TAX PLANNING FOR MANUFACTURERS

HBK® | Manufacturing Solutions

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Jim Dascenzo, CPA

Principal, HBK Manufacturing Solutions

Jim is a Principal in the Youngstown, Ohio office of HBK CPAs & Consultants. After graduating from Youngstown State University, he joined the firm in 1988. He is the National Director of HBK's Manufacturing Solutions Group, the firm's industry group focused on supporting manufacturing clients.

Jim has extensive experience in the areas of tax planning, estate planning, business consulting, finance and accounting services. While Jim works with a variety of industries, he specializes in manufacturing services, with vast experience supporting plastic processing, steel fabrication, food manufacturing, signage, industrial products and additive manufacturing clients.

Jim is an active member of the Mahoning Valley Community. He participates in several community organizations including as Chair and Executive Committee Board Member of the Youngstown Business Incubator.

Peter Roupas, CPA, JD

Senior Manager & Tax Specialist, HBK Manufacturing Solutions

Peter is a Senior Manager in the Pittsburgh, PA office of HBK CPAs and Consultants. He is also a Tax Specialist focused on manufacturing clients. Peter has over thirteen years of experience in taxation with a focus on privately held businesses and high-net-worth individuals. His areas of expertise include partnerships, S corporations, individual taxation, trusts and estates, state and local tax, and gift tax matters. He also assists his clients with year-end planning, wealth succession, charitable giving, choice of entity planning, and conflict resolution. Prior to joining HBK, Peter spent 11 years working for a Big 4 accounting firm..

Peter is a Tax Specialist for HBK Manufacturing Solutions and serves numerous manufacturing clients, performing tax compliance, planning, and consulting.

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TODAY'S DISCUSSION

- IC-DISC
- LIFO
- R&D Credit
- Captive Insurance
- Estate Planning
- Other Considerations
- Bonus Depreciation
- Cost Segregation
- "Small Business" Considerations
- Nexus

IC-DISC

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IC-DISC

Interest Charge Domestic International Sales Corporation

- Authorized by Congress
- Commission is paid to the IC-DISC and is deductible by the company
- IC-DISC pays a dividend to its shareholders
- Company gets an ordinary tax deduction and the shareholders receive dividend income taxed at favorable rates
- Elect by filing IRS Form 4876-A, Election to be Treated as an Interest Charge Domestic International Sales Corporation
- Must be a domestic corporation
- May only have a single class of stock that has a minimum par value of $2,500
- Must pass both a gross receipts and export asset test
- Tax benefits maximized by maximizing the permissible sales commission paid to the DISC

Gross Receipts Test

- 95% of gross receipts of the IC-DISC must constitute qualified gross receipts:
  - From the sale, exchange or other disposition of export property
    - Export property: manufacturing requirement (manufactured, produced, grown, or extracted in the US by a person other than IC-DISC; manufactured if either 20% of conversion costs are incurred in US, there is substantial transformation in US, or operations in US are generally considered manufacturing), destination requirement, and maximum 50% foreign content requirement
  - From the lease or rental of export property for use outside the United States
  - For services that are related in or are subsidiary to any exchange of property
  - For engineering or architectural services for construction projects located outside the US
  - For managerial services for furtherance of production or other qualified export receipts

IC-DISC

Commission

- Sales commission paid is calculated using one of three permissible methods:
    - 4% of qualified export receipts
    - 50% of combined taxable income from export sales
    - Arm’s length amount determined under section 482

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LIFO

LIFO

General Considerations

- LIFO more accurately reflects income by matching current costs against current revenues
- Eliminates artificial profits from earnings resulting from inflationary increases in inventory costs
- Transfers artificially inflated ending inventory values from the balance sheet to the income statement
- Increases cost of goods sold & reduces ending inventory balances in periods of inflation
- Reduces taxable income in periods of inflation & creates material long-term after-tax cash savings
- Inventories maintained at same costs historically used annual side calculation made to adjust inventories at cost (FIFO/avg. cost) to LIFO using contra inventory account called LIFO reserve
- Benefits grow in perpetuity and only decreases when there’s deflation or substantial inventory liquidation

