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A NEWSLETTER FOR THE MANUFACTURING & DISTRIBUTION INDUSTRIES

FALL 2008

AN AUTOMATIC HEDGE

Inflation Fighting LIFO Looks Good Again

Inflation is back after its 15 year nap, and companies are employing various measures to tame it. Among these are new rounds of RFQs, cost pass-ons to customers and locked-in price contracts with suppliers.

Another tactic is also available — one that may not only protect against inflation, but may actually save your company money every time prices go up.

The last-in, first-out (LIFO) accounting method doesn't change the way inventory actually moves. But LIFO accounts for inventory in a way that's different from the traditional first in, first out (FIFO) method.

Under LIFO, the last purchases during a year are treated as the first sold, and inventory is valued at the lower cost that prevailed earlier in the year. In times of price inflation, this method produces lower values for year-end inventory, a higher cost of goods sold and lower taxable income.

Benefits for Manufacturing and Distribution

LIFO is especially relevant for manufacturers and distributors, who are increasingly likely to hold inventory with rising costs. LIFO can be widely applied in a plant — to raw material, work in process and finished goods — and can cover a distributor's entire inventory.

The potential benefits are impressive. When the difference between a company's FIFO and LIFO inventory values increase over a year due to higher supplier prices, the increase is called the LIFO reserve and is not taxed.

Over a year, a woods product manufacturer saw its LIFO reserve increase by \$200,000 due to a 2.5% rise in supplier



prices. Under a marginal tax rate of 40 percent, the company saved \$80,000 that year on taxes. If its inventory inflation averages 2.5% over five years, the company could save \$400,000. A lower inflation rate, of course, will result in lowered savings.

Such tax reductions can reach much higher, depending on inventory value and inflation's course. Measurable benefits can be expected in the implementation year and beyond. As long as inflation continues, generally speaking, LIFO benefits increase.

LIFO's Bad Rap

But LIFO has gotten a bad rap. Some people think it's of little use when inventory turns often. Others see it as only a one-time benefit. And they've heard stories of complexity and implementation headaches.

Act Now on Expanded Tax Incentives for 2008

Earlier this year, Congress adjusted two tax incentives for the specific purpose of stimulating small and mid-size businesses. Both are particularly relevant to manufacturers, distributors and other companies that hold substantial fixed assets. And taking advantage of both requires action this year.

As 2008 opened amid rising fears of recession, the Federal Reserve's Ben Bernanke called for fast action to rally the U.S. economy. The Economic Stimulus Act of 2008 steamed through Congress and President Bush signed it on February 13.

The 10-year, \$275-billion package is famous for the rebate checks it provided to taxpayers. It also funded wider purchasing of mortgages by government-backed entities and sought to shore up the economy with two provisions to encourage business investment.

Section 179 Improves With Age

First, Congress sharply increased the amount of property eligible for the Section 179 deduction. That's the provision the IRS provides to relieve taxpayers somewhat from the pain of depreciation deductions.

Under normal depreciation rules, a company must spread out its deductions for certain large expenses over a period of years. But Section 179, in contrast, permits a company to expense (that is, deduct in the current tax year) certain property up to certain limits — which Congress has now revised sharply upward.

This move to enlarge the allowance for "expensed property" follows a long trend. In 1997, its first year, Section 179's limit was just \$18,000; prior to the 2008 Act it stood at \$128,000, and now Congress has nearly doubled that to \$250,000.

For 2008 this "expensing limit" is reduced by the amount by which total additions of qualifying property exceeds \$800,000 (also sharply up from \$510,000 before the Act took effect).

Expensing is still limited to the amount of taxable income from any of the taxpayer's active trades or busi-

nesses, and the less stringent rules for expensing empowerment zone, gulf opportunity (GO) zone and renewal properties remain in place.

Under the 2008 law, most small businesses, as well as some mid-sized ones with moderate capital equipment needs, will be able to obtain a full deduction for the cost of business machinery and equipment purchased in 2008. Such a deduction effectively reduces the purchase cost of an asset, while triggering no alternative minimum tax (AMT) adjustment.

Bonus Depreciation Is Back

A second business incentive, like the individual tax rebate, is a one-time bonus. The Bush administration explains bonus depreciation as "a temporary change to the tax code that will allow American businesses that buy new equipment this year to deduct 50 percent of the cost of their investment in 2008."

Bonus depreciation, also called accelerated depreciation, was introduced in the Job Creation and Worker Assistance Act of 2002. It permitted a company to "front-load" 30 percent of a qualified property's depreciation deduction into the first year of that property's service. In mid-2003 the bonus was increased to 50 percent, but most property acquired after 2004 didn't qualify (GO zone holdings being a major exception).

Now Congress has reinstated the bonus. The 2008 Act lets companies take a one-time depreciation deduction of 50 percent of the adjusted basis of qualified investments made during the year.

Qualified property includes most new equipment with an expected lifetime of less than 20 years, and the accelerated deduction is also available for certain improvements.

This first-year deduction requires appropriate adjustment to the property's subsequent basis and depreciation allowances. It's not reduced by a short taxable year, and a company may opt out for any class of property. And there is no AMT adjustment during the entire recovery period of the qualified property.

Can Congress Help You?

Congress intended the Economic Stimulus Act to trim the effective cost of qualified land improvements, leasehold improvements, and machinery and equipment, thereby promoting investment for business growth. As 2008 winds down, companies should take time to consider the opportunities these tax incentives may hold out to them. ■

Our firm would be happy to help you discover if the 2008 changes in depreciation and expensing rules can help your company. For more information call Phil Czajkowski at 630-545-4580.

Which Property Qualifies?

The rules for qualifying different kinds of property and calculating the deductions that can be claimed for them are complex, but here's an overview.

