New Tax Code Implications for Manufacturers

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Cash Method of Accounting

- Corporations with average gross receipts of $25 million or less for prior three years permitted to use cash method of accounting
  - Applies to C corporations and partnership with C corporation partner
  - Threshold indexed for inflation
- Effective for tax years beginning after Dec. 31, 2017
- Prior rule was $5 million of average gross receipts for all years after 1985
Accounting for Inventories

- Taxpayers with average gross receipts of $25 million or less for prior three years are exempt from requirement to account for inventories
  - Threshold indexed for inflation
  - Applies to all entity types and industries

- Taxpayer can treat inventories as:
  - Materials and supplies that are not incidental, or
  - Conform to its financial accounting treatment

- Effective for tax years beginning after Dec. 31, 2017

- Prior rule was that cash method was not allowable if purchase, production, or sale of merchandise was a material income-producing factor (exception for small taxpayers with less than $1 million gross receipts)
Uniform Capitalization Rules - §263A

- Taxpayers with average gross receipts of $25 million or less for prior three years are exempt from Uniform Capitalization (UNICAP) rules
  - Threshold indexed for inflation
- UNICAP exemptions not tied to gross receipts are retained
- Prior exemption:
  - Taxpayer with average gross receipts of less than $10 million for personal property acquired for resale
- Effective for tax years beginning after Dec. 31, 2017
Accounting for Long-Term Contracts

- Taxpayers with average gross receipts of $25 million or less for prior three years are exempt from requirement to use percentage-of-completion for contracts to be completed within two years
  - Threshold indexed for inflation
- Prior exemption was for less than $10 million of average gross receipts
- Applies to contracts entered into after Dec. 31, 2017 in a taxable year ending after Dec. 31, 2017
Employer Credit for Paid FMLA

▪ General business credit provided to employers that offer paid leave under the Family and Medical Leave Act (FMLA)

▪ Requirements:
  ▫ Employer must have a written policy in place
  ▫ Must provide at least two weeks of paid leave (pro rata amount if part-time)
  ▫ Must provide at least 50 percent of employee’s regular wages
  ▫ Employee received less than $72,000 of compensation in the prior year
  ▫ Employee must have been employed by the employer for more than one year

▪ Amount of Credit:
  ▫ Ranges from 12.5 percent to 25 percent of wages paid during FMLA leave
  ▫ Credit can be claimed for up to 12 weeks of paid leave

▪ Applies to wages paid in 2018 and 2019
Entertainment Expenses

- No deduction allowed for entertainment, amusement, recreation, or certain club dues
  - 50 percent deduction allowed under prior law
  - The prior law exceptions that allowed a 100 percent deduction are still available
    - Expenses primarily for the benefit of employees

- Qualified transportation fringe eliminated

- Meals provided for the convenience of the employer or via an employer operated eating facility
  - 100 percent deduction allowed under prior law
  - Now 50 percent deductible through 2025, then nondeductible

- Business meals continue to be 50 percent deductible

- Effective for tax years beginning after Dec. 31, 2017
The 20% Pass-Through Deduction

The lesser of:

i. 20 percent of taxpayer’s QBI (qualified business income), or

The greater of:

i. 50 percent of allocable W-2 wages of business, or
ii. 25 percent of allocable W-2 wages of business plus 2.5 percent of the allocable unadjusted basis of all qualified property
- LLC with $50,000 W-2 wages
- No property
- Owner’s 1040 = $500,000 taxable income before LLC income
- LLC has $300,000K QBI pass-through income
- What’s the QBI deduction?

**Example:**

<table>
<thead>
<tr>
<th>QBI Deduction</th>
<th>20% QBI</th>
<th>50% W-2</th>
<th>25% W-2 + 2.5% property</th>
<th>Lessor of:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>60,000</td>
<td>25,000</td>
<td>12,500</td>
<td>60,000 or 25,000</td>
</tr>
<tr>
<td>QBI Deduction =</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Under $415,000 Taxable Income: A Key Metric

- If under $315,000 (MFJ), taxable income, entitled to full 20 percent deduction
- This threshold references the personal income tax return (1040) of the pass-through owner, not the taxable income of the business
- There is a phase-out to the extent taxable income exceeds $315,000 but less than $415,000

This is the case regardless of limitations (which we will discuss later)

- Not limited by nature of business
- Not limited by amount of W-2 wages
- Not limited by degree of capital investment
C Corporation Conversion?

