MANUFACTURER

Winter 2019

Tax Cuts and Jobs Act

4 ways tax reform could benefit U.S. manufacturers

Entity choice: Is it time for a switch?

Critical questions to ask about internal controls

Moving your business to the cloud

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

Tax Cuts and Jobs Act

4 ways tax reform could benefit U.S. manufacturers

The Tax Cuts and Jobs Act (TCJA) — which passed late in 2017 — is long and complicated. Its effects will vary from business to business, depending on each one's structure and the nature of its operations. Here are four major changes that are likely to save taxes for domestic manufacturers starting in 2018.

1. Lower tax rate for C corporations

The TCJA permanently lowers the federal income tax rate for C corporations to a flat 21%. The low, flat tax rate is good news if your business earns enough taxable income to have fallen into the 25%, 34% or 35% bracket under prior law. But it's bad news if you would have fallen into the 15% bracket.

Fortunately, there's at least one silver lining for smaller manufacturers that would have otherwise been in lower tax brackets: The TCJA liberalizes the eligibility requirements for smaller businesses to qualify for the cash method of accounting. This method generally provides greater flexibility in tax planning by deferring revenue recognition and accelerating expense recognition, compared to the accrual method of accounting. In addition, the TCJA liberalizes the eligibility requirements for small businesses to use simplified inventory accounting methods.

2. Lower tax rates for individual owners of pass-through entities

There's good and bad news for owners of pass-through entities — such as sole proprietorships, partnerships, S corporations and limited liability companies (LLCs). The bad news is that tax cuts for individuals are relatively modest — and they're only available through 2025.

A key upside is that individual owners of many manufacturing companies will qualify for a new deduction of up to 20% of qualified business income (QBI). This break is intended to help achieve parity between the tax rates for C corporations and pass-throughs under the TCJA. But it's available only through 2025, and it's subject to many rules and restrictions.

The limitations that are most likely to hit manufacturers relate to W-2 wages and the basis of qualified property. The QBI deduction is generally limited to the greater of an owner's share of 1) 50% of the amount of W-2 wages paid to employees by the business during the tax year, or 2) the sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

So, the QBI deduction for pass-through owners with few W-2 employees and/or limited fixed assets may be partially phased out. However, these limitations don't kick in until the individual owner's taxable income (calculated before any QBI deduction) exceeds $157,500, or $315,000 for a married owner who files jointly.

3. Changes to the AMT rules

The TCJA permanently repeals the *corporate* alternative minimum tax (AMT). Under prior law, corporations faced an AMT rate of 20% of AMT income above an exemption amount, minus any AMT foreign tax credit.

In addition, the new law temporarily increases the AMT exemption amounts for individuals through 2025. As a result, fewer owners of pass-through businesses will owe the AMT starting in 2018 — and those that do will generally owe less than they would have under prior law.

4. Expanded Sec. 179 and bonus depreciation deductions

For qualifying property placed in service in tax years beginning after December 31, 2017, the maximum Section 179 deduction permanently increases to $1 million (up from $510,000 for tax years beginning in 2017). In addition, the Sec. 179 deduction phase-out threshold increases to $2.5 million (up from $2.03 million for tax years beginning in 2017). These amounts will be adjusted annually for inflation. The TCJA also expands the definition of eligible Sec. 179 property.

In addition, the first-year bonus depreciation program has become much more generous under the TCJA. For qualified property placed in service between September 28, 2017, and December 31, 2022, the first-year bonus depreciation percentage on qualifying new and used property increases to 100% (up from 50% in 2017).

First-year bonus depreciation is scheduled to be reduced as follows:

- 80% for property placed in service in calendar year 2023,
- 60% for property placed in service in calendar year 2024,
- 40% for property placed in service in calendar year 2025, and
- 20% for property placed in service in calendar year 2026.

For certain property with longer production periods, the preceding cutbacks are delayed by one year.

The dark side of tax reform

Several provisions of the Tax Cuts and Jobs Act (TCJA) are *unfavorable* to businesses. Specifically, manufacturers should watch out for new limits on:

- Interest expense deductions,
- Net operating losses (NOLs),
- Deductions for business entertainment, and
- Certain transportation-related employee benefits.

In addition, the TCJA repeals the domestic production activities deduction under Section 199. And, starting in 2022, manufacturers will be required to capitalize and amortize specified research or experimental expenditures, rather than to expense them immediately.

Got questions?

These key changes are just the tip of the iceberg. The TCJA may significantly alter income tax obligations for your business's current tax year. If you have additional questions about the effects of tax reform, contact a tax professional. ■

Entity choice: Is it time for a switch?

