above those income levels, the following restrictions are phased in over a $50,000 taxable income range for unmarried filers or over a $100,000 taxable income range for married joint filers.

Service business limitation. This targets professional services providers, such as doctors, athletes and investment advisors. It doesn't generally affect manufacturers, unless a principal asset of the business is the reputation or skill of one or more of its employees.

W-2 wage limitation. This limits the QBI deduction to the greater of the noncorporate owner's share of:

- 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Review your business structure

Some manufacturers that are set up as sole proprietorships and pass-through entities now wonder: Should we operate as a C corporation to take advantage of the permanently reduced corporate income tax rate and avoid the complicated QBI rules?

The answer depends on your specific personal and business circumstances. There are still some advantages to being taxed at the individual, rather than corporate, level.

For example, the income of C corporations is still subject to the threat of double taxation under the new law. And the flat 21% C corporation rate may be higher than the effective tax rate paid by individual owners, depending on their circumstances. In addition, the QBI deduction for some qualified entities might be limited based on the entity's wages and tangible property.

This is a complex decision, and Congress could scale back or reverse some TCJA provisions in the future. Set up a meeting with your tax advisor to discuss whether your current business structure still makes sense under the new law.

Qualified property means depreciable tangible property (including real estate) owned by a qualified business as of the tax year end and used by the business at any point during the tax year for the production of QBI.

Taxable income limitation. Your QBI deduction can't exceed 20% of taxable income calculated before the deduction and without counting long-term capital gains and dividends.

Need help?

These are just the basics. The rules for calculating the QBI deduction are more complicated if you own interests in several qualified businesses or your business reports a tax loss. Contact your tax advisor for more details. ■

Is it time to switch accounting methods?

The Tax Cuts and Jobs Act (TCJA) liberalizes the eligibility requirements for certain accounting methods that are generally easier to use and more flexible. As a result, more small and midsize manufacturers may be eligible for tax reporting shortcuts that may warrant accounting method changes.

Higher gross receipts limit

Starting in 2018, the new tax law increases the gross receipts limit to $25 million for eligible C corporations and partnerships that want to:

- Elect the cash method of accounting (rather than the accrual method),
- Elect simplified alternatives for inventory accounting if the taxpayer's inventory method either 1) treats inventories as nonincidental materials and supplies, or 2) conforms to its financial accounting treatment of inventories, or
- Avoid the complex uniform capitalization (UNICAP) rules that generally require producers and resellers of real and personal property to include in inventory direct costs and certain indirect costs.

The $25 million gross receipts limit will be adjusted annually for inflation after 2018. In addition, the gross receipts test must be satisfied by meeting a three-prior-year averaging test only for the tax year for which you plan to use the new reporting method. Under prior law, your business had to pass a gross receipts test for *all* earlier tax years beginning after 1985.

Cash method vs. accrual method

Which accounting method — cash or accrual — makes more sense for your business?

Unfortunately, there's no universal "right" answer for all manufacturers.

Under the cash method, income is generally recognized when cash is *received* and expenses are generally deducted when they're *paid*. Conversely, under the accrual method, income is recognized when it's *earned* and expenses are deducted when they're *incurred*.

A major drawback of the accrual method is that it generally requires a profitable business's taxes to be paid earlier than under the cash method. That's because accrual-basis businesses must pay taxes on income before customers actually remit payment. This can lead to cash flow problems.

In addition, cash-basis businesses can defer income to the next year by delaying sending out invoices, or they can shift deductions into the current year by accelerating the payment of deductible expenses. For an accrual-basis business to defer income, it would have to postpone shipping products or performing services.

The accrual method has some advantages, however. It provides a more accurate, consistent picture of financial performance by matching revenue with related expenses. And the accrual method conforms to U.S. Generally Accepted Accounting Principles (GAAP). Businesses that prepare GAAP financial statements can still use the cash method for tax purposes, if they

meet the eligibility requirements. But keeping two sets of books only makes sense if you expect significant tax benefits from using the cash method.

Also, accrual-basis businesses can take advantage of certain tax-planning strategies that aren't available to cash-basis businesses. For example, accrual-basis businesses can defer income on certain advance payments and deduct year-end bonuses that are paid within the first 2½ months of the following year.

Discuss your options with a tax pro

The TCJA expands the universe of businesses that are eligible for simplified accounting methods. But these methods aren't right for all businesses, and eligibility rules must be met. Ask your tax advisor if your business is eligible for these methods and, if so, how much tax you could potentially save by switching methods. Note that changing methods may require IRS approval. ■

Vendor fraud: Know the warning signs

When fraud strikes, the culprit might be sitting in your purchasing department. This department is particularly vulnerable to fraud because of the volume of transactions it processes and the varying pricing and billing policies that vendors use. Here's a close-up of common vendor fraud scams and ways to lower your risks.

Phony vendors

A common type of purchasing scheme involves fictitious vendors. Here, an employee in the purchasing department might set up a bogus supplier in the accounting system and then deposit payments to the supplier into his or her personal checking account.