- Corporate tax rate reduced to flat 21 percent for years beginning after Dec. 31, 2017
- Corporate AMT repealed for years beginning after Dec. 31, 2017
C Corporations: The Dreaded Second Level of Tax

- C corporations are subject to a flat 21 percent tax on income plus 20 percent* tax on dividends when cash is distributed.
- It is all about deferral.

<table>
<thead>
<tr>
<th></th>
<th>C corp*</th>
<th>S corp</th>
<th>S corp (QBI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Income Tax</td>
<td>(52,500)</td>
<td>(92,500)</td>
<td>(74,000)</td>
</tr>
<tr>
<td>Dividend Tax</td>
<td>(39,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NIT</td>
<td>(7,505)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash After Tax</td>
<td>150,495</td>
<td>157,500</td>
<td>176,000</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>39.80 percent</td>
<td>37.00 percent</td>
<td>29.60 percent</td>
</tr>
</tbody>
</table>

* Does not include deduction for state income taxes
Changes to Cost Recovery

- No changes to general expense-versus-capsalize rules

- **Bonus depreciation**
  - Old Law: 50 percent → **New Law: 100 percent**

- **Used property** is newly eligible for bonus depreciation
  - Self-trading is prohibited

- **Simplification of nonresidential building improvement categories**
  - Old Law: QLHI, QRP, QRIP, QIP
  - New Law: QLHI, QRP, QRIP, QIP
Changes to Cost Recovery

▪ “Qualified Improvement Property” (QIP)

  ▫ QIP includes any improvement to an **interior** portion of a building which is **nonresidential** real property, if such improvement is placed in service **after** the date such building was first placed in service.

  ▫ Does not require building to be three years old

  ▫ Does not require a lease arrangement
Changes to Cost Recovery

▪ “Qualified Improvement Property” (QIP)

  ▫ Excludes costs attributable to:
    - Enlargement of a building
    - Elevator or escalator
    - Internal structural framework of the building
  ▫ Eligible for 100 percent bonus depreciation*
    * Requires a technical correction to remain eligible for bonus depreciation under the new law
  ▫ Commercial tenant improvements
  ▫ Hotel building improvements
Three time periods with unique cost recovery rules:

- **Period 1 - Old Law**: 1/1/17
- **Period 2**: 9/27/17
- **Period 3**: 12/31/17

**Impacts 2017 Tax Returns**

**Impacts Current & Future Costs**
## Changes to Cost Recovery

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>50 Percent Bonus</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>100 Percent Bonus</td>
<td></td>
<td>X</td>
<td>X(1)</td>
</tr>
<tr>
<td>Used Property Qualifies for Bonus</td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

100 percent for 2018-2022; 80 percent for 2023; 60 percent for 2024; 40 percent for 2025; 20 percent for 2026; zero percent for 2027
# Changes to Cost Recovery

<table>
<thead>
<tr>
<th>Building Improvement Categories</th>
<th>Period 1 1/1/2017 – 9/27/2017</th>
<th>Period 2 9/28/2017 - 12/31/2017</th>
<th>Period 3 1/1/2018 - Beyond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Leasehold Improvements (QLHI)</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Qualified Restaurant Property (QRP)</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Qualified Retail Improvement Property (QRIP)</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Qualified Improvement Property (QIP)</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>
Changes to Cost Recovery

- **Two-part test** to determine which period’s cost recovery rules apply:

1. **Placed in service**: When “ready for use”?

2. **Acquisition**: When was there a **binding written contract** to purchase or construct?

