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Why wait to deduct your purchases?

Turbocharge tax deductions with bonus depreciation and Sec. 179

"Don't put off until tomorrow what you can do today," Benjamin Franklin once advised. This timeless wisdom applies in many business scenarios, from taking advantage of growth opportunities to claiming tax deductions.

In general, business owners should jump on tax-saving opportunities as soon as possible due to the time value of money. Two especially lucrative breaks for capital-intensive manufacturers under the Tax Cuts and Jobs Act (TCJA) are the expanded first-year bonus depreciation deduction and the first-year Section 179 deduction. Both allow you to accelerate deductions for qualifying purchases of property, plant and equipment. Here's what you should know.

First-year bonus depreciation deduction

Businesses can deduct 100% of the cost of certain assets in the first year they're placed in service under the new-and-improved bonus depreciation program. This federal tax break applies to qualifying new *and used* assets placed in service between September 28, 2017, and December 31, 2022.

After that, the bonus depreciation percentage is reduced by 20% per year as follows:

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

Bonus depreciation is fully phased out after 2026, unless the program is extended by Congress. (Note: These deadlines are extended by one year for certain assets with longer production periods and for aircraft.)

Most categories of tangible depreciable assets — other than real estate — qualify for this break. Congress also intended for qualified real estate improvement property (QIP) placed in service after 2017 to be eligible for bonus depreciation. QIP includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. However, due to a drafting error, QIP placed in service after 2017 still has a 39-year Modified Accelerated Cost Recovery System (MACRS) recovery period, as under prior law. Therefore, QIP is ineligible for bonus depreciation, unless Congress passes a technical correction that makes bonus depreciation available.

Sec. 179 deduction

Alternatively, your business can elect to expense the cost of any Sec. 179 property and deduct it in the year the property is placed in service. The TCJA expanded the Sec. 179 deduction for qualifying assets placed in service in tax years beginning in

Depreciation for business vehicles

The Tax Cuts and Jobs Act (TCJA) expands the first-year tax breaks for qualifying business vehicles. Specifically, new and used passenger vehicles placed in service after December 31, 2017, and used over 50% for business, may be eligible for the following maximum annual depreciation deductions:

- $10,000 for 2018 (or $18,000 if you claim first-year bonus depreciation),
- $16,000 for 2019,
- $9,600 for 2020, and
- $5,760 for 2021 and thereafter until the vehicle is fully depreciated.

These allowances will be indexed for inflation for 2019 and beyond. For tax purposes, heavy SUVs, pickup trucks and vans are treated as transportation equipment. That means they qualify for 100% first year bonus depreciation. To qualify, heavy vehicles must have a manufacturer's gross vehicle weight rating (GVWR) above 6,000 pounds, and they must be used over 50% for business purposes.

2018 and beyond. The maximum Sec. 179 deduction is $1.02 million for 2019 (up from $1 million for 2018, thanks to the annual inflation adjustment).

The TCJA also expanded the definition of qualifying assets for Sec. 179 deductions to include:

- Depreciable tangible personal property used mainly in the furnishing of lodging (such as furniture and appliances),
- QIP (except improvements to enlarge a building, elevators or escalators, and the internal structural framework of a building), and
- Roofs, HVAC equipment, fire protection systems, and alarm and security systems for nonresidential real property.

There's an important caveat to remember: The Sec. 179 deduction is phased out for larger businesses. The deduction starts to be phased out if your qualified asset purchases for the year exceed $2.55 million for 2019 (up from $2.5 million for 2018). Sec. 179 limits and phaseouts are adjusted annually for inflation.

Sec. 179 expensing is limited to taxable income from a taxpayer's active trades or businesses. That means that Sec. 179 deductions can't create or increase an overall tax loss for the business. Any amount that can't be currently deducted because of the taxable income limit can be carried forward to later years until it's fully deducted.

Which is right for you?

When both 100% first-year bonus depreciation and the Sec. 179 deduction privilege are available for the same asset, you generally should claim 100% bonus depreciation, because there are no limitations on that break.

However, in some situations, Sec. 179 expensing can be advantageous. For example, it can be used to fine-tune annual deductions, doesn't cause uniform capitalization (UNICAP) problems, and covers certain improvements to nonresidential real property that aren't eligible for bonus depreciation. The availability of the two deductions provides greater flexibility than just bonus depreciation alone.

