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New tax law limits business interest expense deductions

Under the Tax Cuts and Jobs Act (TCJA), starting with tax years beginning in 2018, manufacturers with more than $25 million in average annual gross receipts will generally be able to deduct less interest expense than they could have deducted under prior law. Here are some details about this new limitation.

Nuts and bolts

In general, businesses can deduct "ordinary and necessary" expenses incurred in operating a business, including raw materials, labor and overhead expenses. However, under the TCJA, business interest expense deductions for tax years starting in 2018 and beyond will be limited to the sum of: 1) business interest income, 2) 30% of adjusted taxable income (ATI), and 3) interest on any floor-plan financing (for vehicle dealers).

Businesses with $25 million or less in average annual gross receipts for the preceding three tax years are exempt from the limitation, however. (Farming and real estate ventures with average annual gross receipts in excess of $25 million also can elect out of the limitation in exchange for lower depreciation deductions, but these options to elect out generally don't apply to manufacturers.)

The limitation on deducting business interest expense could have an adverse effect on larger, capital-intensive firms that borrow money to purchase equipment, machines, computers and other fixed assets.

Calculating ATI

Manufacturers don't usually earn much interest income or use floor-plan financing. So, their interest expense deduction will generally be limited to 30% of ATI.

ATI starts with taxable income calculated without considering the business interest expense limitation. That amount is then adjusted by:

- Excluding any nonbusiness income, gains, deductions or losses,
- Subtracting business interest income,
- Adding back business interest expense,
- Adding back any net operating loss (NOL) deduction,
- Adding back the new deduction for up to 20% of qualified business income (QBI) from a pass-through business entity (such as a sole proprietorship, partnership, limited liability company or S corporation), and
- Adding back deductions for depreciation, amortization and depletion for tax years beginning before 2022.

Calculating deductible interest expense under the new limitation

Widgets Makers is a manufacturer with $35 million in average annual sales for the last three tax years. For 2018, Widgets has ATI of $4.5 million after adding back $2 million of business interest expense and $1 million of depreciation. Widgets is a C corporation, so it can't take the qualified business income (QBI) deduction. How much interest expense can Widgets deduct in 2018?

The company's interest expense deduction for 2018 is limited to $1.35 million (30% × $4.5 million of ATI). The $650,000 of disallowed interest expense ($2 million – $1.35 million) is carried forward to future tax years.

Now, let's assume the same facts for 2022 — when the add-back for depreciation, amortization and depletion deductions is no longer permitted. How much interest expense will Widgets be allowed to deduct in 2022?

For 2022, Widgets' ATI will equal $3.5 million, because the $1 million of depreciation isn't added back in calculating ATI. So, the company's interest expense deduction for 2022 is limited to $1.05 million (30% × $3.5 million of ATI). The $950,000 of disallowed interest expense ($2 million – $1.05 million) is carried forward to future tax years.

For example, assume the same basic facts for 2023, except Widgets has only $900,000 of interest expense for 2023. The company's ATI is $3.5 million (the same as for 2022). So, the company's interest expense limitation for 2023 is $1.05 million (30% × $3.5 million of ATI).

In this case, the company can deduct all the interest incurred in 2023 ($900,000). Plus it can deduct $150,000 of the disallowed interest expense carryforward from 2022. That results in a total allowable interest expense deduction of $1.05 million for 2023 ($900,000 + $150,000).

For tax years beginning in 2022 and beyond, depreciation, amortization and depletion deductions will no longer be added back in calculating ATI, which will reduce the interest expense deduction limit for companies with depreciation deductions. (See "Calculating deductible interest expense under the new limitation" above.)

Indefinite carryforwards

What happens to the interest expense that's disallowed under the limitation rule? It's not forgone; rather, it's carried forward indefinitely to future tax years. Then it's treated as business interest expense incurred in the carryforward year.

The interest expense limitation could impact whether larger manufacturers decide to pay cash or take out loans for equipment purchases — or lease these items. This decision also might be affected by rising interest rates and the new accounting rule for leases that goes into effect for public companies in 2019 and private companies a year later.

The updated accounting rule requires companies to report leased assets on their balance sheets. Compared to the current accounting treatment, this could adversely affect a company's debt ratios and loan covenants.