- **Example**: Costs placed in service during Period 2 or 3, but their construction began in Period 1, are subject to the cost recovery rules of Period 1.
Changes to Cost Recovery

- **Section 179 Expense**
  
  - *Annual limit:* $510,000 (2017) → $1,000,000 (2018)
  
  - *Phase-out begins:* $2,030,000 (2017) → $2,500,000 (2018)
  
  - Still limited to taxable income
  
  - *Hotels/lodging newly eligible*
### Changes to Cost Recovery

- **Increased Annual Depreciation Limits for Luxury Automobiles ( < 6,000 lbs)**
  - Plus year one bonus depreciation up to $8,000

<table>
<thead>
<tr>
<th>Year</th>
<th>1/1/2017 – 12/31/2017</th>
<th>1/1/2018 - After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$3,160</td>
<td>$10,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$5,100</td>
<td>$16,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$3,050</td>
<td>$9,600</td>
</tr>
<tr>
<td>Year 4+</td>
<td>$1,875</td>
<td>$5,760</td>
</tr>
</tbody>
</table>

- **Heavy vehicles ( > 6,000 lbs) qualify for 100 percent bonus depreciation**
Changes to Cost Recovery

▪ Capitalize vs Expense
  ▫ To maximize “2.5 percent of cost” factor of QBI deduction, may prefer to capitalize costs (with 100 percent bonus depreciation) rather than expensing

▪ Manage Extent of Tax Losses
  ▫ New $500,000 business loss limitation for individuals
  ▫ 80 percent NOL beginning in 2018
  ▫ Elect out of bonus depreciation for certain asset classes?
Overall Trade or Business Loss Limitation/NOLs

- NOLs incurred in a taxable year after Dec. 31, 2017, must be carried forward. No carryback.
- They carryforward indefinitely, but only offset 80 percent of taxable income.

Limitation for taxpayers other than corporations

- Aggregate deductions from trades or businesses over aggregate gross income or gain from trades or businesses may not exceed a threshold amount
  - Threshold amounts:
    - $500,000 MFJ
    - $250,000 all others

Excess business losses treated as NOL and carried forward indefinitely

Applies at partner or shareholder level for partnership and S corporation losses
Net Operating Losses

▪ Pre-Reform Law
  ▫ NOL may be carried back two tax years and carried forward 20 years
  ▫ NOL may offset 100 percent of taxable income in such years

▪ TCJA of 2017
  ▫ NOL deduction limited to 80 percent of taxable income for losses arising in tax years after 2017
  ▫ Eliminates carryback of NOL (except for farming)
  ▫ Unused NOL to be carried forward indefinitely
  ▫ Adjustments made for overall loss limitations in tax years after 2017
Business Interest Limitation (BIL)

- Business interest deduction limited to 30 percent of “Adjusted Taxable Income”
  - Taxable “EBITDA”
  - After 2021, taxable “EBIT”
- No grandfather provision for existing debt
- Interest that is disallowed is carried forward
- Taxpayers with less than $25 million gross receipts (three-year average) are exempt (subject to related entity aggregation).
<table>
<thead>
<tr>
<th>Tax Filing</th>
<th>Where Is Limitation Determined?</th>
</tr>
</thead>
<tbody>
<tr>
<td>C corp Tax Return</td>
<td>Entity-Level</td>
</tr>
<tr>
<td>S corp Tax Return</td>
<td>Entity-Level</td>
</tr>
<tr>
<td>Partnership/LLC Tax Return</td>
<td>Entity-Level</td>
</tr>
<tr>
<td>Individual Tax Return</td>
<td>Individual-Level</td>
</tr>
<tr>
<td>- Sch C - Trade/business</td>
<td></td>
</tr>
<tr>
<td>- Sch E - Rental</td>
<td></td>
</tr>
</tbody>
</table>
Who Is Not Subject to the Limitation?

1. **Exempt Taxpayers**
   - “Small” taxpayers with less than $25 million gross receipts (three year average)
   - Aggregate receipts of “commonly-owned” entities (> 50 percent common ownership)

2. **Taxpayers that Elect Out**
   - “Real property trade or business”
   - “Farming business”

3. **Floor-plan Financing Interest**
   - Excluded from interest limitation, but can’t take 100 percent bonus on assets

4. **Regulated Public Utilities**
Who Is Subject to the Limitation?