LIFO

Calculation

- LIFO Tax Savings Formula:
  - CY Taxable Income Reduction (LIFO Expense) = Current Year Inflation Rate * Prior Year ending inventory balance @ cost
  - CY After Tax Cash Savings = Current Year LIFO Expense & Tax Rate
- Example
  - Inputs:
    - Prior year end FIFO balance: $10 million
    - Current year inflation rate: 2.5%
    - Tax rate: 30%
  - Outputs:
    - CY Taxable income reduction: $250,000
    - CY After Tax cash savings: $75,000

LIFO

Top Candidates

- YTD inflation of greater than 1%
- 50% or more of the historical 3-, 5-, 10-, or 20-year average annual inflation rate must be inflationary
- Historical average annual inflation rate of 1% or greater
- Overall inflation frequency of 50% or more
- Inflation frequency rate of greater than 50% from 2000-present

LIFO

Top Candidates

Principal Business Activity Codes & Descriptions			Historical Annual & Average Annual Inflation Rates & Inflation Frequency											
Industry Type	IRS Primary Business Activity Code	Principal Business Activity Description	YTD 9M 9/20	1Y Sep. '20	1Y Dec. '19	1Y Dec. '18	3Y Avg. Dec. '19	5Y Avg. Dec. '19	10Y Avg. Dec. '19	20Y Avg. Dec. '19	# Periods with Inflation	# Periods Index Published 2000 - 2019	# Periods with Inflation Freq.	3/5/10/20 Year Annual Avg. Inf. Frequency
Mfg.	311300	Sugar & confectionery product mfg.	1%	2%	4%	2%	3%	2%	2%	3%	17	20	85%	100%
Mfg.	311400	Fruit & vegetable preserving & speciality food mfg.	1%	1%	0%	2%	1%	1%	1%	2%	17	20	85%	100%
Mfg.	312000	Beverage & tobacco product mfg.	2%	3%	3%	3%	3%	3%	3%		17	17	100%	100%
Mfg.	316990	Other leather & allied product mfg.	1%	2%	1%	3%	2%	2%	2%		17	17	100%	100%
Mfg.	321000	Wood product mfg.	22%	22%	0%	1%	2%	2%	3%		14	17	82%	100%
Mfg.	325410	Pharmaceutical & medicine mfg.	2%	1%	2%	4%	4%	5%			15	15	100%	100%
Mfg.	325500	Paint, coating, & adhesive mfg.	2%	2%	2%	4%	3%	1%	2%		15	17	88%	100%
Mfg.	327100	Clay product & refractory mfg.	2%	2%	3%	4%	3%	2%	2%		17	17	100%	100%
Mfg.	327210	Glass & glass product mfg.	1%	1%	2%	3%	2%	3%	2%		16	17	94%	100%
Mfg.	327300	Cement & concrete product mfg.	3%	2%	3%	4%	3%	3%	3%		15	17	88%	100%
Mfg.	327400	Lime & gypsum product mfg.	1%	1%	-2%	4%	2%	2%	4%		14	17	82%	100%
Mfg.	327900	Other nonmetallic mineral product mfg.	1%	1%	1%	3%	1%	1%	3%	2%	19	20	95%	100%
Mfg.	333000	Machinery mfg.	1%	1%	2%	4%	2%	1%	2%		17	17	100%	100%
Mfg.	335000	Electrical equipment, appliance, & component mfg.	1%	1%	0%	5%	2%	1%	1%		15	17	88%	100%
Mfg.	337000	Furniture & related product mfg.	1%	2%	3%	3%	3%	2%	2%	2%	20	20	100%	100%
Mfg.	339110	Medical equipment & supplies mfg.	1%	2%	1%	1%	1%	1%	1%		17	17	100%	100%