Warnings of fictitious vendors include invoices that are photocopied, sequentially numbered, and from companies that have post-office box addresses or addresses that match an employee's home address. Also be wary of invoices with amounts that consistently fall just below sums that require approval for payment and, depending on your business, invoices for round dollar amounts.

Bogus invoices with real vendors

Some purchasing scams require collusion between an employee in the purchasing department and someone at the vendor's office. For example, a

vendor might submit falsified invoices, and then an employee in the purchasing department will deposit refunds into his or her personal account or split duplicate payments with his or her accomplice at the supply company.

Connections between procurement staff and suppliers may provide clues to these types of schemes. Is an employee related to, or otherwise linked with, the owner or management of a supplier? If so, that employee shouldn't make purchasing decisions that involve the vendor.

Kickbacks

If you perform contract work, you also might be susceptible to kickbacks. That is, the person who approves the contracts could be receiving kickbacks

from vendors. Red flags include fewer bids than expected or required, widely divergent bids on the same projects and unexplained deadline changes.

Kickbacks also might occur if it seems like you're paying higher prices for lower quality products. Cash payments to employees can be difficult to detect because those payments aren't reflected in the company's books. They probably are, however, reflected in higher pricing from the vendor. Even fraudulent vendors must cover their costs.

Companies should look for consistent shortages, informal communication (such as mobile phone calls or personal emails) between purchasing staff and suppliers, and poor record-keeping.

Preventive measures

You can prevent vendor fraud by targeting one of the legs of the fraud triangle: motive, opportunity and rationalization. Many preventive measures strengthen internal controls and develop policies and procedures to prevent theft, thereby reducing the opportunity to commit fraud.

For example, no employee should be authorized to handle most or all of your purchasing procedures. The person who orders supplies and materials, for example, shouldn't check shipments or approve invoices. Consider separating these functions or rotating who's responsible for them on a quarterly basis.

Also consider performing background checks on new vendors. Such checks can provide information on the vendors' affiliations, ownership, litigation, regulatory or legal violations or suspensions and financial standing. This can help you weed out vendors with dubious histories.

Companies also should state in writing how they expect employees — and vendors — to conduct business. This code of ethics should be reviewed and updated annually, and employees and vendors should be required to sign it every year, even if nothing changes. Annual reminders will reinforce the idea that the company considers ethical, professional business practices a priority.

Anonymous hotlines — one for employees and a separate one for vendors — can be an effective way to detect purchasing frauds, especially those involving collusion. Giving vendors a separate hotline makes them more comfortable sharing concerns, and allows them to ask questions about the business's ethics practices.

To catch a thief

If you notice the warning signs of vendor fraud, contact an accountant immediately. He or she can help unearth the cause of any anomalies, quantify your losses, build a defensible case (if you decide to prosecute the thief) and fortify your defenses against future scams. ■

Got operating problems?

Employees may have solutions — if you ask for their input

Your management team doesn't have all the answers — and they may be aware of only a fraction of the problems. Rank-and-file workers can provide simple but effective solutions, but they may need an incentive to speak up.

Learn from frontline workers

In March, Widgets 'R Us lost two major accounts. The sales manager blamed it on quality control issues. The plant manager blamed procurement for switching suppliers of raw materials. Marketing

thought the company's prices were too high compared to competitors' prices.

Widgets' owner decided to survey frontline factory workers and customer service reps about ways to improve customer retention. Instead of playing the blame game, these workers had practical solutions from their daily observations.

Based on employee suggestions, the owner realigned workflow on the production line to be more streamlined. These improvements eliminated bottlenecks and sped up the manufacturing cycle time by 10%. Then she negotiated a long-term contract with a low-cost domestic vendor that was willing to supply raw materials on a just-in-time basis. This lowered inventory carrying costs by 4% and improved the gross margin by 6%.

> Make it clear that you're looking for ideas that promote the company goals and add long-term value.

She also received an eye-opening fraud tip: A disgruntled former salesperson had sold stolen customer lists to an unethical competitor. So, the owner spoke with her attorney about investigating the breach and implemented stronger controls to prevent other employees from stealing valuable proprietary data in the future.

Because of these changes, Widgets' profits are up in the second quarter. And no additional customers have been lost since March.

Engage employees

How do you motivate employees to speak up? Some companies implement a cash reward program for suggestions that add value. Consider these guidelines:

Be goal oriented. You don't want to be inundated with complaints. Make it clear that you're looking for ideas that promote the company goals and add long-term value.

Provide a measurable benchmark. Tie rewards to financial results, such as cost savings or revenue growth. For example, if a suggestion saves the company $40,000, a 2% reward is $800.

Acknowledge contributions. Announce people who receive rewards at a companywide meeting or award ceremony. This shows employees that the incentive program is important to your organization.

Go beyond surveys. Solicit feedback from a variety of sources, including emails, bulletin boards, hotlines, newsletters, town hall meetings and departmental groups.

Listen and implement changes

Everyone wants to be heard, regardless of whether they're the CEO or the janitor, full-time or part-time, rookie or veteran. When your employees have the courage and initiative to make suggestions, pay attention and acknowledge their input, even if you decide not to act. Doing so can broaden your management team's perspective, empower workers and improve productivity. ■

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THE HOFFMAN GROUP
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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