UHY LLP
Certified Public Accountants

MANUFACTURING INSIDER

VOLUME 10 :: ISSUE 1

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IS TAX REFORM REALLY ROCKET FUEL FOR MANUFACTURERS?

Not only are many manufacturers wondering how the tax law changes will fuel the economy, but how will the key provisions impact my business. Well, usually most answer(s) provided by your advisor take on a typical response like "it depends," and in some regards that is the case here. However, before we get into specific benefits under the new law, let's step back and look at what this means from a macro level.

Manufacturing in the United States has traditionally been plagued by one of the highest federal tax rates in the world. In certain situations to remain competitive manufacturers have had to look for lower cost/tax countries to set up operations. Hopefully, lower taxes were not the only driver, but certainly taxes have had some serious weight in the decision making process. Bottom line, the US was just not on a level playing field with manufacturers around the world. The new tax law addresses two major factors that have impeded US manufacturers' ability to compete. First, reducing the corporate tax rate to a globally competitive level, and second moving to a more modern territorial system for international tax rules.

We have been waiting more than 30 years for this opportunity, since the last major tax overhaul in 1986! US manufacturers have a lot to be excited about.

Let's get started outlining some of the major corporate changes to manufacturers. My goal in this article is to hit on the larger corporate changes that will have the biggest impact, so there will certainly be some finer details that you and your UHY advisor will need to develop into a specific strategy that is right for you. The impact of the tax law changes to your personal income tax return, and there are many, will be addressed in an upcoming newsletter.

CORPORATE TAX RATE

The new tax law reduces the current graduated C corporate rate structure with a top tax rate of 35% to a flat tax rate of 21%. Talk about leveling the playing field! Reducing the tax rate will have significant benefits for years to come for manufacturing companies. The increased

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The next level of service

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cash flow associated with the tax rate cut could lead to additional spending on capital equipment, R&D, business expansion, reduction in debt levels, and likely increased wages and salaries due to the competitive labor market.

CORORATE ALTERNATIVE MINIMUM TAX (AMT)

Corporate AMT is repealed for tax years after 2017, and allows the prior year minimum tax credit to offset the taxpayer's regular tax liability plus a refundable amount equal to 50% (100% for taxable years beginning in 2021) of the excess minimum tax. Thus the full amount of AMT credit will be allowed by 2021. Repealing the AMT provision certainly will help those manufacturers that were limited in utilizing their full R&D credit due to the AMT limitations.

PASS-THROUGH ENTITIES

Under the new tax law, the highest individual tax is 37% so you would first think all pass-through entities would convert to C corporations. However, what the tax plan incorporated into the law is a new 20% deduction for qualifying flow-through entities. If the taxpayer is eligible to take the full 20% deduction, this would reduce the effective tax rate to 29.6% (37% * 80%) on the flow-through income. I know what you are thinking, 21% is still lower than 29.6%. But, if you need to get cash out of the business and/or do an asset sale, the C corporation will need to pay a dividend or a liquidating distribution, which increases the effective rate to 39.8% (21% plus 79 * 23.8%) on the C corporation income. Therefore, pass-through entities will still retain their approximate 10% tax rate advantage over C corporations.

The 20% deduction calculation is a whole article in itself. So, I am just going to touch on the very basics as there will certainly be more clarification coming in the months ahead. Almost all manufacturers should at least qualify for the 20% deduction, but maximizing the deduction will take some level of tax planning. The deduction is 20% of qualified business income similar to the starting point of how DPAD (Domestic Producers Activity Deduction) was calculated but broader under 199A, and is a deduction against the taxpayer's taxable income not adjusted gross income. The deduction in its simplest form is the LESSER of 1) 20% of the taxpayer's qualified business income, or 2) the GREATER of 50% of the W-2 wages paid by the business or 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of all qualified property. Simple right? NOT! Let's try an example: Flow-through entity has $700,000 of qualified business income, $500,000 of W-2 wages and $700,000 of qualified property. The calculation would be on an entity by entity basis:

LESSER of:
1) 20% * $700,000 = **$140,000, or**
2) The GREATER of:
50% * 500,000 = **$250,000**, or
25% * 500,000 = $125,000 plus 2.5% * 700,000 = $17,500 Total $142,500.
Since $140,000 (20% of income) is less than $250,000 (wage limitation) the deduction would be limited to $140,000, which I expect for the average manufacturer will be a common outcome.

Note*** there are certain other business limitations and thresholds that are outside the scope of this article. So buckle up, as there will be much more to come to take full advantage of this new deduction. Additional tax planning will be necessary to manage the level of compensation vs. flow-through income, amongst a host of other items.

