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2019 Tax Update for Manufacturers

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Key Tax Provisions in the Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed into law, the Tax Cuts and Jobs Act. A majority of the provisions under the Act sunset for tax years beginning after December 31, 2025.

C Corporations

Reduction in C Corporation Tax Rate

Pre-Act Law: C corporations were subject to graduated tax rates of 15 percent (for taxable income of $0 - $50,000), 25 percent (for taxable income of $50,001 - $75,000), 34 percent (for taxable income of $75,001 - $10,000,000), and 35 percent (for taxable income over $10,000,000).

- Personal service corporations pay tax on their entire taxable income at the rate of 35 percent.

New Law: For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21 percent rate, including personal service corporations.

- No sunset - permanent.
- **Note:** This rate will also apply to the S corporations who have recognized built-in-gains in years beginning after December 31, 2017.

Should I Convert to a C Corporation?

- Many are asking if with the tax rates on C corporations now at 21 percent, does it make sense to convert their business to a C corporation?
- Although a detailed analysis should be done, the answer in most cases will probably be no.
- Although at a 21 percent corporate tax rate, wages paid out are still taxed as ordinary income tax rates (and are not eligible for the 20 percent QBI deduction).
- Dividends paid out of the after-tax income of the corporation are subject to capital gains rates as the corporation does not receive a deduction for the dividends that income will be subject to double taxation with Federal tax rates approaching 37 percent.
    - (21 percent Corp Tax + (79 percent x 20 percent) Dividend Tax = 37 percent Total Tax (ignores state tax).

Corporate Alternative Minimum Tax Repealed

- The corporate alternative minimum tax (AMT) is repealed.
- **Note:** Under pre-Act Law, one of the possible disadvantages of having corporate owned life insurance to fund an entity-purchase buy-sell agreement was the potential taxation of the proceeds under the AMT. This is no longer the case with the repeal of the corporate AMT.

Pass-Through Businesses

Code Section 199A - Qualified Business Income
(20 Percent Deduction for Qualified Business Income)

- The Section 199A “pass-thru entity” tax cut gives a non-corporate taxpayer, including a trust or estate, who has qualified business income (QBI) a deduction of up to 20 percent of the qualified business income.
- Pass-through businesses include:
  - Sole-proprietorships (no entity, Schedule C).
  - Real estate investors (no entity, Schedule E).
  - Disregarded entities (single member LLCs).
  - Multi-member LLCs.
  - Any entity taxed as an S corporation.
  - Trusts and estates, REITs and qualified cooperatives.

Code Section 199A - Qualified Business Income

(20 Percent Deduction for Qualified Business Income) (con’t)

- The 20 percent deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income (similar to the standard deduction).
- Effective for tax years after December 31, 2017, and before January 1, 2026.
- The Section 199A deduction is the lesser of 20 percent of net QBI, or 20 percent of taxable income adjusted for any net capital gains and without the adjustment for the Section 199A deduction.

Limitations

- There are two limitations which must be applied where a taxpayer meets certain taxable income thresholds. They are:
  - **W-2 Wage and Property Limitation:**
    - Applies to all taxpayers and all business types where the taxpayer's taxable income exceeds a threshold amount.
    - Limitation is calculated separately for each entity based on the wages and property specific to that entity.
  - **Specified Service Trade or Business Limitation:**
    - Applies only to taxpayers where QBI is generated in a specified service trade or business.
    - Will result in full allowance, partial limitation or total disallowance based on taxable income of taxpayer.

Aggregation Rules

- The QBI limitations (wage and property) are calculated for each separate trade or business (not for each entity), as one entity may have multiple trade or business activities.
- Taxpayers may be able to aggregate certain trades or businesses for QBI purposes.
  - Wages and property limitation factors may be able to be used from one trade or business for another trade or business.
- Aggregation rules require common ownership, common trade or business products, property or services, none of the businesses can be an SSTB, among other requirements.
- Self-rental provision.
  - Real estate entity will automatically meet or trade or business requirement under Internal Revenue Code Section 162 if "self-rental" to commonly controlled business.
  - C corporation entities have special rules and generally cannot use "self-rental" provision.
  - Revenue Procedure 2019-38 provides "safe-harbor" provisions for treating rental real estate as a trade or business for QBI.