Weigh your options

A tax professional can discuss whether bonus depreciation, Sec. 179 expensing, regular MACRS depreciation or a combination of these methods makes the most sense for your business. There's no right answer for everyone, but the TCJA provides a lot of flexibility in deducting purchases of property, plant and equipment. ■

Keeping a lid on unemployment taxes

The manufacturing sector tends to spend a lot on salaries and bonuses. So, federal and state unemployment insurance can represent a significant cost of doing business. Fortunately, your management team can take proactive measures to help lower this cost, which varies depending on your work states, employment history and management practices. Here's what you should know.

The basics

Unemployment insurance provides a temporary weekly benefit to qualified workers who lose their job through no fault of their own. Funding for the state and federal portions of the unemployment insurance system is drawn from payroll taxes imposed on employers under the State Unemployment Tax Act (SUTA) and the Federal Unemployment Tax Act (FUTA), respectively.

Under the unemployment insurance system, individual states have the authority to do the following:

- Administer the unemployment insurance system.
- Establish eligibility rules.
- Set regular benefit amounts.
- Pay benefits to eligible people.

Each state sets a tax rate schedule and a maximum amount of wages that is subject to taxation. Currently, the state wage base ranges from $7,000 in Arizona, California, Florida and Puerto Rico to $46,800 in Hawaii. The average tax rate also varies from state to state. So, just because your state's wage base is higher than another state's, it doesn't necessarily mean that you'll pay more in state unemployment taxes.

For example, although California's unemployment tax wage base is only $7,000, the average employer in California contributed 4.33% of taxable wages to the state's unemployment program in 2018. By contrast, the average employer contribution rate in Hawaii was only 1.01% of taxable wages in 2018.

Since 1983, the FUTA tax rate has been 6% of a maximum of $7,000 in covered wages per employee per year. Employers may be eligible for a maximum FUTA credit of 5.4%, resulting in a normal net FUTA rate of 0.6% — or $42 per year for each employee earning at least $7,000 annually.

Estimating your cost

In most states, established businesses will be assigned an "experience rating" from the state. That rating determines your state unemployment tax rate.

Your company's experience rating and, therefore, its tax rate may be influenced by the number of former employees who've filed unemployment claims with the state, the number of your current employees and your company's age. Typically, the more claims made against your company, the higher your premiums climb. Conversely, your company will pay state unemployment tax at a lower rate if your company's involuntary turnover rate is lower.

Some states may allow employers to buy down their unemployment tax rate. Or businesses that recently acquired another may be able to use the acquired company's unemployment tax rate or request the transfer of the previous company's unemployment reserve fund balance.

In addition, you can follow these "best practices" to help lower turnover and, thus, lower unemployment taxes:

1. Hire new staff conservatively.
2. Consider using temporary workers, part-timers and contractors during peaks, if possible.

3. Assess candidates with standardized testing before hiring them.

4. Conduct ongoing staff training to enable employees to succeed.

If you must terminate an employee, consider giving him or her a severance payment as well as offering outplacement benefits. Severance pay may reduce or delay the start of unemployment insurance benefits. Plus, effective outplacement services may hasten the end of unemployment insurance benefits, because the claimant has found a new job.

Cost-analysis study

A cost-analysis study, which can be performed with the help of your CPA, will enable you to see via black-and-white projections whether increasing your payroll is worth the investment. If it isn't financially attractive to add staff, consider other options. ■

4 signs that your budget is unreliable

Every business should prepare an annual budget, but it's especially important in the capital-intensive manufacturing sector. Comprehensive, realistic budgets allow you to identify potential shortages of cash, production capacity constraints and other threats. They also can help you develop a strategic plan that takes advantage of opportunities to improve performance. Here are four signs that your budget may not be doing its job.

1. It's based on last year's results

Too often, companies create a budget by applying an across-the-board percentage increase to the prior year's actual results. This approach may be oversimplified in today's ever-changing marketplace.

Historical results are a good starting point. But some costs are fixed, rather than variable based on revenue. And certain assets — such as machines and people — have capacity limitations to consider. Accurate forecasts of revenue and expenses are prepared on a department-by-department basis and use technology to capture "real-time" sales data.