EXPENSING OF QUALIFIED PROPERTY

Temporarily allows 100% expensing of qualified property placed in service after Sept. 27, 2017 and before Jan. 1, 2023. Also, the provision expands the property eligible beyond new property to include used property that is acquired by the taxpayer for the first time. With the extra dollars saved due to the reduced tax rates, now may be the time to reinvest and or expand business operations due to the 100 percent expense reduction opportunity available through Dec. 31, 2022 at which time a phase out begins. We continue to advise clients that the fourth industrial revolution is underway and that speed and technology will be very important to remaining competitive. Hopefully, this gives you another reason to make some capital investments.

SECTION 179 EXPENSING

Section 179 is still around with some enhanced benefits for the taxpayer. The maximum expense is increased to $1 million with the dollar threshold at which the deduction begins to phase-out increased to $2.5 million. Also, the definition of qualified property is expanded to include qualified improvements like interior improvements, roofs, heating and air conditioning, and security systems.

ACCOUNTING METHOD SIMPLIFICATION

<u>Cash Method and Accounting for Inventories:</u>
The $5 million average gross receipts threshold for corporations and partnerships with corporate partners that were not allowed to use the cash method of accounting is increased to $25 million. Also, a key provision is that taxpayers with average gross receipts of $25 million are permitted to account for inventories as materials and supplies that are not incidental. Under the old law many small manufacturers were required to use the accrual method of accounting since they had inventory. We expect this

change will lead to a renewed look at converting to cash basis to potentially benefit from an accrual to cash tax deferral. Please note additional analysis and consultation should be performed before converting to cash basis.

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Yes, finally a provision no manufacturer is really excited about calculating gets repealed for entities with revenues under $25 million. Yes, this one really is that simple.

RESEARCH AND DEVELOPMENT (R&D)

No changes were made to impact R&D. However, those C corporations that were limited due to AMT will now be able to offset regular tax since AMT was eliminated for C corporations. An interesting additional provision will require companies to capitalize R&D and amortize these costs over five years. However, the provision does not kick in until tax years ***after 2021***. There will likely be more to come on this provision.

WORK OPPORTUNITY CREDIT

The new bill does not repeal this provision and continues to be a credit available to manufacturers hiring workers from targeted groups.

DOMESTIC PRODUCERS ACTIVITY DEDUCTION (DPAD)

Simply this provision has been repealed for tax years beginning after 2017. The thinking is the reduced tax rates offset what DPAD was trying to accomplish by getting to a level playing field. However, when you take into account that certain manufacturers will now lose up to 9% DPAD deduction from taxable income, the impact of the corporate tax rate changes may not seem as beneficial to manufacturers as originally thought.

LIMITATION ON INTEREST DEDUCTION

The amount of business interest deduction will generally be limited to 30% of the business's adjusted taxable income, which is taxable income computed without regard to interest expense, interest income, net operating losses, depreciation, amortization and, depletion. For tax years after 2021, depreciation, amortization and depletion will be deducted when computing adjusted taxable income. Companies with gross receipts less than $25 million are exempt from the interest limitation rules. Also, disallowed interest would be carried forward indefinitely. This provision could be an issue for those entities that are highly leveraged or private equity owned.

NET OPERATING LOSS DEDUCTION (NOL)

The new law will limit the NOL deduction to 80% of taxable income, eliminates the carryback and allows NOLs to be carried forward indefinitely for NOLs incurred after 2017. This is certainly a big change for those companies that are in need of immediate cash as the carryback provisions are now gone.

LIKE-KIND EXCHANGES

Like-kind exchanges will be limited to real property and not apply to personal property, which may impact certain manufacturers that utilize the like-kind provision for equipment exchanges. The provision could be a hit to very capital intensive companies.

ENTERTAINMENT EXPENSES

No deduction will be allowed for entertainment, amusement, or recreation, or membership dues relating to such activities or other social purposes. The bill will repeal the 50% limit and be replaced with zero percent. The current 50% limitation would still apply to food or beverages and qualifying meals. Certain manufacturers that have suites or season sports tickets will certainly be impacted by this new provision.

INTERNATIONAL PROVISIONS

There are several key provisions which impact companies with global operations, however, I am only going to share the cliff note version right now.

Repatriation:

Currently, income that is earned by foreign subsidiaries are only taxed when the money is brought back to the US. The new law moves from a worldwide system to more of a territorial system, which provides for a dividend exemption system. Under the provision, 100 percent of the foreign-sourced portion of a dividend received by US shareholder that owns at least 10% of a foreign subsidiary would be exempt from US taxation. The bill also includes a repatriation provision under which a one-time deemed repatriation corporate tax would be imposed at 15.5% of foreign earnings held in cash or cash equivalents and an 8% tax on illiquid assets. A slightly higher rate of 17.53% on cash or cash equivalents and 9.05% on illiquid assets would be imposed upon individuals subject to the deemed repatriation. The US shareholder will have an election to pay the tax over a period of up to eight years. If the US shareholder is an S corporation, the tax will not apply until the corporation ceases to exist or the stock in the S corporation is transferred.