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LIFO

Election Requirements

Requirement	Financial Reporting	Tax
Opening (beginning) inventories must be valued at cost for a company's first year on LIFO	✓	✓
Ending inventories must be valued using FIFO, earliest acquisitions or average cost	✓	✓
Financial reporting LIFO election scope must be equal to or greater than tax scope (only applies for companies with differing book & tax LIFO calculations. Goods on LIFO for tax purposes can not be greater than what is on LIFO for financial reporting)	✓	✓
Prior LCM & excess obsolete reserve writedowns must be restored over a three-year period		✓
Must be used for financial reporting & tax purposes for all periods beginning in year of election		✓
IRS Form 970 Application to Use LIFO Inventory Method & statement attachment must be filed with federal tax return in year of adoption		✓

LIFO

Effect of Inflation

- With LIFO
  - Cost of Goods Sold **Increases**
  - Ending Inventory, Net Income & Tax Liability **Decrease**
- Without LIFO
  - Cost of Goods Sold **Decreases**
  - Ending Inventory, Net Income & Tax Liability **Increase**

LIFO

Inventory Price Index Computation Method

- Any manufacturer with inventory of $1,000,000 or more of currently using the LIFO method (Last-In, First-Out). By using the LIFO Method for inventory, manufacturers can deduct the impact of current inflation.
  - Benefits:
    - Provides a greater tax benefit
    - Price index method simplifies computation
    - Reduces administrative cost

R&D Credit

R&D Credit

Fundamentals

- Government incentive to complete research and development, or R&D, activities
- Manufacturers and other businesses who develop or design new products or processes or enhance existing products or processes.
- Qualified expenses:
    - Aim to resolve technological uncertainty related to a capability or process
    - Relate to the development of a product or process
    - Rely on science
    - Are considered experimental
- Does not require success in meeting end goal

R&D Credit

Calculations

- Typically required:
  - Wages and/or payroll records
  - R&D expenses
    - Supplies used during research and development
    - Contractor (3rd party) expenses
    - Other research expenses
  - Project descriptions and summaries

Poll Question #1

Did you have R&D Activity in 2020?

- YES
- NO
- I'M NOT SURE

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Captive Insurance Company

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Captive Insurance Company

General Considerations

- Insurance company that the business owner or business owns and insures the business that it is related to (or a form of self-insurance)
- To design:
  - Operating business forms its own insurance company
  - Insurance company provides insurance to the operating business
  - Insurance company acquires reinsurance coverage to protect against catastrophic risks
  - Insurance company processes claims and pays out of its own funds for smaller claims, using reinsurance for larger claims
- The main purpose should be to insure the risks of the owners.

Captive Insurance Company 831(b)

Potential for Scrutiny

- While captives have existed since 1986, they have recently come under increased IRS scrutiny after being labeled as a “transaction of interest” (Reference Notice 2016-66)
    - In Notice 2016-66, the IRS concluded that certain micro-captive insurance transactions had the potential for tax avoidance and evasion and notified taxpayers that these transactions were "transactions of interest" that need to be disclosed to the IRS.
    - In January 2020, the IRS announced that it would significantly increase enforcement activity around micro-captive insurance transactions. The IRS said it would begin deploying 12 new examination teams comprised of employees from both the IRS Large Business and International and Small Business/Self-Employed divisions to open additional audits.
    - In March 2020, the IRS provided instructions, on its website, to taxpayers who wished to amend previously filed tax returns to remove deductions or other tax benefits related to micro-captive insurance transactions.
    - In March and July 2020, IRS issued letters to taxpayers who participated in a Notice 2016-66 transaction alerting them that IRS enforcement activity in this area will be expanding significantly and providing them with the opportunity to tell the IRS if they've discontinued their participation in this transaction before the IRS initiates examinations.
- Several recent Tax Court cases were not taxpayer favorable
- We strongly suggest that all existing 831(b) captive insurance companies are reviewed for compliance.

