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THE NEWSLETTER OF THE BDO MANUFACTURING & DISTRIBUTION PRACTICE

BDO MANUFACTURING OUTPUT

3 NEW YEAR'S RESOLUTIONS FOR MANUFACTURING & DISTRIBUTION BUSINESSES

By Mike Metz

**Should auld tax rulings be forgot, and new ones take their place,
We'll give a cup of good advice, to help our clients keep pace.**

In the spirit of the New Year, here are three tax resolutions to help manufacturing and distribution (M&D) businesses enhance their performance and maximize tax savings.

RESOLUTION #1: Comply With New Affordable Care Act Reporting Requirements and Avoid Penalties

The Affordable Care Act (ACA), also referred to as ObamaCare, mandates comprehensive health insurance reforms and has been one of the more challenging business developments impacting M&D companies in recent years. Under the Employer Shared Responsibility payment and reporting rules, businesses that fail to offer their employees coverage meeting the affordability and minimum value standards must make shared responsibility payments and may be obligated to disclose this liability on their financial statements. In order to collect the data necessary to enforce compliance, new tax information reporting is required for businesses with 50 or more full-time or full-time-equivalent employees, with reporting duties starting in early 2016 for the 2015 calendar year.

DID YOU KNOW...

Eighty percent of companies surveyed believe that they'll meet or exceed their 2014 revenue totals this year, and 83 percent expect to match or grow revenue in 2016, according to Prime Advantage's Purchasing and Manufacturing Survey.

According to the 2015 BDO 600 CEO and CFO Pay Study, average CEO pay in the manufacturing industry increased 9 percent year-over-year to $2,521,679.

Seventy-three percent of manufacturing respondents feel that the Internet of Things gives them a competitive advantage, representing a 21 percent increase from 2013, according to an Aeris survey.

Nearly 90 percent of distribution center officials surveyed expect to add new mobile devices and mobile technology to operations over the next five years, according to a YouGov and Honeywell poll.

A recent Commerce Department study estimates that 8 to 10 percent of production jobs in manufacturing are filled by temps.

The worldwide market for welding robots is expected to grow 6.09 percent annually through 2019, according to a recent forecast from Market Research Reports.

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NEW YEAR'S RESOLUTIONS

Don't procrastinate when it comes to ACA reporting! Now is the time for businesses to determine which of the information reporting forms (Forms 1094-B, 1095-B, 1094-C and/or 1095-C) are required and get a jump start on gathering the necessary data in order to ensure accurate filing of the forms with the IRS by the February 28, 2016, deadline (or March 31, if filing electronically).

The new health insurance reporting requires businesses to provide a summary statement to their employees, in addition to sending a copy to the IRS. This reporting, similar in some ways to a W-2 or 1099, details the specific coverage periods and the amount of health insurance premiums paid on an employee's behalf. Employees then use this information to support their individual responsibility payment claims on their personal tax returns.

RESOLUTION #2: Review Accounting Methods for Tax Savings Opportunities and Simplification

Accounting methods affect when various items of income and expense are recognized for tax purposes. The manufacturing and distribution industry has changed significantly over the years, but some companies in the sector have been stagnant with tax accounting methods for many aspects of their evolving businesses.

To start 2016 on the right foot, take a fresh look at how your business and your accounting methods match up. Appropriate choices among permissible accounting methods can reduce current taxes and increase cash flow. Sometimes businesses are using an improper method of accounting and a voluntary change to a proper method is a better result than having the issue discovered during an IRS audit.

Ask yourself this: Is the UNICAP method we adopted many years ago still optimal? Does the calculation still reflect our current business model?

While optimal accounting methods tend to be company-specific, areas for manufacturers to consider reevaluating include revenue recognition, uniform capitalization and accounting for inventories, fixed assets and cost recovery, and the timing of tax deductions, including bad debts, prepaid expenses, repairs and software development costs.

Now is the time to kick off a phased approach to your tax accounting methods. Begin by reviewing the substantial list of opportunities endorsed by the IRS and assessing the feasibility of those possibilities to help you achieve your business objectives. Next, prepare comparisons of your current methods to the optimal methods and estimate the tax savings. Lastly, prepare the calculations and forms required for a change in accounting method and file them with the IRS.

RESOLUTION #3: Review State and Local Tax Filing Requirements

As your business grows and expands, your tax filing requirements may likewise be expanding. A sound business practice and great resolution is to make an annual determination of the jurisdictions where you need to file tax returns for each type of tax (sales, income, franchise, etc.) With state audit activity on the rise, manufacturers would be wise to be proactive now, rather than risk facing repercussions later.

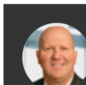
Businesses are required to file in states where they have sufficient business activity to create "nexus" with the state. States are increasingly applying an economic nexus test under the theory that the use of a state's resources by a business creates nexus -- even if the business in question doesn't have a physical presence in the area. Manufacturers frequently trip up on nexus issues related to out-of-state inventory storage, product delivery or on-site installation and repair services.

Public Law 86-272, also known as the Federal Interstate Income Tax Law, prohibits states from levying income taxes on interstate commerce activity if companies meet certain criteria. While P.L. 86-272 provides a welcome safe harbor, it is limited in that it applies only to income tax and, more specifically, income from the sale of tangible personal property. Some states have a gross receipts tax or franchise taxes that fall outside of the safe harbor. Also, certain activities in a state beyond the narrowly protected activities, such as installation or repairs, could void the safe harbor protection.

