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Manufacturing and Distribution

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Tax Reform Update

A Look at Current Tax Planning Opportunities

American taxpayers are now one year into the Tax Cuts and Jobs Act (TCJA)—and what a challenging year it's been. The act represented some of the most sweeping tax changes in decades, but much is still up in the air about its implementation and impact.

For example, the IRS has continued to issue illuminating guidance on several issues impacting businesses over the last year (TCJA meals and entertainment deductions were clarified late in 2018) and legislation to retroactively extend certain tax provisions that lapsed in 2017, and 2018 was still being voted on well into 2019.

With the caveat of further IRS guidance likely to come, here are some TCJA implementation considerations for the coming year:

Lower tax rates: As part of TCJA, the tax rate for C corps decreased from a top rate of 35 percent to a flat rate of 21 percent. To even the playing field for owners of S corps and partnerships, the IRS created IRC Section 199A, giving pass-through entities a 20 percent deduction on qualified business income (QBI).

Of course the law is full of limitations, phase-ins, and phase-outs. For example, certain types of service businesses are excluded from the QBI deduction, but manufacturers and distributors qualify. Also, the deduction is subject to W-2 wage, depreciable assets, and taxable income limits.

The TCJA also lowered individual tax rates, from a maximum of 39 percent to 37 percent, which is a welcome relief to many top-wage earners.

Interest expense limitation: Pre-TCJA, business interest expense was deductible in the year in which it was paid or accrued, subject to certain limitations—the so-called "earnings stripping rules"—under IRC Section 163(i).

The new tax law replaced those rules with a new limitation, allowing manufacturers and distributors with more than $25 million in average annual gross receipts to deduct their net interest expense only when it is less than 30 percent of the company's "adjusted taxable income." (The "excess" interest expense disallowed under the new legislation can be carried forward indefinitely into future tax years.)

For tax years beginning after December 31, 2017, adjusted taxable income is computed without regard to deductions for depreciation, amortization, depletion, or business interest expense (EBITDA). For tax years after December 31, 2021, adjusted taxable income will include these deductions.

Going forward, this new limitation could impact your decision to pay cash or get a loan for large purchases. With interest rates potentially rising and a new accounting rule for leases going into effect for private companies in 2020, you must carefully consider the tax implications of such decisions.

NOL limitations: Prior to TCJA, net operating losses (NOLs) generally could be carried back two preceding tax years, with any excess carried forward to the 20 succeeding tax years.

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Word to the Wise

Revenue Recognition Rules Now in Effect

In 2014, the Financial Accounting Standards Board (FASB) issued new revenue recognition rules for customer contracts. These new standards, known as ASC 606, are now in effect for most privately held companies and will impact 2019 financial reporting and disclosures.

Five-Step Model

As you may recall, the new rules require a five-step model of revenue recognition for contracts with customers for the transfer of goods, services, or real estate. These five steps apply to each customer contract:

1. Identify all customer contracts. A contract is defined as having the following conditions: It identifies the rights of the parties, has payment terms and commercial value, has been approved by the parties, and payment is likely collectible.

2. Identify performance obligations. The standard requires identification of "distinct" obligations. If the customer can use a deliverable on its own, it is considered a distinct performance obligation. If the deliverable is dependent on other pieces included in the contract, it is not considered to be distinct.

3. Determine transaction price. If a contract includes discounts, rebates, or refunds, what are you actually going to get paid? What about other factors impacting the price, like market volatility or weather? How does the time value of money figure in if a customer pays early or late?

4. Allocate transaction price. If the contract includes separate performance obligations, you must recognize revenue as each is complete. This means you must calculate a standalone price for each obligation.

The same goes for discounts, which must be allocated against the price of each performance obligation or proportionately as revenue is recognized.

5. Recognize revenue. You must recognize revenue as each performance obligation is completed and the control of the goods or services is transferred to the customer.

Urgency Required

If you haven't yet started reviewing your contracts, now is the time. Some manufacturers and distributors have already implemented the new rules, and others can learn from their experience. For example:

Document your process. Every company is different. Even companies in the same industry may arrive at different answers relative to the five steps. Be sure to document your contract evaluation process because you might need to explain it to banks, auditors, the IRS, or other users of your financial statements.

Anticipate advanced income. For many companies, the new rules will result in advanced income recognition. If this is the case for your business, you will need to work with your finance and accounting team to determine the impact of the earlier timing.

Prepare for disclosures. The standard requires more significant disclosures on financial statements. What used to be explained in one or two sentences will now likely take one or two pages.

Evaluate complex contracts. If your company has master service agreements or long-term, complicated contracts, you must evaluate them as soon as possible. The process is time consuming.

Don't Wait

The ASC 606 standard and its related documents total more than 1,000 pages. Expect to invest a significant amount of time and effort to meet these new requirements.

We are familiar with ASC 606 and are ready to help you understand and implement the new rules.

Considerations for the TCJA

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NOLs could offset up to 100 percent of taxable income, and any excess unused portion expired after 20 years.

Now, NOLs in tax years beginning after December 31, 2017 can offset only up to 80 percent of taxable income. Also, NOLs can no longer be carried back two years, but they can be carried forward indefinitely.

For NOLs generated in tax years before December 31, 2017, the earlier tax law still applies.

AMT eliminated: For many years, the Alternative Minimum Tax (AMT) was an expensive irritation to individual taxpayers. The TCJA effectively eliminated the AMT for most taxpayers. However, like many provisions in the TCJA, this one expires in 2026.

