Heinold Banwart, Ltd.
Certified Public Accountants

Third Floor
201 Clock Tower Drive
East Peoria, IL 61611-2449

Tel (309) 694-4251
Fax (309) 694-4202
Web www.hbcpas.com

March 20, 2018

Tax Reform Alert: Manufacturer Impact

The Tax Cuts and Jobs Act made significant changes to individual and corporate taxation by generally lowering tax rates and widening tax brackets. In addition, certain deductions were curtailed. This article will highlight several key provisions that are of most significance to the manufacturing industry.

Tax Rates

C Corporations

The corporate rate drops to a flat 21% beginning in 2018. For C corporations who have historically reported less than $90,000/$100,000 of taxable income, this will be a tax increase because of the removal of the 15% bracket. For higher income corporations, this will be a clear tax cut as the former top rate was 35%. Additionally, the alternative minimum tax has been eliminated. State income taxes remain deductible.

Individuals (S corporation, Partnership, Sole Proprietor)

Individual tax rates have generally decreased, and tax brackets have been widened. For example, under the old law, the 25% tax bracket was applied to income between $77,400 and $156,15 (married taxpayers). Now there is a 24% bracket that is applied to income from $165,000 to $315,000. The top rate was 39.6% for incomes over $480,050 (married); under new law the top rate is 37% and starts at $600,000. Some deductions have been curtailed under the Act, namely state income and property taxes are capped at $10,000. Therefore, the Illinois state income tax (4.95%) may be largely nondeductible for individuals that own S corporations or partnerships.

Capital Spending & Depreciation

Bonus Depreciation

Businesses can take 100% bonus depreciation (immediate write-off) on qualified property acquired and placed in service after September 27, 2017. Previously, such property was eligible for 50% bonus depreciation. 100% bonus depreciation remains in effect through 2022. After that the percentage is scaled down to 80% - 2023, 60% - 2024, 40% - 2025, and 20% - 2026. Qualified property for bonus depreciation now includes used assets and generally applies to property with a depreciable life of 20 years or less. This is a significant change as previously only new assets qualified.

Section 179 Expense

The maximum deduction under the Section 179 provisions is $1,000,000 starting in 2018. This is an increase from $510,000 in 2017. The starting point for the phaseout threshold (maximum property that can be placed in service) was increased from $2,070,000 to $2,500,000.

Improvements to nonresidential real property such as roofs, heating, ventilation, air conditioning, fire alarm, and security systems are also eligible (must be placed in service after the date the building was placed in service).

Pass-Thru Deduction

As described in more detail in our *Section 199A Alert*, most business income from manufacturers will be eligible for a 20% deduction which effectively lowers the top individual rate from 37% to 29.6%. This deduction is available to all taxpayers except C corporations.

In its simplest form, the deduction is equal to 20% of Qualified Business Income (QBI). This is generally "trade or business" net income (noninvestment income). QBI does not include reasonable compensation (wages) paid to S corporation owners or guaranteed payments to partnership owners.

Limitations

For taxpayers (individual owners of manufacturers) who have taxable income less than $315,000 (married) or $157,500 (single), the only limitation is that the pass-thru deduction cannot also be more than 20% of taxable income excluding investment income (capital gains). Note: this 20% of taxable income limitation applies to all taxpayers no matter the income level.

For taxpayers with taxable income over $415,000 (married) or $207,500 (single), there is an additional limitation. The 20% deduction cannot be more than the greater of:

1. 50% of wages paid by the entity (owner share of wages paid at the entity level), or
2. 25% of wages paid by the entity plus 2.5% of qualified property unadjusted cost basis

The practical impact of first limitation is that wages must be 40% of net business income. Or similarly, for the second limitation, the combination of wages and 2.5% of qualified property need to be 40% of net business income.

If a taxpayer falls within the phaseout range - $315,000 to $415,000 (married) or $157,500 to $207,500 (single) there are additional computations to both limitations which effectively serve to gradually reduce the benefit over the range of income - $100,000 (married) or $50,000 (single). Contact our office for more information on this phaseout computation.