The Tax Cuts and Jobs Act (TCJA) lowers the federal income tax rate for C corporations to a flat 21%. This fundamental change has caused some manufacturers that are set up as sole proprietorships, partnerships, S corporations or limited liability companies (LLCs) to ask whether it still makes sense to continue to operate as a so-called "pass-through" entity.

Here's what you need to know to make an educated decision about your business structure under today's tax law.

Pros of C corporations

A flat 21% tax rate works to the advantage of C corporations that expect to report substantial profits. The tax rates on income from pass-throughs depend on their owners' rates. For individual owners, income is taxed at graduated rates that top out at 37% for 2018 through 2025.

In addition, the tax rate for C corporations has been *permanently* reduced under the TCJA. However, the new deduction for qualified business income (QBI) — which was designed to create tax rate parity between C corporations and pass-throughs — will expire at the end of 2025, unless Congress extends it.

Larger manufacturers also might be restricted from using pass-through structures altogether. For example, most publicly traded companies are structured as C corporations (although a few are set up as publicly traded partnerships). Your tax and legal advisors can explain which structures your business is eligible for.

Pluses for pass-throughs

It's important to remember that pass-through entities are still only taxed once — at the owner level. Pass-throughs aren't taxed at the entity level.

However, C corporations are still potentially taxed twice under the TCJA. First, the C corporation pays entity-level income tax. And then, corporate shareholders pay tax on dividends paid by the corporation and capital gains when shares are sold for a profit. Dividends and capital gains also may be subject to the 3.8% net investment income tax at the individual shareholder level.

Additionally, pass-through entities may qualify for the new QBI deduction. (See "Tax Cuts and Jobs Act: 4 ways tax reform could benefit U.S. manufacturers" on page 2.) Most pass-through manufacturing businesses won't be subject to the limitations on the QBI deduction that affect 1) service businesses, and 2) businesses with minimal W-2 wages and fixed assets. So, individual owners of pass-through manufacturing businesses will often be eligible for the maximum deduction of 20% of QBI.

If your business will report a slight profit — and you're in the 0%, 10% or

12% individual tax bracket — your effective tax rate might be lower if your business is set up as a pass-through entity than if it's a traditional corporation. Moreover, if your business consistently generates losses, there's no tax advantage to operating as a C corporation. Losses from C corporations can't be deducted by their owners. So, it's usually better to operate as a pass-through entity and deduct the losses on your personal tax return.

In addition, C corporations are subject to complex accumulated earnings tax (AET) rules. In general, the AET rules kick in if a C corporation retains earnings beyond the reasonable needs of the business, rather than distributing them as dividends to the owners. If you prefer to stockpile cash in your company's bank account, discuss the AET rules with a tax professional.

Run the numbers

When it comes to selecting a legal structure for your manufacturing business, there's no universal "best" choice. The decision requires consideration of various tax and legal issues. Your professional advisors can discuss the pros and cons of each structure under today's tax law. ■

Critical questions to ask about internal controls

When fraud strikes manufacturers, the effects can be devastating. The median fraud loss in the manufacturing sector was $240,000, according to the 2018 *Report to the Nations* published by the Association of Certified Fraud Examiners (ACFE). That's almost double the median fraud loss for all industries ($130,000).

Internal controls are a company's first line of defense in preventing and detecting fraudulent activity. How do your controls measure up? Proactive managers can ask these questions to evaluate whether their control systems are strong enough to help protect against theft or misstatement.

Is access to assets restricted?

Start by examining your company's restrictions on physical access to assets. Employees should be able to access only those assets that are necessary to perform their jobs. Locks, security cameras and RFID tags can safeguard inventory in the warehouse. Encryption software and passwords can limit access to the accounting system and sensitive employee and customer data.

To help define who has access to what, conduct interviews and review formal job descriptions — if they're available and accurate. In addition to outlining the scope of employees' responsibilities, job descriptions should address the separation and duplication of sensitive duties.

For example, billing schemes are especially common among manufacturers. So, the person who's responsible for billing customers shouldn't also deposit customer payments and reconcile the accounts. When limited staff makes segregation of duties difficult, supervision is particularly important.

Are accounts reviewed by management?

One sign of strong controls is regular reconciliation and analysis of key accounts. Your company shouldn't wait until year end to confirm account balances.

Monthly bank reconciliations and quarterly (or rolling) inventory counts may be appropriate. Strong internal control systems require management to review employees' work — via test counts, recalculating mathematical computations or replicating tasks. Managers also should analyze account balances using variance analysis, common-sizing and breakdowns of sales by territory or product line to identify unusual trends.

Is your system protected from management overrides?