Other Business Provisions

Increased Section 179 Expensing

- For 2019, the Act increases the maximum amount a taxpayer may expense under Section 179 to $1,020,000 and increases the phase-out threshold amount to $2,550,000.
- The $1,020,000 and $2,550,000 amounts, as well as the $25,500 sport utility vehicle limitation, are indexed annually for inflation.
- The Act expands the definition of Section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.

Increased Section 179 Expensing

- The Act also expands the definition of qualified real property eligible for Section 179 expensing to include any of the following improvements to non-residential real property placed in service after the date such property was first placed in service:
  - Roofs;
  - Heating;
  - Ventilation and air-conditioning property;
  - Fire protection and alarm systems; and
  - Security systems.
- No sunset provision.

100 Percent Expensing of Qualified Business Assets (Bonus Depreciation)

- **Pre-Act Law:** An additional first-year depreciation deduction was allowed equal to 50 percent of the adjusted basis of qualified property placed in service before 2020.
- **New Law:** Allows 100 percent expensing for qualified property (generally, depreciable assets other than buildings) that are acquired and **placed in service after September 27, 2017** and before 2023 (before 2024 for "longer production period" property and certain aircraft.

100 Percent Expensing of Qualified Business Assets (Bonus Depreciation) (con't.)

- A 20 percent per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027 (2023 - 80 percent, 2024 - 60 percent, 2025 - 40 percent, 2026 - 20 percent).
- The Act also removes the requirement that the original use of qualified property must commence with the taxpayer.
  - **Thus, the provision applies to purchases of used, as well as new items**.
- To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction.
- Sunset provision.

Like-Kind Exchange Limited to Real Property

- **Pre-Act Law:** Like-kind exchanges (LKE's) are permitted for property held for use in a trade or business or for investment.
    - LKE's were permitted for both real property and personal property.
- **New Law:** Like-kind treatment will be limited to real property only.
- **Note:** With the increased Section 179 expensing and the 100 percent bonus depreciation expensing provisions, the inability to defer the gain recognized on a trade-in will have limited impact as the increased basis of the property acquired can most likely be expensed in full.

Limitation on Deduction for Entertainment Expense/Fringe Benefits

- No deduction will be allowed for expenses of a trade or business related to entertainment, amusement or recreation activities or for membership dues to any club organized for business, pleasure, recreation or other social purposes.
  - This eliminates the subjective determination of whether such expenses were sufficiently business related.
- **The 50 percent limitation on deductions for meals continues to apply** and is expanded to include meals provided through an in-house cafeteria or otherwise on the premises of the employer.
- The deductions for employee transportation fringe benefits (e.g., parking and mass transit) are no longer allowed and the exclusion from income for such benefits received by an employee is retained.

Change in Treatment of Net Operating Losses

- **Pre-Act Law:** Generally, with some exceptions, a net operating loss (NOL) could be carried back 2 years and carried over 20 years to offset taxable income in such years.
- **New Law:** For NOLs arising in tax years ended after December 31, 2017, the **2 year carryback** and the special carryback provisions are **repealed.**
  - A 2 year carryback continues to apply in the case of certain losses incurred in the trade or business of farming.
- For losses arising in tax years beginning after December 31, 2017, the NOL deduction is **limited to 80 percent of taxable income** (determined without regard to the deduction).
- Carryovers to other years are adjusted to take account of this limitation and **NOLs can be carried forward indefinitely.**

Converting from Accrual to Cash Basis Method of Accounting for Income Tax Purposes

- One of the most significant planning opportunities for manufacturers brought about by the TCJA is the opportunity for certain "qualified small business taxpayers" to convert from the accrual basis method of accounting to the cash basis method of accounting for income tax purposes (while staying on the accrual basis method of accounting for financial statement purposes).

- The TCJA simplified and eased certain restrictions that manufacturing entities previously faced in utilizing the cash basis method of accounting for income tax purposes. Under prior law, all manufacturing entities were ineligible to utilize the cash basis method of accounting due to them maintaining inventory.
- Effective for the tax years beginning in 2018, more small businesses have the ability to utilize the overall cash basis method of accounting for income tax purposes.