Captive Insurance Company

Alternatives

- Immediate liquidation
- Repurposing
- 831(a) options
  - Is taxed on premium income
  - Can deduct loss reserves subject to IRS discount rates
  - May lower third-party insurance costs and provide additional protection for policies not available on the market
  - Tax rates currently sit at 21%

Estate Planning

Estate Planning

General Considerations

- Who should be looking at estate planning before the end of 2020?
  - Clients with net worth between $7 million ($3.5 million if single) and $20 million ($10 million if single) who would be adversely impacted if the gift and estate tax exemption is reduced
  - Clients with net worth over the current gift and estate tax exemption who are now subject to estate taxes (current gift and estate exemption is $11,580,000 per person).

Estate Planning

General Considerations

- Other factors indicating estate planning is appropriate:
    - Have not evaluated their estate plans recently
    - Have not used all their available gift exemption and are likely to be subject to estate taxes
    - Liquidity concerns
    - Own businesses that have declined in value since the COVID-19 pandemic
    - Businesses expected to grow in value
    - Businesses without a succession plan
    - Businesses without adequate shareholder agreements
    - Significant values in IRA and other retirement accounts
    - Existing irrevocable trusts that no longer meet client's objectives
    - Asset protection is important
    - Life insurance polices that have not been evaluated recently

Estate Planning

Fundamental Planning Issues

- Who inherits assets?
- When will assets be distributed to beneficiaries?
- Who will be the executor?
- Who will be the trustee(s) and successor trustee(s)?
- Succession plans for family businesses
- Asset protection issues
- Durable Power of Attorney
- Health Care Directives and Power of Attorney

Estate Planning

2020 Estate and Gift Tax Law

- Gift, estate, and GST Exemption is $11.58 million and is indexed
- Tax rate is 40%
- Annual exclusion is $15,000/$30,000
- Income tax basis "step-up" rules apply
- Portability of unused estate tax exemption applies
- Valuation discounts for lack of control and lack of marketability is possible
- Zeroed out GRATs allowed
- Intentionally defective trusts are possible
- Generation-skipping trusts duration based on state law – NJ, OH, PA allow for perpetual trusts; FL law allows a trust to last for up to 360 years

Estate Planning

Planning Opportunities & Issues

- Aggressive gifting
  - Maximize annual exclusion gifting
  - Take advantage of $11.58 million exemption
  - Consider financial needs
  - Consider basis issues – no basis carryover for gifts; compare possible income tax cost with estate tax cost
  - Use of spousal trusts (SLATs) not qualifying for marital deduction
  - Life insurance trusts – preferred future premium costs
  - Consider generation skipping
  - Use intentionally defective trusts
  - Use GRATs
  - Power of substitution

Estate Planning

Life Insurance Audit

- Insurance Due Diligence – When was the last time a third party reviewed your life insurance coverage?
    - **40%** of permanent coverage reviewed is projected to terminate at or before life expectancy
    - **65%** of existing policies can be restructured to provide greater client value

Estate Planning

For Those Not Subject to Estate Tax

- With the estate tax exemption over $11.5 million, for many tax planning needs to focus more on income taxes
- Maintaining basis and basis step-up planning will be more important
- Gifting may not be the best tax strategy
- May be best to maximize use of portability to get possible double step-up
- Valuation discounts may be detrimental to planning
- Fundamental issues on who inherits, how and how governed still apply

Estate Planning

Leveraging Use of Lifetime Exemption

- High net worth individuals can reduce estate tax through current transfers of assets using various techniques such as:
  - Gifts
  - Creation of family limited partnerships
  - Sales between family members
  - Sales to intentionally defective grantor trusts
  - Benefits:
    - Take advantage of current low valuations of securities

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Estate Planning

Conclusions

- Always consider the prospect for legislative changes
- Consider estate plan formulas that provide one result if there is an estate tax and another if there is no estate tax
- Consider life insurance solutions to provide liquidity and create equality of inheritance if business interests would pass to some family members and not other family members
- Flexibility in planning is even more important
- Not always driven by tax reasons
- Consider philanthropic endeavors

IRA/Retirement Plan Beneficiary Check Up

IRA/Retirement Plan Beneficiary Check Up

- Individuals with an IRA or qualified retirement plan balance should consider an IRA/retirement plan beneficiary check.
  - Benefits:
    - Beneficiary tax deferral
    - Beneficiary designations
    - Detecting beneficiary designation omissions, inconsistencies, and errors
    - Discuss IRA and/or qualified plan investments and current investment advisor

Poll Question #2

When have you last reviewed your estate plan?

