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Accounting Method Change Could Benefit Manufacturers

by Jon Shoop, CPA

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The Tax Cuts and Jobs Act of 2017 was designed in large measure to simplify the tax system and deliver tax relief for businesses.

For U.S. manufacturing and distribution businesses, a key goal of lawmakers in shaping the legislation was to facilitate reinvestment in domestic production. In this respect, the Act offers several relief provisions that provide accelerated tax benefits to manufacturers and also simplify conventions with respect to tax accounting methods. Specifically, a change from the accrual method to the cash receipts and disbursements method (i.e., cash method) can potentially streamline reporting obligations for many small and midsize manufacturing and distribution businesses. The cash method traditionally is used by sole proprietorships and individuals; under the Act, it offers potential benefits to manufacturing businesses as well.

As background, accounting methods generally refer to the practice of determining when to recognize income and/or expense items. Manufacturing businesses currently using an accrual method will accrue items of income when *all the events have occurred that fix the right to receive that income*, as well as *when the amount of said income can be determined with reasonable accuracy*.

Conversely, manufacturing businesses that utilize the cash method will usually recognize items of income when *actually or constructively received*, and items of expense when paid. The cash method is fairly no-nonsense from an administrative standpoint (a bonus for small manufacturers with limited capacity), and it provides flexibility in terms of how income recognition is timed.

Prior to enactment of tax reform in December 2017, C corporations, partnerships with a C corporation as a partner, and tax-exempt trusts or corporations with unrelated business income were, with few exceptions, precluded from using the cash method. This generally included manufacturing and distribution businesses, since these businesses typically must keep inventory records to determine costs of goods sold for the taxable year.

Now, for tax years beginning in 2018, the pool of businesses that can utilize the cash method increases. Specifically, it includes businesses with average annual gross receipts, based on the prior three years, of less than $25 million. This applies regardless of whether the production, purchase or sale of goods is an income-producing factor.

More good news: Small manufacturing businesses under this gross receipts threshold (i.e., those with gross receipts under $25 million) are no longer required to account for inventories. Their alternative options include treating inventories as non-incidental supplies and materials, or conforming to their financial accounting treatment of inventories.

Note that if the cash method is used, and if a business treats inventories as non-incidental materials and supplies, it is also exempted from the application of Section 263A. This section of the tax code details uniform capitalization rules that require certain costs that are normally expensed to be capitalized as part of inventory for tax purposes. These rules apply to real or tangible personal property produced by the taxpayer, and real or personal property acquired by the taxpayer for resale.

In summary, a change to the cash method can potentially yield sizeable benefits very quickly for manufacturing and distribution businesses and be a powerful tax deferral tool over time.

Skoda Minotti's **Manufacturing and Distribution Group** can help you quantify the impact of adopting this method, and can assist with implementing this accounting method change.

Do you have questions about the cash method, or other manufacturing and distribution issues? Please contact Jon Shoop, CPA, at 440-449-6800 or **email Jon**.