- What is the difference between the accrual and cash basis methods of accounting?
- The difference lies in the timing of when sales and purchases (revenue and expenses) are recorded:
  - Accrual Basis - recognizes revenue when it's earned (not received), and expenses when they are billed (not paid).
  - Cash Basis - recognizes revenue when cash is received, and expenses when paid (or checks mailed).

- Why is it beneficial to be on the cash basis method of accounting for income tax purposes?
  - Deferral of revenue - since revenue is not recorded (or taxed) until received, taxpayers can defer their unreceived accounts receivable until future years. Under the accrual method, receivables that remain uncollected at year-end are taxed.
  - Acceleration and prepayment of expenses - since expenses are recorded when paid, taxpayers can control their cash basis net income through the prepayment of expenses, which can be especially effective at year-end.

- Can my financial statement still be presented using the accrual method of accounting (GAAP)?
  - The accrual basis method of accounting can still be utilized for financial statement reporting, while the cash basis is utilized for income tax reporting.
  - As a result, manufacturers can still maintain accrual basis financial statements, which will generally reflect a stronger financial position.

- Who qualifies under the TCJA?
  - Under the pre-TCJA rules, the cash basis method of accounting was generally available to most service businesses and for certain small business taxpayers in other industries, with several special rules and exclusions. One rule that eliminated the ability of most manufacturing entities to utilize the cash basis method of accounting was the inventory rule. This rule stated that entities who maintained inventory records were required to use the accrual basis method of accounting for income tax purposes.
  - Taxpayers were generally required to maintain inventory records if they were engaged in production, purchase or sale of merchandise and those activities were a material income-producing factor, thus eliminating most manufacturers.

- Who qualifies under the TCJA? Continued
  - For years beginning in 2018, the TCJA amended this inventory rule. The amended rule provides that the taxpayer’s method of accounting for inventory will <u>not</u> limit their ability to utilize the cash basis method of accounting, so long that they:
    - Treat inventory as non-incidental materials and supplies; or
    - Inventory for tax purposes conforms to the taxpayer’s method of accounting reflected in an applicable financial statement <u>(audited financial statement)</u> of the taxpayer with respect to the tax year being filed or if the taxpayer does not have an applicable financial statement, the books and records of the taxpayer are prepared in accordance with the taxpayer’s accounting procedures.

- Who qualifies under the TCJA? Conclusion.
  - All "qualified small business taxpayers" with average annual gross receipts during the preceding three years of less than $26,000,000 (effective January 1, 2019) annually will qualify to convert from the accrual to cash basis method of accounting for income tax purposes. While this conversion may not be appropriate for every taxpayer, it is important to perform the exercise on an annual basis to ensure significant tax savings are not missed.
  - Let's look at a few examples:

Example #1:

XYZ Company, Inc.
Balance Sheet

	December 31,			
	2018 Accrual	**2019 Accrual**	**A2C Adjustment**	**2019 Cash**
Current Assets				
Cash	$100,000	$150,000		$150,000
Accounts Receivable	600,000	1,000,000	(1,000,000)	-
Prepaid Expenses	20,000	15,000	(15,000)	-
Inventory	200,000	250,000		250,000
Total Current Assets	920,000	1,415,000	(1,015,000)	400,000
Property, Plant, and Equipment	800,000	870,000		870,000
Accumulated Depreciation	(600,000)	(615,000)		(615,000)
Net Property, Plant, and Equipment	200,000	255,000	-	255,000
Total Assets	$1,120,000	$1,670,000	($1,015,000)	$655,000
Current Liabilities				
Accounts Payable	$100,000	$50,000	($50,000)	$0
Accrued Expenses	80,000	70,000	(70,000)	-
Current Portion of Long-Term Debt	150,000	200,000		200,000
Total Current Liabilities	330,000	320,000	(120,000)	200,000
Long-Term Debt	400,000	650,000		650,000
Stockholders' Equity				
Common Stock	1,000	1,000		1,000
Retained Earnings	389,000	699,000	(895,000)	(196,000)
Total Stockholders' Equity	390,000	700,000	(895,000)	(195,000)
Total Liabilities and Stockholders' Equity	$1,120,000	$1,670,000	($1,015,000)	$655,000