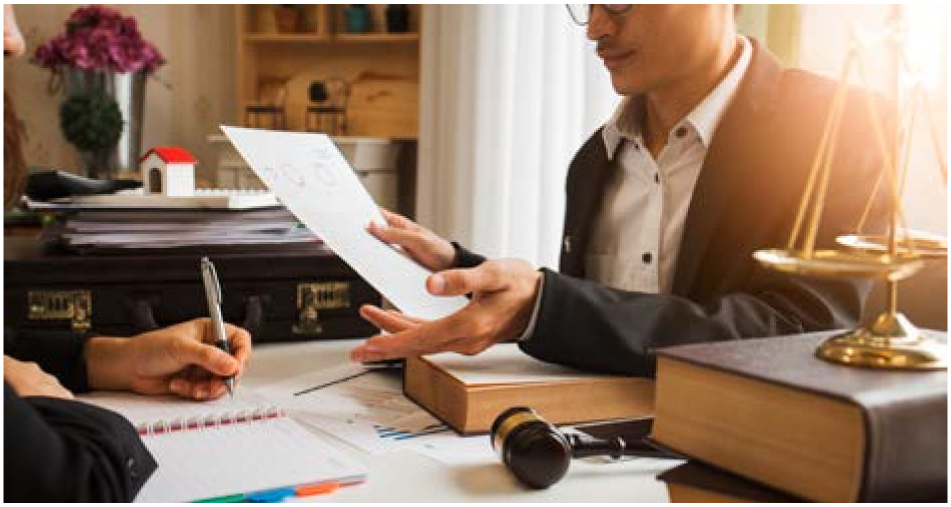
Accounting method options: Businesses with average gross receipts of up to $25 million or less for the prior three years can now opt for the cash method of accounting. Choosing this option gives taxpayers a one-year boost because it pushes tax liabilities into the future.

While this option will benefit many manufacturers and distributors, changing accounting methods is not appropriate for all businesses. Be sure to discuss the pros and cons with your tax advisor. (See article on page 4.)

Bonus depreciation: The TCJA allows 100 percent bonus appreciation in the first year for qualifying assets—both new and used—placed into service between September 28, 2017 and December 31, 2022.

Qualifying assets include computer software and Modified Accelerated Cost Recovery System (MACRS) property with a recovery period of 20 years or less. Rules regarding qualified improvement property (QIP) are still uncertain.

Beginning in 2023, the bonus depreciation percentage will drop 20 percent each year for four years until it expires at the end of 2026.



Meals & Entertainment Expenses: The TCJA eliminated the deduction for business entertainment expenses incurred after December 31, 2017, with certain exemptions. For example, sporting event tickets and club memberships are no longer deductible at all.

Meals provided for employers' convenience are now only 50 percent deductible (and nondeductible after 2025), and water, coffee, and snacks at the office are now only 50 percent deductible (and non-deductible after 2025).

Wayfair & Nexus: While not part of TCJA, the June 2018 U.S. Supreme Court decision in *South Dakota v. Wayfair* will also have a major tax impact on companies doing e-commerce business in multiple states.

The law in question, passed by the South Dakota legislature in 2016, required an economic presence rather than just a physical presence in the state to meet nexus requirements. The law applied to companies that annually delivered at least $100,000 in sales of goods or services or engaged in at least 200 individual transactions for the delivery of goods into the state.

After its passage, three big out-of-state sellers, including the online home goods e-store Wayfair, did not comply, causing what South Dakota estimated to be a loss of $50 million in state sales taxes annually. The case went all the way to the U.S. Supreme Court, and in its June 2018 ruling, the high court overturned existing and longstanding precedent regarding nexus, upheld South Dakota's law, and cleared the way for states to legally collect sales taxes from online and remote sellers.

While the aftermath of this ruling will take some time to unfold, other states have already followed South Dakota's lead and passed legislation related to an economic nexus standard instead of a physical presence standard.

Stay Tuned

Tax law is obviously in major flux right now. All of the intricacies and nuances of the TCJA have yet to be clarified, and it is expected that the IRS will continue to issue guidance about TCJA implementation into the future.

With these numerous tax changes in mind, be sure to keep in close contact with your tax advisor regarding planning opportunities for this year and beyond.

Our team is up to date on the latest TCJA-related rulings from the IRS. Contact us soon to talk about your company's tax situation.

Should You Consider Cash Method of Accounting?

One part of the Tax Cuts and Jobs Act (TCJA) that's particularly attractive to manufacturers and distributors is the new rule that expands the opportunity for businesses to use the cash method of accounting.

The change raises the gross receipts limit for resellers from a pre-TCJA limit of $10 million or less to the new higher limit of $25 million or less for the immediately preceding three years—a significant increase.

Most manufacturers and distributors are accustomed to the accrual method of accounting, which recognizes revenue on the income statement when *earned* and expenses when *incurred*. In contrast, the cash method of accounting recognizes revenue when *received* and expenses when they are *paid*.

Both methods offer some tax planning advantages. For example, companies using the cash method can defer income by sending invoices later or shift deductions into the current year by accelerating payment of deductible expenses. Companies using the accrual method can defer income on certain advance payments and deduct year-end bonuses paid within the first two-and-a-half months of the following year.

In terms of timing, switching to the cash method will create a one-time boost of a smaller tax bill in the first year. For companies with increasing sales, the change will seem great in year one but will have little effect after the first year. For companies with volatile or decreasing sales—or whose sales numbers are close to the $25 million limit—the change may not be worthwhile.

The TCJA also included some changes that affect inventory accounting, namely allowing simplified alternatives for inventory accounting if the business meets certain requirements relative to how it treats inventory and allowing companies to avoid the complex uniform capitalization (UNICAP) rules under certain circumstances.

To determine whether a change in accounting methodology is right for your company, talk to your tax advisor.