2. It lacks companywide input

Your finance or accounting department shouldn't complete the budget alone. Rather, you should seek input from people in every department and at various levels of management.

For example, your sales department may be in the best position to estimate future revenue. The production manager may offer insight into anticipated maintenance expenses or necessary investments in equipment upgrades. And the product development team can help forecast revenue and expenses related to new products and processes.

In addition, soliciting broad participation gives employees a sense of ownership in the budgeting process. In turn, this can help enhance employee

engagement and improve your odds of achieving budgeted results.

3. It's not realistic

Good budgets encourage hard work to grow revenue and cut costs. But the targets should also be attainable, based on industry trends.

Employees will likely become discouraged if they view the budget as unachievable or out of touch with what's happening in the market. After years of failed attempts to meet the budget, workers may start to ignore it altogether. Tying annual bonuses to the achievement of specific targets can help encourage employees to buy in to the budget.

4. It ignores cash flows

Cash is king. Even if expected revenue is forecast to cover expenses for the year, production and cost fluctuations, as well as slow-paying customers and uncollectible accounts, can lead to temporary cash shortages.

An unexpected shortfall can seriously derail your budget. So, look beyond the income statement and balance sheet. You'll need to forecast cash flows on a weekly or monthly basis. Then create a plan for managing any anticipated shortfalls.

For example, owners may need to contribute extra capital, or you might need to apply for a line of credit at the bank. Alternatively, you might consider buying materials on consignment, revising payment terms with customers or delaying payments to suppliers to manage the cash flow cycle more effectively.

Recognize the power of fluidity

Markets are constantly evolving, so budgeting is an ongoing process. Work with your CPA to help develop a reliable budget and monitor budget vs. actual results on a real-time basis. The sooner you identify problems, the less likely you are to be blindsided by threats or miss opportunities to grow and improve performance. Continual monitoring allows you to take corrective actions and build a better budget for the future. ■

QOE reports look beyond the numbers

In mergers and acquisitions, potential buyers may obtain a quality of earnings (QOE) report to evaluate the accuracy and sustainability of the seller's reported earnings. It's also common for sellers to obtain their own QOE reports to spot potential problems that might derail a transaction and identify ways to preserve or even increase the company's value.

How do QOE reports differ from audits?

An audit yields an opinion on whether a company's financial statements fairly present its financial position in accordance with Generally Accepted Accounting Principles (GAAP). It's based on historical results as of the company's fiscal year end.

In contrast, a QOE report determines whether a company's earnings are accurate and sustainable and whether its forecasts of future performance are achievable. It typically evaluates performance over the most recent *interim* 12-month period.

What affects earnings' quality?

Generally, the starting point for a QOE report is the company's earnings before interest, taxes, depreciation and amortization (EBITDA). Many buyers and sellers believe this metric provides a better indicator

of a company's ability to generate cash flow than net income does. In addition, EBITDA helps filter out the effects of capital structure, tax status, accounting policies and other strategic decisions that may vary depending on who's managing the company.

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The next step is to "normalize" EBITDA by:

- Eliminating certain nonrecurring revenues and expenses,
- Adjusting owners' compensation to market rates, and
- Adding back other discretionary expenses.

Additional adjustments may be needed to reflect industry accounting conventions. Examples include valuing a manufacturer's inventory using the first-in, first-out (FIFO) method rather than the last-in, first-out (LIFO), or recognizing revenue based on the percentage-of-completion method rather than the completed-contract method.

A QOE report identifies factors that bear on the company's continued viability as a going concern, such as operating cash flow, working capital adequacy, related-party transactions, customer concentrations, management quality and supply chain stability. It's also critical to scrutinize trends to determine whether they reflect improvements in earnings quality or potential red flags.

For example, an upward trend in a manufacturer's EBITDA could be caused by increasing sales (a positive indicator of future growth) or decreasing costs (a sign that management is being more fiscally responsible). Alternatively, higher earnings may result from deferred spending on plant and equipment (a sign that the company isn't reinvesting in its future capacity) — or from changes in accounting methods (which is unrelated to *real* economic improvements).

A valuable tool

Whether you're buying or selling a business, or simply looking for ways to improve performance, a QOE report is a powerful tool. It goes beyond the financials to provide insight into the factors that drive value. ■

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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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