Example #1: (continued)

XYZ Company, Inc.
Income Statement

	Year Ended December 31,		
	2019 Accrual	**A2C Adjustment ***	**2019 Cash**
Revenues	$11,400,000	($1,000,000)	$10,400,000
Cost of Goods Sold	9,500,000	(50,000)	9,450,000
Gross Profit	1,900,000	(950,000)	950,000
Selling, General, and Administrative Expenses	1,000,000	(55,000)	945,000
Income from Operations	900,000	(895,000)	5,000
Other Income (Expense):			
Other Income	15,000		15,000
Other Expense	(7,000)		(7,000)
Net Income	$922,000	(895,000)	$27,000

	Accrual	**Cash**	**Savings / (Cost)**
Net Income	$922,000	$27,000	895,000
Tax Rate	35%	35%	35%
Total Tax	$322,700	$9,450	$313,250

* Total adjustment will be split between prior year Section 481(a) adjustment and current year accrual to cash adjustment.

Example #2:

XYZ Company, Inc.
Balance Sheet

	December 31,			
Assets:	**2018 Accrual**	**2019 Accrual**	**A2C Adjustment**	**2019 Cash**
Current Assets				
Cash	$100,000	$150,000		$150,000
Accounts Receivable	50,000	100,000	(100,000)	-
Prepaid Expenses	-	-	-	-
Inventory	200,000	250,000		250,000
Total Current Assets	350,000	500,000	(100,000)	400,000
Property, Plant, and Equipment	800,000	870,000		870,000
Accumulated Depreciation	(600,000)	(615,000)		(615,000)
Net Property, Plant, and Equipment	200,000	255,000	-	255,000
Total Assets	$550,000	$755,000	($100,000)	$655,000
Liabilities and Equity:				
Current Liabilities				
Accounts Payable	$0	$200,000	($200,000)	$0
Accrued Expenses	-	10,000	(10,000)	-
Current Portion of Long-Term Debt	150,000	200,000		200,000
Total Current Liabilities	150,000	410,000	(210,000)	200,000
Long-Term Debt	400,000	650,000		650,000
Stockholders' Equity				
Common Stock	1,000	1,000		1,000
Retained Earnings	(1,000)	(306,000)	110,000	(196,000)
Total Stockholders' Equity	-	(305,000)	110,000	(195,000)
Total Liabilities and Stockholders' Equity	$550,000	$755,000	($100,000)	$655,000

Example #2: (continued)

XYZ Company, Inc.
Income Statement

	Year Ended December 31,		
	2019 Accrual	**A2C Adjustment**	**2019 Cash**
Revenues	$11,400,000	($100,000)	$11,300,000
Cost of Goods Sold	9,500,000	(200,000)	9,300,000
Gross Profit	1,900,000	100,000	2,000,000
Selling, General, and Administrative Expenses	1,000,000	(10,000)	990,000
Income from Operations	900,000	110,000	1,010,000
Other Income (Expense):			
Other Income	15,000		15,000
Other Expense	(7,000)		(7,000)
Net Income	$922,000	$110,000	$1,032,000

	Accrual	**Cash**	**Savings / (Cost)**
Net Income	$922,000	$1,032,000	(110,000)
Tax Rate	35%	35%	35%
Total Tax	$322,700	$361,200	($38,500)

* Total adjustment will be split between prior year Section 481(a) adjustment and current year accrual to cash adjustment.

Limitation on Business Interest Expense Under Internal Revenue Code Section 163(j) - Form 8990

Limitation on Business Interest Expense (IRC Section 163(j))

- Under pre-Act Law, businesses were allowed to deduct 100 percent of their business interest expense. Limitations did apply to certain "Earnings Stripping" transactions.
- Under the Act, interest deductions for businesses with average annual gross receipts over $26 million (effective January 1, 2019) for the 3 prior years generally are limited under the Act to 30 percent of the corporation's adjusted taxable income.
- No limitations for businesses under the $26 million (effective January 1, 2019) average annual gross receipts test.
- No sunset provision.

