

Switching Accounting Methods Can Provide Instant Tax Savings for Manufacturers



As a manufacturer or distributor, you probably determine taxable income using the accrual method of accounting, but switching accounting methods from accrual to cash basis provides tax savings. In the past, anyone with inventory was generally required to file tax returns under the accrual method. **The Tax Cuts and Jobs Act changed this requirement in 2018!** Under the new tax law, Tax Cuts and Jobs Act, manufacturers can now switch to the cash basis for tax reporting if gross revenue is under \$25 million. There are many breaks for manufacturers with this new law.

What Is The Difference Between Accrual Basis and Cash Basis?

The biggest difference is timing. Under the accrual method, income is taxed when earned or *invoiced*. Under cash basis, income is taxed when *collected*. Conversely, expenses are deducted when they occur for accrual basis. For cash basis, expenses are deducted when paid: think Accounts Receivable and Accounts Payable. The company defers quite a bit of taxable income under the cash basis. Below is an illustration for a typical \$12 million per year manufacturer. Projected savings in 2018 is \$288,400.

Example of Conversion from Accrual to Cash Basis

Without getting too detailed, here is what a conversion to cash basis from accrual basis looks like:

ABC Manufacturing, Inc.

FACTS		
2018 Taxable Income Accrual Basis	\$900,000	
Accounts Receivable at 12/31/18	\$1,500,000	
Accounts Payable at 12/31/18	\$500,000	
Accrued Expenses at 12/31/18	\$200,000	
CONVERSION CALCULATION		
Accrual Basis Taxable Income	\$900,000	
Less: 12/31/18 Accounts Receivable	(1,500,000)	Not taxable until collected
Add: 12/31/18 Accounts Payable	500,000	Not deductible until paid
Add: 12/31/18 Accrued Expenses	200,000	Not deductible until paid
Cash Basis Taxable Income	\$100,000	Conversion to Cash Basis decreases 2018 income by \$800,000
Federal Tax deferred @29.6%	\$236,800	Assume max Federal tax rate on business income 29.6%
Estimated State Tax deferred @ 6.45%	51,600	Assume State tax rate of 4.95% plus 1.5% State Replacement tax
Total tax deferred	\$288,400	

This company will save \$288,400 in cash flow. This could eliminate the need to make any estimated tax payments for 2018. They can use the cash saved to invest in new equipment, pay down the line of credit, and increase investment in new product lines or just increase income paid to shareholders.

FAQs on Converting to Cash Basis

Is this a permanent deferral of tax? It's permanent as long as you are in business and total accounts receivable exceeds accounts payable and accrued expenses. The amount of deferred tax can grow as the business grows.

How do I know if converting to cash basis will save me money? If your total accounts receivable is greater than your accounts payable, converting will save you money.

Do I have to switch in 2018? No, you can switch in any future year under the current law. The biggest tax impact occurs in the year you make the switch.

How is the \$25 million dollar gross revenue test calculated? Eligibility is determined annually based on the average gross revenue for the prior three years. To be eligible for 2018, your average revenue for 2015, 2016 and 2017 must be under \$25 million.

What happens if we exceed the \$25 million average in a future year? A company is required to switch back to the accrual method if average gross revenue exceeds \$25 million. The deferred income is added back over a four-year period.

Switching to the cash basis can provide a significant tax deferral and can be a tool to help your company grow. It does require planning. Although this seems like a "loop hole," it was intended to help small manufacturers. If eligible, this is a strategy that most manufacturers should adopt.

At Blackhawk Bank, we specialize in working with manufacturers and have the guiding expertise needed to maximize the benefit of this tax method. If you are interested in speaking with a Commercial Banker, please visit <https://www.blackhawkbank.com/business/business-bankers>.

Source: dhjj.com by Ed Brooks