



CPAs & Business Advisors

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## **Do you know how business decisions can affect your tax liability?**

In the day-to-day pressure of meeting your production and sales goals, time constraints can make it difficult to consider the tax implications of business decisions. Three decisions that can directly affect your manufacturing company's tax liability are your choices of depreciation method, inventory valuation method and fringe benefits.

### **Depreciation method**

The IRS allows manufacturers to depreciate tangible property over a given period of time. Generally, office equipment, such as copiers and faxes, can be depreciated over five years while factory machinery can be depreciated over seven years. Vehicles and property used in research and development fall into the five-year classification.

The depreciation amount is equal to the cost of the item less its residual value. For example, a punch machine costing \$450,000 with a residual value of \$30,000 will have a depreciable value of \$420,000.

The two most common depreciation methods are straight-line and declining-balance. Because these methods produce different depreciation expenses in any given year, the method you select may significantly affect your bottom line and, thus, your tax liability.

As the name implies, the straight-line method depreciates an item in equal amounts for each accounting period. To illustrate, let's use the example of the punch machine above. In this case, the company will depreciate \$420,000 over seven years:  $\$420,000/7 = \$60,000$ .

The declining-balance method differs from the straight-line method in that the depreciation expense varies from year to year and is higher in the earlier years of ownership.

Using the declining-balance method, the asset is depreciated at a constant rate, usually double the rate produced with the straight-line method. But with the declining method, the asset's value is reduced every year.

Using the previous example, and a depreciation rate of 30%, the first-year depreciation is  $\$420,000 \times .30 = \$126,000$ . For the second year, the first year's depreciation of \$126,000 is subtracted from the asset's value, and then the depreciation rate is applied:  $(\$420,000 - \$126,000) \times .30 = \$88,200$ . This calculation continues until the asset is fully depreciated.

As shown above, the straight-line method produces a depreciation expense of \$120,000 for the first two years, while the declining method writes off \$214,200 to depreciation expense during the same period.



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Bear in mind that in later years these numbers will reverse, with the straight line yielding greater expense amounts.

### **Inventory valuation method**

Inventory is the heart of a manufacturing company. The method you use to determine inventory also determines the cost of goods sold (COGS), which affects your taxable income.

There are several methods to value inventory, including last-in, first-out (LIFO) and first-in, first-out (FIFO). Industry norms and product types influence your valuation method.

As a general rule, when prices are rising, LIFO produces a higher COGS, and thus, a lower income than the more commonly used FIFO. For example, let's say during the year you produce 1,000 widgets. The first 500 cost you \$10 each to produce, and the next 500 cost you \$15 each. During the year you sell 500 widgets. Under FIFO, your COGS would be \$5,000 (500 widgets x \$10). Under LIFO, it would be \$7,500 (500 widgets x \$15). If you sold the widgets for \$20 apiece, for total sales of \$10,000 (500 x \$20), your FIFO income would be \$5,000 (\$10,000 – \$5,000), while your LIFO income would be only \$2,500 (\$10,000 – \$7,500).

The IRS allows you to use either the LIFO or FIFO inventory method, stating that the method you select should conform to generally accepted accounting principles for similar businesses and clearly reflect income. Keep in mind that you must use LIFO for both tax and book purposes.

### **Fringe benefits**

Facing a tight labor market, manufacturers use fringe benefits to attract and retain top workers. Benefits are a form of payment for the performance of a service. Like other allowable expenses, benefit expenses are fully deductible for the manufacturer. However, some benefits are nontaxable to the recipient, while others must be included in taxable wages. For this reason, it's important to understand which fringe benefits are taxable and use this information when structuring benefit packages.

Nontaxable benefits include health insurance, adoption assistance, meals, transit passes and group-term life insurance up to \$50,000. Benefits that don't qualify include the use of an employer's vacation home and cash bonuses.

Benefits with little dollar value, such as coffee, generally are nontaxable. But if these benefits are given on a regular basis, they must be included in an employee's gross income.

### **Take time to review**

As the end of the year approaches, schedule time to review business activities and related tax issues. Doing so can help ensure there will be no unpleasant surprises when tax time rolls around.