Limitation on Business Interest Expense

- Adjusted Taxable Income: Defined as the taxpayer's taxable income, computed without regard to:
  - Any item of income, gain, deduction or loss that is not properly allocable to a trade or business;
  - Any business interest expense or business interest income;
  - The amount of any net operating loss (NOL) deduction under Code Section 172;
  - The amount of any qualified business income deduction allowed under Code Section 199A; and
  - For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

Example

- XYZ Corp has net income of $90,000 after the following deductions, depreciation and amortization of $60,000, business interest expense of $100,000. XYZ's average annual gross receipts for the past three years were $30 million.
- XYZ Corp's business interest deduction is limited to $75,000 calculated, as follows:
  - Adjusted taxable income = $250,000 ($90,000 + 60,000 + $100,000).
  - Limitation: $75,000 ($250,000 x 30%).
  - Allowable interest deduction: $75,000.
  - Disallowable interest deduction: $25,000.
  - Carryover subject to indefinite carryforward.
- After 2021, the business interest limitation would be $57,000 (no addback for depreciation and amortization).

Limitation on Business Interest Expense

- Disallowed interest can be carried forward indefinitely.
- Various exceptions apply in determining the interest deduction limitation.
  - Floor plan interest is fully deductible. (However, the business cannot utilize the unlimited bonus depreciation expensing provision in most cases).
  - Electing real property trade of business or electing farming business will not be subject to the limitation but will not be able to utilize the unlimited bonus depreciation expensing under IRC Section 168(k).
  - Special reporting rules apply to partnerships and S corporations. (Limitations apply at the entity level).

Treatment of R&D Under the TCJA

- Companies currently can deduct the full cost of their R&D expenses immediately. However, starting in 2022, companies will have to amortize their R&D costs over five years, starting with the midpoint of the taxable year in which the expense occurs. For research conducted outside of the US, the time horizon for amortization will be 15 years.
- The new treatment of R&D may significantly reduce the immediate tax benefit for future R&D activities.

Example

- For the 2019 tax year, a corporate taxpayer could currently expense $100,000 of qualifying research or experimental expenses. The taxpayer would generate a reduced R&D tax credit of approximately $5,530 (under the alternative simplified method) plus income tax savings of $21,000 ($100,000 x 21% tax rate) for a total benefit of $26,530.
- However, the same $100,000 spent in 2022 may only yield a total benefit of $7,630. The same $5,530 R&D tax credit, plus $2,100 ($100,000 amortized using the midpoint over five years x 21%).

Excess Business Losses (Non-corporate Taxpayers) Internal Revenue Code Section 461

Overview of Excess Business Losses

- The Tax Cuts and Jobs Act (TCJA) provided for rules relating to an "excess business loss" for tax years beginning after December 31, 2017 and before January 1, 2026.
- IRC Section 461(l) provides for a disallowance of "excess business loss" for noncorporate (non-C corporation) taxpayers.
- Disallowed excess business losses are treated as a "net operating loss" (NOL) carryover, subject to the NOL rules under Section 172.
- Wages were originally thought to be excluded from the calculation; however all wages have been specifically added to the calculation on the 2018 issued Form 461.

Excess Business Losses - Defined

- Excess business losses are determined at the individual (partner/shareholder/sole proprietor) level.
- An "excess business loss" is the excess of:
  - The taxpayer's aggregate deduction for the tax year attributable to trades or businesses of the taxpayer (determined without regard to the Section 461 excess business loss limitation), over
  - The sum of:
    - The taxpayer's aggregate gross income or gain for the tax year which is attributable to those trades or businesses, plus
    - $250,000 threshold (single) or $500,000 threshold (married filing joint)
      - Rev Proc 2018-57 provided inflation increases to these limits in 2019 to $255,000 (single) and $510,000 (married filing joint).