Digesting the new rules

The TCJA brings sweeping changes to the tax code — and not all the changes are positive for businesses and their owners. The new limitation on business interest expense deductions could be especially unfavorable to larger manufacturers with significant debt on their balance sheets. Contact your tax advisor to understand how the new limitation on deductible business interest is likely to affect your business. ■

Employee or independent contractor: Worker classification matters

There's a fine line between employee and independent contractor. The distinction may take on even greater importance under the new tax law as some employees try to shift ordinary income into business income to be eligible for the new qualified business income (QBI) deduction. Here's an overview of this issue and the characteristics that distinguish employees from contractors.

Worker classification affects tax revenue

If your company engages an independent contractor, it doesn't need to withhold payroll or income taxes from his or her compensation. In addition, you don't have to remit the company's obligatory percentage of FICA or Medicare taxes, or pay into unemployment and workers' compensation insurance.

So, when an employer misclassifies an employee as an independent contractor, the federal government potentially loses out on quite a bit of money. (Although the rules differ for states, state taxing agencies also look closely at this issue.) If the IRS determines you've committed employee misclassification, you could be liable for unpaid federal and state income tax withholding, Social Security, Medicare and unemployment insurance contributions, as well as penalties and interest.

Moreover, you could be on the hook for both your company's share and the employee's share of these amounts. And this may hold true even if you've filed Form 1099 and paid all taxes due.

It's also important to remember that the federal government isn't the only one that may raise the issue. Often, former workers who were classified as independent contractors will file lawsuits to recover employee benefits, overtime pay and unreimbursed business expenses or other amounts associated with employee status.

IRS considers various factors

To determine whether a worker is classified properly, the IRS asks three critical questions:

Does the company control the worker's behavior? The agency looks at how, where and when job tasks are performed.

Does the company control the worker financially? When an independent contractor becomes largely or wholly dependent on a single entity to generate income, he or she starts to veer toward employee status.

What is the true nature of the company's relationship with the worker? Informal agreements or those that go on for a long time can start to look like employment.

The IRS isn't alone in its pursuit of employers who misclassify workers. The Department of

Labor (DOL), under the Fair Labor Standards Act, also sets forth its "economic realities" test. For example, long, consistent interaction between the parties implies employee status. Similarly, if the services provided are integral to the business, the DOL will tend to view the independent contractor as an employee.

Contractor status gains popularity

The use of independent contractors is on the rise. Some manufacturers, for example, hire contractors for seasonal peaks or custom projects. In the past, workers were generally hesitant to be classified as independent contractors, because they didn't want to forgo health and retirement benefits — or job security — that come with being an employee. However, thanks to the new QBI deduction under the Tax Cuts and Jobs Act (TCJA), more workers are expected to jump on the 1099 bandwagon.

From 2018 through 2025, self-employed individuals and contractors that operate so-called "pass-through entities" (such as partnerships, limited liability companies and S corporations) can take a deduction of up to 20% of QBI. Although the TCJA limits the QBI deduction for service businesses, that limitation doesn't kick in until an individual owner's taxable income exceeds $157,500, or $315,000 for a married individual who files a joint return.

Numerous rules and restrictions apply to the new QBI deduction, but it could provide significant tax savings for many independent contractors. The IRS is aware of this income-shifting strategy, and it's expected to monitor worker classification closely while the QBI deduction is available.

Protect your business

Do you use independent contractors? Manufacturers who outsource work to independent contractors must work closely with tax and legal advisors to stay out of trouble with the IRS, state tax agencies and the DOL. ■

Financial restatements

Why can't management get it right the first time?

Fraud isn't the only reason behind financial restatements. Sometimes they're caused by unintentional errors or omissions, especially as companies record complex transactions or implement new accounting and tax rules.

Error-prone transactions

When a company restates its financial results, investors and lenders may jump to the conclusion that management is cooking the books. But sometimes a restatement happens because management lacks a clear understanding of U.S. Generally Accepted Accounting Principles (GAAP).

Restatements generally coincide with more complicated accounting rules or management's handling of an unusual, one-time transaction. Historically, the leading causes of restatements include:

- Recognizing revenue from contracts,
- Reporting related-party transactions,
- Classifying cash flows as investing, financing and operating on the statement of cash flows,
- Reporting compensation expense from share-based payments,

- Issuing common or preferred stock,
- Accounting for business combinations, and
- Estimating goodwill impairment.