Frauds perpetrated by executives are the costliest. These frauds produce a median loss of $850,000 — nearly six times larger than the median loss caused by managers, and 17 times higher than the median loss caused by low-level employees, according to the latest ACFE report.

> When limited staff makes segregation of duties difficult, supervision is particularly important.

To help prevent fraud in the executive suite, hiring policies should include background checks and possibly supplemental screening, such as drug testing or psychological evaluations, on new hires. Executive expense reimbursement requests also warrant scrutiny. Often, fraud perpetrators use falsified expense reports to test internal controls. If successful in expense report fraud, they may graduate to bolder, costlier scams.

Are your financial statements audited?

Audits can help catch problems early, thereby minimizing fraud losses. They might be performed by an internal audit committee consisting of senior managers — though in many cases management is too busy with other responsibilities to perform this function. For this reason, many manufacturers hire

external accounting professionals to audit their financial statements.

Keep in mind that external audits can unearth material irregularities and deter corruption, but they won't necessarily detect immaterial frauds. In fact, no type of audit provides an absolute guarantee against dishonest employee behavior.

Are controls a priority?

For internal controls to be effective, your company needs to publicize them. You might, for example, offer training classes or publish articles in the employee newsletter to let everyone know that internal controls are a priority and that serious consequences await perpetrators.

Management should communicate fraud reporting mechanisms, such as anonymous hotlines. In addition, train managers to recognize possible red flags, including unusual journal entries and employees living beyond their means.

Lessons learned

Monitoring controls is a continuous improvement project to ensure they remain adequate and effective. The trick to preventing fraud is to stay one step ahead of would-be thieves.

Manufacturers with proactive controls — including thorough physical controls over assets, management review, account reconciliation and monitoring — can reduce the duration of schemes and their fraud losses. Contact a forensic accounting expert to investigate suspicious activity or reinforce your controls to prevent fraud from happening in the first place. ■

Moving your business to the cloud

Many manufacturers and distributors have already jumped aboard the cloud computing bandwagon — but is it right for your business? Some haven't yet moved to the cloud, possibly because their staff resources and IT expertise are limited. Others have transitioned to the cloud, but they're dissatisfied with the cost, service offerings and security features of their current provider.

Evaluating the benefits

Cloud computing uses a network of remote third-party servers made available online. Rather than relying on your own computers or server, you remotely share software and storage to process, manage and share information. Potential benefits include:

Lower costs. Cloud customers typically pay a monthly subscription fee or are billed based on actual usage. Reputable cloud service providers update their offerings and provide security patches on an ongoing basis.

Scalability. You can scale up (or down) as your storage or data capacity needs change. For instance, you might use more cloud storage during seasonal peaks.

Convenience. Cloud services aren't limited to a physical location. Rather, the cloud can be accessed from anywhere, anytime, on any device. This helps employees collaborate on projects and access reports and ledgers in real time.

The cloud also allows manufacturers to share data with supply chain partners to facilitate just-in-time production and streamline workflow — as well as providing access to financial data for auditors, tax advisors and lenders. If you invite outside users to view data, the cloud allows you to control the level of access.

Vetting cloud service providers

Uncertainty about data security has caused some manufacturers to put off moving to the cloud. So, when shopping for a cloud service, ask about basic security features, such as firewalls, authorization restrictions and data encryption. You'll also want to know:

- How frequently the cloud is updated,
- Whether data is backed up in multiple locations around the country,
- Whether the service has experienced any previous data breaches,
- How quickly the provider has responded to past security threats, and
- Whether you can retrieve all of your data in a nonproprietary format should the service go out of business.

Reputable cloud services offer continuous data backup and disaster recovery capabilities, so you don't have to worry about losing important records due to a physical server failure or a lost or broken hard drive. But, beware, you might ultimately be responsible for any data breach, even if the information was stored by a third-party cloud service provider. So, consider negotiating restitution clauses into your contracts for cloud applications.

Ask for referrals

When researching vendors, ask for recommendations from other business owners and professional advisors such as your CPA. Once you've selected a cloud provider, periodically review your decision and consider alternatives. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2018 MFGwi19

THE HOFFMAN GROUP
Certified Public Accountants & Consultants

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.

TAX & ASSURANCE

- Tax Compliance & Preparation
- Audit, Review & Compile Financial Statements
- Sales & Use Tax
- International Tax
- Cost Segregation Studies
- Mergers & Acquisitions
- Research & Development Credits
- Minimize Multistate Tax Burden

CONSULTING

- Strategic Planning
- Forecasting & Budgeting
- Inventory Costing
- Operational Assessments
- E-Business Strategy
- Business Plans
- Financing Assistance
- Internal Control Assessments
- Performance Measurement

hoffmancpas.com 443.320.4101 info@hoffmancpas.com