Excess Business Loss - Example #1

Income Calculation (Single taxpayer)

Investment Income	15,000
Business Income (Sch C)	
Gross Receipts	100,000
Expenses	(450,000)
Net Income (Loss)	(350,000)
Excess Business Loss Adj.	**100,000**
Adjusted Gross Income	(235,000)
Standard Deduction	(12,000)
Taxable Income	-

Excess Business Loss Calculation

Business #1	(350,000)
Net Business Income (Loss)	(350,000)
Section 461 Limitation (Single)	250,000
Excess Business Loss	**100,000**

Excess Business Loss - Example #2

Income Calculation (Single taxpayer)

Investment Income	15,000
Business #1	
Gross Receipts	1,000,000
Expenses	(375,000)
Net Income (Loss)	625,000
Business #2	
Gross Receipts	100,000
Expenses	(450,000)
Net Income (Loss)	(350,000)
Excess Business Loss Adj.	**-**
Adjusted Gross Income	290,000
Standard Deduction	(12,000)
Taxable Income	278,000

Excess Business Loss

Business #1	625,000
Business #2	(350,000)
Net Business Income (Loss)	275,000
Section 461 Limitation (Single)	250,000
Excess Business Loss	**-**

Excess Business Loss - Example #3

Income Calculation (Single taxpayer)

Investment Income	15,000
Business #1	
Gross Receipts	1,000,000
Expenses	(375,000)
Net Income (Loss)	625,000
Business #2	
Gross Receipts	1,000,000
Expenses	(2,000,000)
Net Income (Loss)	(1,000,000)
Excess Business Loss Adj.	**125,000**
Adjusted Gross Income	(235,000)
Standard Deduction	(12,000)
Taxable Income	(247,000)

Excess Business Loss

Business #1	625,000
Business #2	(1,000,000)
Net Business Income (Loss)	(375,000)
Section 461 Limitation (Single)	250,000
Excess Business Loss	**125,000**

Excess Business Loss - Example #4

Income Calculation (Single taxpayer)

Wages (S Corporation #1)	100,000
Investment Income	400,000
S Corporation #1	200,000
S Corporation #2	(1,000,000)
Excess Business Loss Adj.	**450,000**
Adjusted Gross Income	150,000
Standard Deduction	(12,000)
Taxable Income	138,000

Excess Business Loss

Wages	100,000
S Corporation #1	200,000
S Corporation #2	(1,000,000)
Net Business Income (Loss)	(700,000)
Section 461 Limitation (Single)	250,000
Excess Business Loss	**450,000**

Excess Business Loss - Example #5

Income Calculation (Single taxpayer)

Wages (S Corporation #1)	1,000,000
Investment Income	250,000
S Corporation #1	(1,000,000)
Excess Business Loss Adj.	**-**
Adjusted Gross Income	250,000
Standard Deduction	(12,000)
Taxable Income	238,000

Excess Business Loss

Wages	1,000,000
S Corporation #1	(1,000,000)
Net Business Income (Loss)	1,000,000
Section 461 Limitation (Single)	250,000
Excess Business Loss	**-**

Excess Business Losses - Other Information

- The disallowed excess business losses are converted to a net operating loss carryover.
- Under the NOL carryover rules (for NOL's generated after 2017), Section 172 limits the use of NOL's to 80 percent of taxable income (calculated without regard to any NOL deduction).
- Planning for the excess business loss rules are extremely important when bonus depreciation or any potential state level adjustment may require an addition to income, as it may result in paying state tax when a Federal loss is completely disallowed.

Update on Interest Charge Domestic International Sales Corporations (IC-DISC)

Manufacturing and IC-DISC's

<u>What is an IC-DISC</u>?

- An IC-DISC is a <u>tax-exempt</u> corporation (pays no Federal income tax), which generates commission income from a "related producer," or the manufacturing entity.
- The IC-DISC generates commission income from the related producer's sale of "qualified export property," which is <u>deductible</u> to the related manufacturer.

Manufacturing and IC-DISC's (con't)

Transactions with the IC-DISC.

- The IC-DISC generates commission income from the related manufacturer on qualified export sales equal to the greater of:
  - 50 Percent of the net profit on the export sales; or
  - 4 Percent of the total export sales (limited to net profit).
- The IC-DISC generates commission income, while the related producer deducts the commission expense, reducing taxable income of the manufacturer.