- In the last year
- In the last three years
- In the last five years
- In the last ten years
- Never

Other

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Deemed Dividend Election by an S Corporation

Deemed Dividend Election

- An S Corporation with earnings and profits accumulated in C Corporation years may, with the consent of its shareholders, make a deemed dividend election in order to eliminate its earnings and profits and the disadvantages that result from the presence of such earnings and profits
    - Benefits:
        - No tax on excess net passive income
        - No termination of S corporation election
        - After expiration of 15% federal income tax rate, it will be more expensive for shareholders to consent to deemed dividend elections
        - JIM!

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Employee Stock Ownership Plans (ESOPs)

ESOP

- Middle market business owners who have greater than 80% of their net worth locked up in their company stock, have pre-tax earnings of at least $1 million, and want to 1) obtain liquidity & diversify risk, 2) retain operational control of their business, and 3) dramatically reduce the amount they pay in taxes each year, can implement a properly planned and structured ESOP.
  - Benefits:
    - Pay fair market value for between 30% and 100% of the company
    - Use corporate credit to finance the purchase of company stock
    - Allow the owner to pay no capital gains taxes on the sale
    - Permit the company to receive a tax deduction equal to the purchase price over time
    - Allow the existing owners to maintain operational control of the company

Bonus Depreciation

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Bonus Depreciation

Considerations

- 100% bonus depreciation applies to new and used property acquired and placed in service
    - Binding contract rule applies
    - Contract date is generally “acquisition date” for bonus purposes.
- Applies to any property with a MACRS life of less than 20 years
- Qualified Improvement Property (“QIP”) is now 15 year property eligible for 100% bonus depreciation

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Bonus Depreciation

- QIP includes improvements a taxpayer makes to an interior portion of an existing building that is nonresidential real property.
    - Examples of QIP:
        - Installation or replacement of drywall
        - Ceilings
        - Interior doors
        - Fire protection
        - Mechanical
        - Electrical
        - Plumbing
    - Excluded improvements: internal structural framework, enlargements to the building, and elevators/escalators

Bonus Depreciation

Benefits

- Accelerated Depreciation
- Potential to generate NOL's and carry the losses back 5 years, under the new provisions of the CARES Act to tax years when the corporate tax rates were 35%, and individual tax rates (if passthrough entity) was 37%

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Cost Segregation

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Cost Segregation

Basics

- Cost segregation studies can help owners of commercial and residential buildings increase cash flow by accelerating federal tax depreciation of construction-related assets.
- Uses engineering-based methodology on existing, newly constructed or acquired buildings.
- Take advantage of the 5-, 7-, and 15- year property (instead of the typical 39-year depreciable life).
- Qualified improvement property, as corrected by the CARES Act, will enhance benefits of study
- Applies to:
  - Newly constructed facilities
  - Existing facilities acquired in the current year
  - Facilities constructed or acquired in prior years – automatic change in accounting method