Foreign Derived Intangible Income (FDII):

FDII is designed to reward US corporations who provide sales or services to foreign parties. A US corporation is allowed a deduction in the amount equal to 37.5 percent of its FDII, resulting in an effective tax rate of 13.125 percent (for tax years before 2026). Generally, FDII is the amount that exceeds a 10% return on certain assets, calculated on an annual basis. There are several additional provisions that are outside the scope of this article that should be discussed with a tax professional.

CONCLUSION

Manufacturers have a lot to cheer about in the new law, which certainly provides some extra cash to help fuel growth in your business. The trusted professionals at UHY LLP can help you navigate and benefit from the new provisions. The world is changing, so let's make the most of this opportunity!

By Tom Alongi, Partner and National Manufacturing Practice Leader (Sterling Heights, MI)

PARTNERS IN GROWTH

WHY DID SUNNEN CHOOSE UHY MEMBER FIRMS TO HELP IT MEET ITS GLOBALISATION CHALLENGES AND REALISE THE 1924 VISION OF FOUNDER JOE SUNNEN?

Based in St. Louis, Missouri, US, Sunnen Products Company (referred to as Sunnen) is a global leader in the design, manufacture and distribution of bore sizing and finishing equipment, engine rebuilding equipment, and tooling and abrasives. Its honing products are used in the sizing and finishing of cylindrical bores for internal combustion engines; in mechanical gears; in hydraulic valve bodies, blocks, and cylinders; and in petroleum extraction tubes, among others.

The company's prime markets include automotive and transportation, construction, mining, aerospace and energy. Customers range all the way from small, owner-operated machine shops to large, publicly-traded original equipment manufacturers.

A FAMILY AFFAIR

The business has grown substantially since founder Joe Sunnen and his wife Cornelia sold their first valve lifting tool from the back of their converted automobile in 1924. They took the Sunnen dream on the road with little more than ten dollars in their pocket, but today the dream is alive and well: nearly a century later, Sunnen is the largest integrated precision bore sizing company in the industry - and still a family business.

Staff now number 450 in St. Louis, where specialist industry skills and experience characterise the workforce. What is more, Sunnen family values mean that the health and welfare of employees come first, and their talent and success is appreciated and celebrated. The consequence is long tenure and low turnover of a loyal and motivated staff.

Revenue worldwide is now in excess of USD 100 million, with half of that coming from customers outside of the US. As well as primary manufacturing in the US, Sunnen employs an international workforce of 200 overseeing smaller manufacturing operations in Brazil, China and Switzerland, plus distribution subsidiaries in Belgium, the Czech Republic, France, India, Italy, Poland, Russia and the UK. It is truly a global company.

PARTNERS IN GROWTH

In 2016, the UHY international network celebrated its 30-year anniversary. Over that time UHY has expanded its US-UK collaboration into a global presence, helping countless clients to not only grow domestically but also move successfully into foreign markets. Sunnen has been a client of UHY's member firm in the US for almost the same length of time. UHY LLP in St. Louis, US, provides the company with audit, tax and consultancy services.

UHY LLP's audit and assurance partner in St. Louis is Gerald Townsend. "It is very satisfying being able to help a longstanding domestic client to expand its operations overseas," says Gerald. "We have introduced Sunnen to our colleagues in the UHY global network and worked together to help the business understand country impacts on various strategic and operational alternatives. At the same time, we have been able to streamline the consolidation process and increase transparency in Sunnen's growing intercompany transactions."

Rob Ludwig, Sunnen's vice-president and chief financial officer, is equally enthusiastic. "When we hired UHY LLP at home, we wanted a firm that was positive, attentive and responsive. Our business was, and is, all about productivity – getting more from less – and we need our trusted advisors to understand that and get on board. UHY LLP met the brief in every way."

THE CHALLENGE

Sunnen's expansion abroad began with the development of a Chinese manufacturing subsidiary in 1994 in Pudong, Shanghai, and the subsequent opening of sales and service centres in Beijing, Chongqing, Guangdong, Liaoning and Shanxi. This was the first step in an international growth strategy, and an opportunity to call on UHY's own cross-border expertise. UHY Advisors' China Desk in New York has been a valuable source of consultancy and advice on numerous development issues at the Shanghai Sunnen Mechanical Company, and indicative of how specialised local market knowledge is a key factor in success abroad.

Europe has also been a challenging market for Sunnen, with mandated higher regulatory and technical accounting standards issues to address as well as the establishment of new country offices within the group's holding company, Sunnen Products Limited. So with a compatible footprint of UHY member firms to mirror the company's own centres of operation, it was inevitable that the cultural and professional fit between UHY and Sunnen would bring more UHY member firms into the equation, through introductions from UHY LLP, US as the lead firm. According to Rob Ludwig, this coordinated approach has made a complex European tax and audit challenge a lot simpler to manage. "We find this consolidation of audit and tax work occurs better between UHY member firms due to their cooperative approach," he says. "This is not something we would have easily found by using different advisors – and the UHY member firms working with our subsidiaries locally have been great."