Manufacturing and IC-DISC's (con't)

Benefits of the IC-DISC.

- The related manufacturer is able to deduct commission payments against taxable income:
  - 21 Percent (2018) for C-Corporations; and
  - Up to 37 percent (2018) for S-Corp / Partnership.
- The IC-DISC pays no Federal income tax on the commission income (no state tax in New York) on undistributed profits.

Manufacturing and IC-DISC's (con't)

Benefits of the IC-DISC (continued).

- The commission income is not taxed until a taxable dividend is paid from the IC-DISC to its shareholders.
  - Taxed at "qualified dividend" rates (15-20 percent), and subject to net investment income tax rules (3.8 percent).
- IC-DISC can defer tax on up to $10 million in export gross receipts per year, and deferral is indefinite (until dividends are paid to its shareholders).

Manufacturing and IC-DISC's (con't)

Benefits of the IC-DISC (continued).

- Undistributed profits are subject to an annual interest charge on the amount of income tax deferred.
  - 2018 interest rate was 2.0813 percent (base period T-bill rate).
  - In 2018, the cost to defer $500,000 of undistributed IC-DISC income was computed, as follows:
    - Undistributed Income ($500,000) x Tax Rate (23.6 percent) = $118,000 (Deferred tax).
    - Deferred Tax ($118,000) x Interest Rate (2.0813 percent) = **$2,456** (interest charge).

Manufacturing and IC-DISC's (con't)

- Increasing Interest Rates.
  - There have been significant interest rate increases in the past few years:
    - 2017 (1.0151%) - cost of $1,198.
    - 2016 (0.5415%) - cost of $639.

Manufacturing and IC-DISC's (con't)

<u>Additional Considerations & Planning Opportunities</u>.

- Profits may be deferred (indefinitely) without the imposition of income tax.
- To defer income, cash must be paid from manufacturer (producer) to IC-DISC, and cannot be distributed to IC-DISC shareholders (taxable dividend).
- IC-DISC shareholders defer tax on undistributed IC-DISC profits at the cost of the "interest charge" on the deferred tax.

Manufacturing and IC-DISC's (con't)

Additional Considerations & Planning Opportunities.

- With the reduced tax rates in 2018, is the IC-DISC still worth doing?
  - Manufacturer tax rate = 21 percent to 37 percent.
  - Shareholder tax rate (dividend) = 15 percent to 23.6 percent.
  - Rate differential = 6 percent to 13.4 percent (without state tax impact).
- Ability to control taxable income.
  - Potential zero (or reduced) tax in years with losses or lower income.

Manufacturing and IC-DISC's (con't)

IC-DISC Producer's Loan (IRC Sec. 995).

- Rather than deferring tax by letting cash (undistributed profits) sit in IC-DISC bank account, IC-DISC has the ability to issue a "producer's loan" to the related manufacturer (producer).
- Producer's loans are considered a "qualified export asset" of the IC-DISC.

Manufacturing and IC-DISC's (con't)

IC-DISC Producer's Loan (Continued).

- Producer's loan cannot exceed manufacturer's assets related to export sales (prorated based on percentage of export sales);
- Loan must be evidenced by a note, with stated maturity date not to exceed 5 years (can be extended for any number of fixed five-year periods); and
- Bears a Section 482 ("arm's length") interest rate.

Manufacturing and IC-DISC's (con't)

<u>IC-DISC Producer's Loan (Continued)</u>.

- Manufacturer (producer) has an obligation to increase inventory, plant, machinery and equipment and/or research and development expenditures equal to the loan balance.
- Increased investment requirement applies to each taxable year the loan is outstanding.

Are You Taking Advantage of All Credits and Incentives Currently Available to Manufacturers?

- Federal Work Opportunity Tax Credit.
- NYS Investment Tax Credit & Employee Incentive Credit
- New York State Real Property Tax Credit for Manufacturers.
- NYS Excelsior Program.
- Grants and PILOT incentives for expansion projects.

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