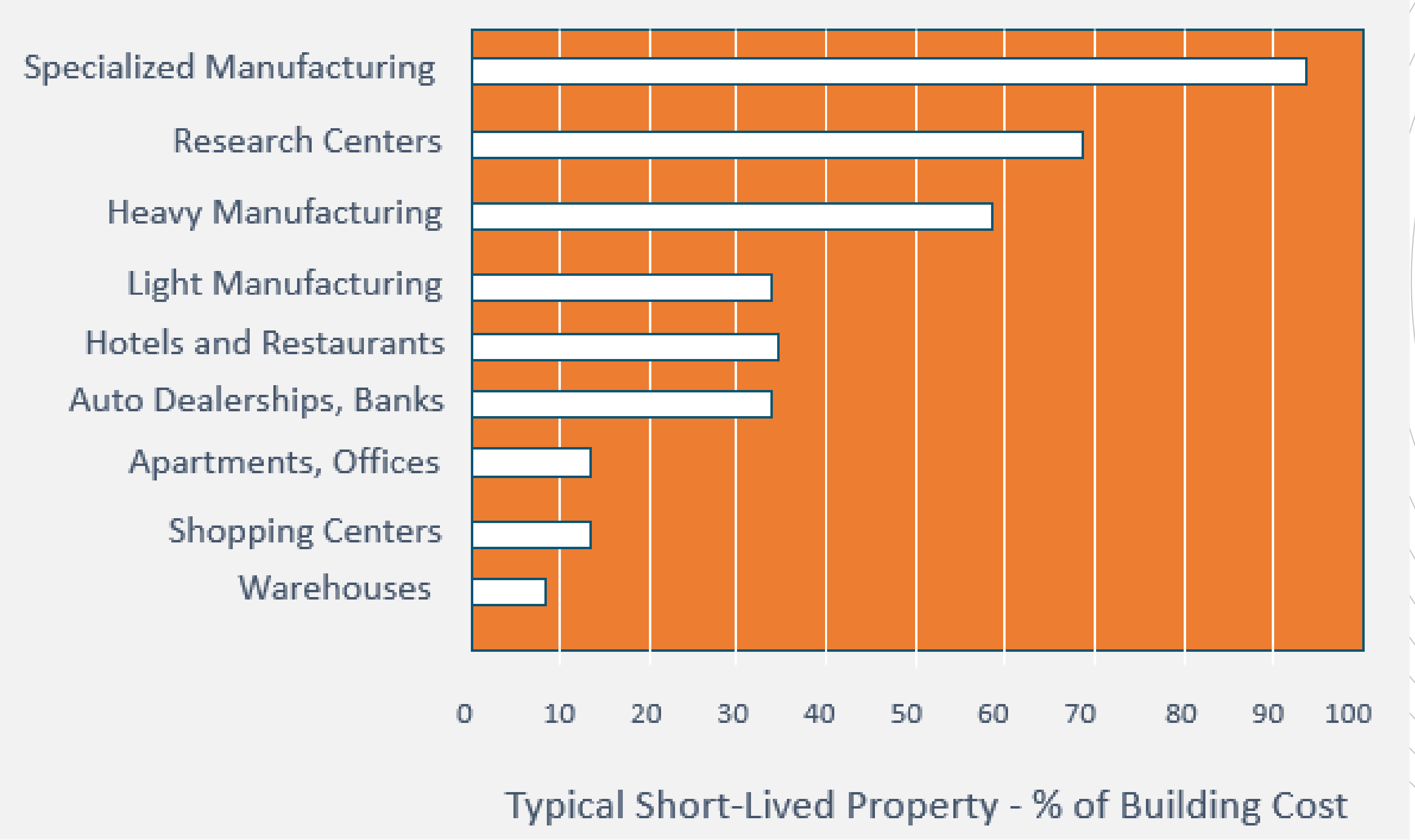
Cost Segregation

Benefits

- Accelerated Federal Tax Depreciation of Real Estate Assets
  - Increased Cash Flow in Early Years
  - Net Present Value Benefits may be Significant
  - Maximizes Bonus Depreciation
  - Additional benefits of a study:
    - Identify Energy Efficient/Sustainable Technology – Green Energy Tax Incentives
    - Facilities that Have Been Improved - Identify Repair Expense Opportunities
    - Projects that Qualify for the Rehabilitation Tax Credit

Cost Segregation

Opportunity by Type of Building



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“Small Business” Considerations

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Tax Considerations for “Small Businesses”

Definition

- Per TCJA, taxpayers with less than $25 million in average, annual gross receipts over the three prior years are considered “small taxpayers” for:
  - Cash vs. accrual rules (§448)
  - Inventory rules (§263A, §471) inventory rules
- Threshold increases to $26 million for 2020