THE SOLUTION

Sunnen's audit and tax teams in Belgium, Italy, Switzerland and the UK work closely with their UHY counterparts on a wide range of requirements. For example, as well as

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providing statutory audits to Sunnen's Swiss businesses, UHY member firm Balmer-Etienne AG, in Zurich, also provides VAT (value added tax) checks and other tax compliance services. "Their local knowledge is critical for us," says Rob Ludwig. "Local accounting law, local VAT and other tax requirements combined with knowledge on US GAAP means we can operate there with confidence." UHY Italy and UHY-CDP Partners in Belgium provide similar local reassurance and compliance in their respective markets.

For the last 15 years, Sunnen has consolidated its European accounts through UHY Hacker Young, London, UK. In addition to this work, the UK member firm provides international tax and restructuring advice, as well as auditing Sunnen's UK entity and providing corporation tax services. UHY Hacker Young has significant experience in providing services to UK subsidiaries of US companies as well as European groups headed by a UK parent, so the fit with Sunnen was clear. Rob agrees. "Working with common UHY member firms has meant that the consolidation packs prepared by our European subsidiaries can be used by the UK and the US in preparation of the respective consolidated group accounts."

THE RESULT

Confidence in UHY's member firms and a positive long-term experience in developing smooth, effective relationships between teams and member firms have resulted in more partnerships with UHY as part of Sunnen's international expansion. UHY Yans-Audit LLC, one of UHY's member firms in Russia, provides statutory audit services to Sunnen's Russian subsidiary. Most recently, Sunnen has developed joint venture (JV) operations in two of the most traditionally difficult markets to enter – Brazil and India.

Rob Ludwig explains: "Brazil is particularly demanding and UHY Moreira Auditores played a part – alongside our legal attorneys – in navigating the complex regulatory and fiscal hurdles, and the culture. It is a difficult time for the country economically and politically, but setting up as a JV allowed us to have an invested partner locally which made the challenges surmountable."

Likewise in India, where Sunnen's JV with a longstanding local distribution partner required considerable navigation on issues of compliance and multiple taxation, UHY's member firm has been instrumental in supporting Sunnen through the process. "Chandabhoy & Jassoobhoy has played a very solid role in India," says Rob. "Our operation there is progressing well, right on plan and no concerns."

LOOKING TO THE FUTURE

Rob is under no illusions that Sunnen's ambition will face many more challenges, despite continuing success today. "Of course we have plans for the future," he says. "Europe, in particular, is a changing and complicated landscape. Over the next few years, we will be re-evaluating legal and capitalisation structures and how we handle pan-European logistics and market management. We may need, for instance, a different approach to the dispersion of assets."

One thing is for sure, Sunnen will be looking for even more technical and local expertise and advice, and Rob is confident that his company's relationship with UHY member firms, in the US and across the world, will continue to bear fruit. "We are not a big enough business to have all the specific skills and knowledge in-house," he says, "but working with advisors like Gerald and his team, and the wider UHY network, I know we are in good hands. They have never been less than responsive, cooperative and, more than anything, they have always been there for us."

By Gerald Townsend, Partner
(St. Louis, Missouri)

> "It was inevitable that the cultural and professional fit between UHY LLP and Sunnen would bring more UHY member firms into the equation."

CURRENT STATE OF THE MANUFACTURING INDUSTRY

According to a new Standard & Poor's report, there are two key indicators that will tell you what kind of shape the manufacturing industry is in. The first is the Institute for Supply Management's Purchasing Manager's Index and the second is the Federal Reserve's Capacity Utilization Index for motor vehicles and parts. A reading above 50 percent for the ISM index indicates that manufacturing is expanding in the US, and below 50 means that it is contracting. History shows that each time since 1983 that the index fell below 43 percent "speculative grade" automotive companies began to panic. Similarly any time the Fed's utilization rate dropped below 72 percent during that period, it caused stress to automotive companies. Let's take a look at where we stand as of December 2017:

ISM Purchasing Managers Index: 59.7%

Fed.Capacity Utilization Rate: 77.9%

MANUFACTURING INDUSTRY INSIGHT

UHY LLP recognizes that manufacturing companies require their auditors, tax specialists and business advisors to add value to financial reporting activities. That is why we combine the strength of business and financial expertise with a hands-on, "shop floor" approach to solving complex business decisions in these key segments:

- Aerospace & Defense
- Distribution
- Automotive Suppliers
- Industrial Manufacturing
- Consumer Products

Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new trends, accounting requirements and regulations.

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