For Section 179 expensing:

- Machinery and equipment
- Furniture and fixtures
- Software off the shelf
- Automobiles used more than half for business
- Gasoline storage tanks
- Livestock

For bonus depreciation:

- New assets
- Assets covered by the IRS's Modified Accelerated Cost Recovery System
- (MACRS) with an expected lifetime of less than 20 years
- Certain fixtures, interior decoration and improvements
- Software off the shelf



In fact, the first two are misconceptions. Inventory turns are not an issue: LIFO measures inflation for an entire year instead of an item's shelf time, no matter how often it's bought or sold. Nor is the LIFO benefit a one-off: Inflation is measured every year, and the LIFO reserve is cumulative.

That leaves complexity. While LIFO might have once deserved its reputation, new methodologies, software and skilled specialists have emerged to help manage the process. Today the transition to LIFO, as well as day-to-day record keeping and year-end resolution, can be a smooth and transparent process.

The IPIC Method

"Item definition" — the detailed classification of inventory items necessary for an accurate calculation of inflation — is one of the most difficult challenges of using LIFO.

Relying on a company's internal cost records for this calculation can be burdensome and complicated, which the IRS acknowledged in 1981 by introducing the optional inventory price index computation, or IPIC. This computation lets taxpayers rely on external government-published indexes instead of internal records.

Since 2001 the IRS has streamlined IPIC regulations to make the method even more attractive. Today's IPIC LIFO rules no longer require grouping and weighing inventory, or calculating the cost complement formerly

used to convert a government price index to a "company specific" one.

A company's election to use IPIC LIFO is automatically approved, and it carries protection against IRS audits of prior LIFO calculations not currently under audit, so long as no fraud is involved.

Implementation

A company elects the LIFO method for a given year simply by including a short form and a statement of the calculated LIFO reserve with the year's tax return. Most companies elect LIFO for the long term, but after five years a company can drop the method, again with automatic approval. Before then, "electing off" LIFO requires a filing fee and IRS consent.

A company considering LIFO should begin with a preliminary estimate of the LIFO benefit, now and in subsequent years. The switch over is easy. Implementation can be outsourced, requiring little more than inventory records for the beginning and end of the year and answers to a few questions about valuation and inventory turns.

Good for Some, But Not All

The LIFO benefit is primarily driven by inflation: As supplier prices rise, tax savings mount. But even during sustained inflation, there are other considerations.

LIFO is often an attractive option for a profitable company facing inflation it expects to continue, or even a temporary spike that's unlikely to give way to deflation. The company should be interested in deferring income, and comfortable showing reduced income on its financial statements.

On the other hand, some circumstances point away from LIFO. The method doesn't deliver much for a company that's experiencing net operating losses, which negate the advantage of lower inventory values. And some companies prefer to pay

tax as they go, without deferring income or showing less income on financial reports. Also, companies that expect their costs to drop — yes, there are some — won't benefit from LIFO. ■

Our firm can help you gauge LIFO's potential and introduce you to specialists in LIFO implementation. For more information contact Keith Friedlein at 630-545-4505.

LIFO in Real Life

High Plains Stamping bought 1,000 steel blanks in January and 600 more in December, for a total of 1,600. During the year the company's supplier raised prices, charging High Plains \$5 each for the first lot and \$8 each for the second. By year's end the company had stamped 800 of the blanks into engine braces and sold them.

If High Plains uses the FIFO inventory accounting method, the cost of the blanks it sold is \$4,000 (800 parts, whose actual cost was \$5 each). Its year-end, 800-blank inventory is valued at \$5,800 (because it bought 200 of them at \$5 and 600 at \$8).

High Plains Stamping can reverse these figures by using the LIFO calculation. Under LIFO the company's cost of goods sold rises to \$5,800 — of the 800 blanks it sold, 600 are assigned a cost of \$8 and 200 are assigned the earlier, lower rate of \$5.

Meanwhile, the value of its year-end inventory drops to \$4,000 — since all 800 parts are treated at the earlier, lower price of \$5. These changes reduce taxable income by \$1,800.

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FIN 48 May Cause Unwanted Financial Disclosures

FIN 48 is a new accounting standard that requires a company to disclose any tax position that would “more likely than not” cause a taxing authority to impose a tax if it knew all the relevant facts.

In other words, the standard – Accounting for Uncertainty in Income Taxes is its full title – requires a company to predict taxing authorities’ decisions. Depending on that prediction, the company may have to record some tax positions as liabilities in its financial statements.

Consider a New England distributor’s position that its New York City customers don’t constitute a “nexus” requiring a corporate tax return. (Like many cities, New York City doesn’t recognize S corporations.) Even if that longstanding, good-faith position has never been challenged, FIN 48 says the dis-

tributor must decide whether it’s “more likely than not” that New York City would reject that position and impose a tax.

If so, the distributor must disclose the potential tax obligation – every year, cumulatively – as a liability on its financial statements. Meanwhile, the tax office gets a ready-made list of targets to pursue as municipal finances tighten.

FIN 48 applies to all recording entities. But since S-Corps aren’t normally subject to corporate taxes, inter-jurisdictional issues will probably be the first area in which they are forced to list such positions on financial statements. Decisions on how to characterize, classify and allocate out-of-state income can be complicated – and even a crystal ball can’t predict the thinking of a distant tax clerk.



Last month the Financial Accounting Standards Board delayed FIN 48’s implementation for all nonpublic companies until fiscal years beginning after December 15, 2008. Barring further delay or revision, that means “uncertain” tax positions need not be reported in financial statements for one more year. ■

We can help you address FIN 48 requirements for your company. For more information call Tom Murtagh at 6300-545-4509.