- Everyone else (with business interest expense)
ATI → Base for 30 Percent Limit Calculation

- Adjusted Taxable Income (ATI) = Net taxable income, PLUS…
  - Business interest expense
  - Depreciation, amortization or depletion
  - Net operating loss
  - QBI deduction

- “EBIDA+” (as opposed to “EBITDA”)
- “NOI” or net operating income
ATI → Base for 30 Percent Limit Calculation

- But, beginning 2022…
- ATI = Net taxable income, PLUS:
  - Business interest expense
  - Depreciation, amortization or depletion
  - Net operating loss
  - QBI deduction

- Losing the add back for depreciation and amortization in 2022 will significantly diminish interest deductibility for some businesses
### Example – Calculation Before 2022

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$60,000</td>
</tr>
<tr>
<td>Plus: Business interest</td>
<td>$45,000</td>
</tr>
<tr>
<td>Plus: Depreciation</td>
<td>$75,000</td>
</tr>
<tr>
<td><strong>Adjusted taxable income</strong></td>
<td><strong>$180,000</strong></td>
</tr>
<tr>
<td><strong>x 30%</strong></td>
<td><strong>x 30%</strong></td>
</tr>
<tr>
<td><strong>Limitation amount</strong></td>
<td><strong>$54,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business interest</td>
<td>$45,000</td>
</tr>
<tr>
<td>Limitation amount</td>
<td>$54,000</td>
</tr>
<tr>
<td><strong>Disallowed business interest</strong></td>
<td><strong>$0</strong></td>
</tr>
</tbody>
</table>
Example – Calculation Beginning in 2022

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$60,000</td>
</tr>
<tr>
<td>Plus: Business interest</td>
<td>$45,000</td>
</tr>
<tr>
<td><strong>Plus: Depreciation</strong></td>
<td>$0</td>
</tr>
<tr>
<td>Adjusted taxable income</td>
<td>$105,000</td>
</tr>
<tr>
<td>x 30%</td>
<td></td>
</tr>
<tr>
<td><strong>Limitation amount</strong></td>
<td>$31,500</td>
</tr>
<tr>
<td>Business interest</td>
<td>$45,000</td>
</tr>
<tr>
<td>Limitation amount</td>
<td>$31,500</td>
</tr>
<tr>
<td><strong>Disallowed business interest</strong></td>
<td>$13,500</td>
</tr>
</tbody>
</table>
Election Out of the Interest Limitation

- Election is **irrevocable**

- Only available for:
  - “Real property trade or business”
  - “Farming business”

- What is the catch?
Election Out of the Interest Limitation

▪ The Catch: Depreciation slows down

▪ ADS lives required for:
  ▫ Residential building: 27.5 years → 30 years (+2.5)
  ▫ Nonresidential building: 39 years → 40 years (+1)
  ▫ Qualified improvement property: 15 years → 20 years (+5)

▪ Cannot take bonus on Qualified Improvement Property (QIP)
Election Out of the Interest Limitation

- Therefore, the only potentially *material* trade-off of electing out of the interest limitation is losing bonus depreciation on any QIP*

- **Residential Real Estate:**
  - Will generally prefer to elect out (if limited)
  - QIP is only for *nonresidential* property

- **Nonresidential Real Estate:**
  - May not prefer to elect out (if limited), depending on frequency/magnitude of building improvements

* Assumes the earlier-mentioned technical correction comes to fruition
Election Out of the Interest Limitation

▪ What is a “real property trade or business”?

▪ “Any real property development, redevelopment, construction, redevelopment, acquisition, conversion, rental, operation, management, rental, operation, management, leasing, or brokerage *trade or business*”

▪ Management/operation of a lodging facility (hotels) is eligible to elect out
  ▫ Committee Report Footnote #697
Planning Considerations

- Begin to identify which entities would be limited based on 2017 tax returns
- Remember the $25 million gross receipts exemption
- Real estate/farming businesses: Consider depreciation trade-offs if elect out
- Redistribute per-entity debt when structure/lenders allow
- Combine low leverage entities with high leverage entities
R&D Tax Credit

- R&D credit:
  - Tax reform preserved this credit.
  - However, after Dec. 31, 2021, research expenses will be required to be amortized over five years. No current deduction.
International Provisions

1. Deemed Repatriation Under Section 965
2. Participation Exemption
3. Global Intangible Low Taxed Income (GILT)
4. Foreign Derived Intangible Income (FDI)
5. Base Erosion and Anti-Abuse Tax (BEAT)
6. Other Miscellaneous Items
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