Qualified Property

Qualified property is property that is depreciable (not land), held at the end of the tax year, used in the production of QBI and for which the "depreciable period" has not ended. The "depreciable period" is the longer of 10 years or the depreciable life of the property for tax purposes. For property with lives of 3, 5, or 7 years, these assets will be a factor in the §199A computation for 10 years. For assets over 10 years (15, 27.5 years, or 39 years) these assets would be a factor for the entire depreciable life of the property.

Research Tax Credit and Research Expenses

The Act preserves the research tax credit. Similarly, research expenses are still able to be deducted immediately though 2021. After 2021, such expenses are to be capitalized and amortized over 5 years.

Methods of Accounting – Income Tax

Accounting for Inventories

If the production, purchase, or sale of merchandise (inventory) is a material income-producing factor to the taxpayer, an inventory of such merchandise (materials cost) must be kept. In other words, most manufacturers were required to use the accrual method of accounting for inventory purchases and sales. In 2017, an exception applied such that if average gross receipts were less than $1 million, a business could instead account for inventory as non-incidental materials and supplies and therefore was permitted to use the cash method of accounting. Under the cash method of accounting, businesses recognize income and deduct expenses when cash is received or paid.

For 2018, the Act increases the $1 million exemption to $25 million for businesses that have inventories and would allow such businesses to treat inventory as non-incidental materials and supplies or treat inventory in the same manner as is reflected on its financial statements. Similarly, those businesses could use the cash method of accounting. Therefore, for a business who capitalizes inventory for financial statement purposes, there may be no change to the inventory accounting rules for income tax purposes. However, a manufacturer with revenues under $25 million would now be required to capitalize only materials costs and not labor and overhead as long as that followed the book accounting treatment.

Uniform Capitalization Rules

The uniform capitalization (UNICAP) rules require certain direct and indirect costs associated with real or tangible personal property manufactured by a taxpayer to be capitalized into the cost of inventory or capitalized into the basis of such property. These rules generally require more costs to be capitalized for income tax purposes as compared to financial statement purposes. Often the adjustment relates to indirect costs and certain general and administrative costs that are not treated as a period cost under the UNICAP rules.

The Act now stipulates a gross receipts threshold of $25 million in 2018, such that many small manufacturers would now be exempt from the UNICAP rules. The $25 million exemption for manufacturers is significant as previously there was no such threshold and almost all manufacturers were required to comply with the UNICAP rules.

Domestic Production Activities Deduction (DPAD) Repealed

The domestic production activities deduction that was available to manufacturers has been repealed for 2018. This generally allowed for a 9% deduction from taxable income subject to certain wage limitations. In effect, the new 20% pass-thru deduction replaces the DPAD at a higher rate although it is now available to many more industries other than manufacturing and production.

Like Kind Exchanges for Personal Property

While the Act kept like kind exchanges for real estate (Section 1031 exchanges), it eliminated the ability to defer the gain on an exchange of personal property (equipment and vehicles). This will mean that the trade in allowance will be considered cash sale proceeds and gain will be recognized for the amount that this exceeds basis.

Because of recognizing the gain, the entire cost of the equipment being acquired will be eligible for depreciation. Therefore, given the new depreciation provisions, many times the overall transaction can still result in a wash for federal income tax purposes. Gain on sale of item traded off can be completely offset by first year depreciation on acquired item.

This issue is also something to watch for those S corporations who are still within the 5-year built in gains recognition period (corporation who elected S status on January 1, 2014, or later). For those S corporations, trading equipment will trigger the federal built-in gain tax, where previously the built-in gain tax could be deferred.

Summary

Manufacturers should generally benefit from the new tax bill themselves; in addition, the provisions should drive demand for manufactured products. There are several more provisions applicable that are unable to be discussed in an article of this length. Please contact our office for more information.