Mistakes and omissions are typically found when the company's financial statements undergo a higher level of scrutiny. For example, restatements may be necessary when you upgrade your level of assurance from a compilation to a review or from a review to an audit. A new controller or audit firm also may identify the need for a restatement.

Major changes coming

Recent changes to the accounting rules and the new tax law might increase the number of companies issuing restatements in the coming years. Specifically, the Financial Accounting Standards Board has issued two major changes to GAAP that will affect many manufacturers in the next few years:

1. Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, effective in 2018 for public companies and in 2019 for private ones, and
2. ASU No. 2016-02, *Leases*, effective in 2019 for public companies and in 2020 for private businesses.

The updates may cause some errors that require restatements, especially if management waits until the last minute to implement the changes. In addition, the Tax Cuts and Jobs Act contains numerous provisions — including lower tax rates, new and eliminated deductions, and foreign tax changes — that will affect the amount of tax-related assets and liabilities companies report on their financials.

The impact of the new law may be difficult to quantify, but companies that follow GAAP must report the effect of a new tax law in the quarter it's enacted. By the end of 2018, some companies may need to revise their initial estimates.

Need help?

Restatements can complicate financial reporting and possibly raise a red flag with stakeholders. As your company implements the recent changes to the accounting and tax rules, work with a CPA advisor to get it right. ■

Deducting travel and entertainment expenses with confidence

When owners, managers and salespeople attend trade shows, call on customers and evaluate suppliers, they may incur travel and entertainment expenses. Here are the rules for deducting these costs, including how they've changed under the Tax Cuts and Jobs Act (TCJA).

Keep detailed records

You must keep detailed records to substantiate any business expense. But it's especially important for travel and entertainment expenses. Why? These expenses are IRS hot buttons, so those records are likely to be scrutinized if you're audited by the IRS.

Detailed recordkeeping includes these details about the expense:

- The amount,
- The time and place, and
- The business purpose.

The IRS allows recordkeeping shortcuts under certain circumstances. For example, a business owner may opt to use the standard mileage rate, as established by the IRS for a given tax year, in lieu of substantiating actual auto expenses. In 2018, the standard mileage rate is 54.5 cents per mile for business travel. In addition, if you drive the same route consistently, you may be able to use an accurate record for part of the year to show your business mileage for the whole year.

Avoid potential pitfalls

When substantiating expenses, it's important to note the business relationship of any person entertained. Mixing business with pleasure can be risky. Consult with your tax advisor before claiming meals and entertainment expenses that are for both purposes to avoid raising a red flag with the IRS.

If you reimburse employees for meals, entertainment and travel expenses, make sure they're complying with all the rules. And enforce a policy that requires *timely* expense report submission. It's almost impossible to re-create expense logs at year end or to wait until the IRS sends a deficiency notice.

Learn about the new tax law

The rules for deducting meal and entertainment expenses have changed under the TCJA. Specifically, the new law disallows deductions for most business-related entertainment expenses paid or incurred after December 31, 2017, including the cost of facilities used to entertain customers.

Examples of nondeductible expenses under the TCJA include:

- Tickets to sporting events,
- License fees for stadium or arena seating rights,
- Private boxes at sporting events,
- Theater tickets,
- Golf club dues and greens fees,
- Company golf outings for customers, and
- Hunting, fishing, and sailing outings.

Some business-related entertainment expenses may still be deductible, but only in very limited circumstances (such as when entertainment is presented at an event open to the public). While it was unclear at the time of this publication, it may be that taxpayers can still deduct 50% of food and beverage expenses incurred at entertainment events, but only if business was conducted during the event or shortly before or after.

It's also uncertain whether you can still deduct 50% of the cost of meals when business is conducted during the meal. At the time of publication, the IRS was expected to issue additional guidance on these questions. Contact your tax advisor for the latest information.

There is a silver lining: The new law still allows businesses to deduct 50% of the cost of meals for an owner or employee who is traveling away from home for business purposes.

Review policies and procedures

If you haven't done so already, it's important to assess your company's expense allowance policies to determine if the new TCJA provisions warrant changes — especially for entertainment expenses. Accounting system changes may be necessary to separately track entertainment expenses and business-related meal expenses, which might still be 50% deductible. ■

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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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