Cash Method

Benefits

- Administratively simpler
- Better matching of revenues with the cash on hand to pay taxes
- Considerable tax deferral could occur in the year of change (from accrual to cash)

Cash Method Change Example

Background

- XYZ, an accrual basis taxpayer, manufactures widgets
- Annual sales are $15M
- A/R at year end is $1M. A/P at year end is zero
- On an accrual basis, its 2020 income is $5M

Tax Idea

- XYZ applies for a method change to cash method of accounting
- The $1M of receivables is not taxed until 2021, when the cash is received.
- XYZ's 2020 taxable income is now $4M (under the cash method), instead of $5M
- Assuming a 21% tax rate (corporate) or individual rates (passthrough), tax savings in 2020 could exceed $200k

Simplified Inventory Rules (263A/471)

§263A

- §263A requires capitalization of certain overhead costs into inventory
- Costs to be capitalized for tax purposes usually exceed costs capitalized for financial reporting purposes
- Since TCJA (2018), taxpayers with less than $26 million in average, annual gross receipts are no longer required to capitalize certain costs to inventory for tax purposes.

Simplified Inventory Rules (263A/471)

Background

- MNO, an S corporation manufacturer, is on the accrual method of accounting
- Gross receipts of $18M through the end of 2020, ending inventory of $2.0M
- For tax purposes, ending inventory is $2.5M (i.e. $500k is §263A)

Tax Idea

- MNO applies for a method change to cease applying 263A
- MNO gets a $500k favorable adjustment on its 2020 tax return
- Depending on how it is taxed, MNO can defer over $100k in taxes

Other Considerations

IBNR

Consideration

- Accrual method business self-insuring its employee medical plan that deducts its employee medical costs in tax year when claims are received or paid.

Tax Idea

- Change accounting method to accrue estimated employee medical costs in the preceding tax year when the medical service is provided.

Advance Payments

Consideration

- Accrual method taxpayers that receive advance payments for services to be provided and goods to be delivered in later years.

Tax Idea:

- Rev. Proc. 2004-34 provides liberalized rules for when taxpayers can defer income from advance payments for services or goods.
- Opportunities for service companies issuing multi-year contracts
- Defer income from advance payments to next tax year.

Prepaid Expenses

Consideration

- Generally, accrual method taxpayers deduct expenses when services are provided or goods received (not when paid).
- However, certain expenses (called “Payment liabilities”) may be deducted when paid, even if the service/goods have not been received yet. Common examples include insurance and hardware/software maintenance costs.

Tax Idea

- Prepay such expenses related to the following year and get the deduction in the current year.
- Method change required

State Tax Matters

Poll Question #3

During the pandemic, some of our employees have worked from home.

- TRUE
- FALSE

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Nexus in the Time of COVID

- Some employees have been working remotely since March
- Determining nexus is an important consideration for each manufacturer.
- PL 86-272: allows manufacturers to go into a state to solicit orders for goods without being subject to income tax

COVID and Income Tax Nexus

- Some states have communicated that employees working in the state during COVID will not create an **income** tax liability.
  - Alabama
  - Arizona
  - California
  - District of Columbia
  - Georgia
  - Iowa
  - Indiana
  - Louisiana – intends to issue a ruling
  - Massachusetts
  - Maryland
  - Minnesota
  - Mississippi
  - North Dakota
  - New Jersey
  - Oklahoma
  - Oregon
  - Pennsylvania
  - Rhode Island
  - South Carolina

COVID and Sales Tax Nexus

- Some states have communicated that employees working in the state during COVID will not create a **sales tax** collection responsibility
  - Massachusetts will not assert nexus until the earlier of December 31,2020 or 90 days after the state of emergency in MA is lifted.
  - Minnesota
  - New Jersey
  - Oklahoma
  - Pennsylvania
  - Rhode Island
  - South Carolina

Your Questions

NEXT MONTH

Join us for December’s Webinar

Wednesday, December 16
11 AM – Noon

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NEED MORE INFORMATION?

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