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Tax Reform's Impact on Manufacturing Companies

An article by Karen E. Adams, CPA; Mark E. Goodman, CPA; and Mark S. Ulishney, CPA



On Dec. 22, 2017, President Donald Trump signed into law H.R. 1, known as the *Tax Cuts and Jobs Act*. The act includes significant changes to the Internal Revenue Code (IRC) meant to spur the economy, increase employment and job growth in the United States, and encourage business investment within the United States. Many provisions affect U.S. manufacturing companies, and these are some of the significant items.

Repeal of the Domestic Production Activities Deduction

Before the act, manufacturing companies could claim a deduction equal to 9 percent of their qualified manufacturing income, subject to taxable income and W-2 wage limitations. Manufacturing companies that benefited from this deduction effectively lowered the company's tax rate up to 3 percent if all of the company's activities were qualified manufacturing activities. The act repeals the domestic production activities deduction for tax years beginning after Dec. 31, 2017, and lowers the top corporate tax rate from 35 percent to 21 percent. Manufacturing companies will benefit from the lower corporate tax rate, although the overall benefit decreases when taking into account the repeal of the domestic production activities deduction.

Depreciation and Cost Recovery

Accelerated depreciation and cost recovery methods can be beneficial, as machinery and equipment purchases can be significant for manufacturing companies. Prior to the act, a taxpayer could claim 50 percent bonus depreciation for qualified original-use property placed into service during 2017, with the remaining depreciable basis recovered through depreciation deductions over the useful life of the property. The act provides for an increased bonus percentage and allows taxpayers to claim bonus depreciation on used property, subject to certain restrictions. Generally, for qualified property acquired pursuant to a written binding contract entered into from Sept. 28, 2017, to Dec. 31, 2022, a taxpayer may claim 100 percent bonus depreciation. The allowable percentage begins to phase out between 2023 and 2027, with no bonus depreciation available in 2028.

IRC Section 179 provides taxpayers with immediate expensing of qualified property. The expense limitation for the 2017 tax year was \$500,000 for qualified property, with a phasedown threshold for additions in excess of \$2 million. The act increases the expense limitation to \$1 million and phasedown threshold for additions to \$2.5 million in 2018, subject to inflation adjustments for tax years beginning after 2018. Further increasing the potential benefit, the definition of qualified property is expanded to include improvements to nonresidential real property, including roofs; heating, ventilation, and air conditioning systems; fire protection and alarm systems; and security systems. IRC Section 179 differs from bonus depreciation in that the taxpayer (or its owners for flow-through entities) must have taxable income to realize a benefit from the deduction; otherwise, the expense will carry forward to a year in which the taxpayer does have taxable income. In addition, Section 179 is not set to expire like bonus depreciation, so taxpayers that meet the additions threshold will continue to benefit from Section 179 after the bonus depreciation provisions expire.

Manufacturing companies should realize significant benefit from the favorable cost recovery provisions. A company will benefit from the bonus depreciation expense or Section 179 expense claimed on qualified purchases of property. A company that manufactures and sells property may realize an increase in sales, as customers are more willing to purchase property with the immediate benefit provided by the cost recovery provisions. As larger taxpayers may not realize a benefit from Section 179 due to the phaseout threshold, those taxpayers should consider purchases of property prior to Dec. 31, 2022, in order to claim 100 percent bonus depreciation.

Advance Payments and Revenue Recognition

Pursuant to the act, Section 451(b) modifies when income is recognized for accrual method taxpayers, while Section 451(c) provides accrual basis taxpayers with a new election related to deferral of advance payments. Under the new rules, income is recognized no later than the taxable year in which an item of revenue is taken into account on an applicable financial



statement or another financial statement under rules specified by the Secretary of the Treasury. Applicable financial statements generally include a generally accepted accounting principles (GAAP) statement that is a 10-K, an audited financial statement used for credit purposes, shareholder reporting, federal regulatory filings, or any other substantial nontax purpose. An International Financial Reporting Standards financial statement filed with a foreign equivalent of the SEC is considered an applicable financial statement. The statute also requires tax to conform to a business's GAAP allocation of sales price to multiple performance obligations. This requirement may accelerate income for tax reporting purposes.

Prior to the act, accrual basis taxpayers could defer advance payments for services until the end of the next taxable year under Rev. Proc. 2004-34. For accrual method taxpayers that receive advance payments for inventorable goods, Reg. 1.451-5 provided for a deferral of up to the end of the second subsequent taxable year. Under either method, a taxpayer could not defer income

if it was not deferred for financial reporting purposes. The election under Section 451(c) codifies the Rev. Proc. 2004-34 deferral of one year, but it shortens the deferral period for advance payments for inventorable goods from two years to one. Taxpayers now are required to include the advance payment as income upon receipt unless the election to defer is made. The IRS has not yet provided guidance on how to make the election to defer advance payments for one year under Section 451(c). It is anticipated that a Form 3115 likely will be required to adopt the new rules under Section 451.

Plan Appropriately

The *Tax Cuts and Jobs Act* affects businesses in a number of ways, with the reduction of the corporate tax rate seemingly the biggest potential benefit to taxpayers.

Manufacturing companies will realize additional benefits from the cost recovery and depreciation provisions of the act and should carefully consider the impact of other provisions to implement appropriate planning opportunities.

Learn More

Karen Adams
+1 630 586 5211
karen.adams@crowehorwath.com

Mark Goodman
Partner
+1 630 586 5118
mark.goodman@crowehorwath.com

Mark Ulishney
Partner
+1 415 230 4968
mark.ulishney@crowehorwath.com