On audit, most states require prior year returns and taxes if there was nexus in those years. Often, penalties are assessed for delinquent years. While most states have a statute of limitations on prior year assessments, it doesn't start running until a return is filed. Should you belatedly determine your company has nexus exposure, some states offer voluntary disclosure and amnesty programs that limit the number of prior year returns required and reduce penalties.

As you gear up for 2016, review your business operations and transactions to assess state tax exposure and filing requirements for recent changes to laws or business activities that might give rise to nexus. Also, if delinquent filing requirements exist, this is your opportunity to get your business back in compliance.

Failure to comply with new reporting and regulatory requirements and utilizing improper accounting methods can lead to significant monetary penalties. The start of a new year is the perfect inspiration for manufacturers to embrace tax planning resolutions—and stick to them.



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HOLIDAY WISHLIST: TAX EXTENDERS

By Brian Berning & Rick Schreiber

It's the holiday season once again, and good taxpayers are eagerly awaiting decisions from Congress to bring bundles of tax extenders and joy.

Last year, Congress's decision to extend most of the 2013 tax provisions didn't come down until mid-December.[1] That's why many analysts are predicting that Congress will act in a similar fashion this year and arrive with a clatter at the stroke of midnight late this holiday season to extend tax provisions and give tidings of fiscal cheer.[2]

Manufacturing and distribution (M&D) companies are particularly excited for Congress to arrive with tax extenders this holiday season, because the package was so generous last year. The following are at the top of M&D companies' wishlist for tax extenders this holiday season:

The Work Opportunity Tax Credit (WOTC) — Code section 51

The WOTC is a hot topic right now; if extended for 2015, it's projected to cost the federal government $1.4 billion in treasury revenues over a 10-year budget window, making it one of the more expensive tax extenders on the list.[3]

The WOTC is a non-refundable wage credit intended to increase job opportunities for certain categories of disadvantaged individuals. WOTC-eligible hires include certain welfare recipients, ex-felons and veterans.[4] For most eligible hires who remain on a company's payroll for at least 400 hours, an employer can claim an income tax credit equal to 40 percent of wages paid during the worker's first year of employment up to a certain wage maximum.[5] For example, the wage maximum for most WOTC-eligible hires is $6,000, for a total credit of $2,400, but the wage maximum can be much higher for certain veteran workers.[6] Recent studies have shown that the WOTC increased wage income of disabled veterans and increased employment among long-term welfare recipients overall.[7]

Bonus Depreciation — Code section 168(k)

A relic from the Great Recession of 2008, bonus depreciation is like Grandma's sugar cookies, but sweeter. Bonus depreciation allows businesses to deduct a higher portion of the cost of equipment in the first year the equipment is placed into service, rather than smaller annual deductions under the typical depreciation schedules. In 2014, the upfront bonus depreciation deduction was 50 percent[8] of the cost of the equipment. It's expected to be the same for 2015, but it has been as high as 100 percent in previous years.[9]

Like that limited-edition *Star Wars* Bobba Fett action figure you wanted back in '81, bonus depreciation may not be around much longer. Most of the economic stimulus provisions enacted in response to the recent economic slowdown have been allowed to expire, and there is some debate as to the current effectiveness of bonus depreciation.[10] What's interesting is that studies show bonus depreciation is effective as a short-term economic stimulus, but only if it's made available on a temporary basis, because businesses are more likely to invest in equipment sooner under a temporary provision than a permanent one.[11] Whether bonus depreciation remains available for 2016 will depend largely on the state of the economy and whether Congress feels the bandage can come off.

Section 179 Expensing Limitations — Code section 179

Section 179 is a mechanism by which smaller companies are able to expense (deduct immediately) the cost of investments in equipment, rather than depreciate them over time. In 2014, the investment amount was $500,000.[12] Once a company's investment reached at least $2 million, the amount eligible is reduced dollar-for-dollar for investments in equipment over $2 million.[13] Thus, once a company's investment

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HOLIDAY WISHLIST

reaches $2.5 million, no deduction is allowed. Without an extension, the expense allowance will revert to its permanent level of $25,000, with a phase-out beginning at $200,000 (i.e., no deduction would be allowed when investment is over $225,000). The policy debate is similar to that of bonus depreciation — is the stimulus still necessary? While it's expected that Congress will deliver the same Section 179 expensing limitations for 2015 as were in place for 2014, companies shouldn't be surprised if Congress decides to send the inflated Section 179 expensing limitations to the Island of Misfit Tax Provisions in subsequent years.

Research and Development Credit (R&D Credit) — Code section 41

A perennial favorite of the tax extenders package, the R&D Credit tax provision has been extended numerous times, lapsed for one year and has even been extended retroactively.[14] Generally, the R&D Credit provides an income tax credit for a certain amount by which qualified research expenses exceed a base amount.[15] There are typically two different methods for calculating the R&D Credit: one determines the base amount using gross receipts[16] and the other determines the base amount using a three-year lookback for average R&D spending.[17] Qualified research expenses must be experimental for the purpose of discovering information that is technological in nature and used in the development of a new or improved product, process, computer software technique, formula or invention that is to be leased, licensed or used by the company.[18] These expenses include wages and salaries of researchers, supplies, costs of using computers and from 65 to 100 percent of contract research.[19] Equipment and structures are not eligible.[20] Research must be conducted in the United States.[21]

The only rationale for the R&D credit's year-by-year enactment is its hefty price tag of nearly $180 billion. After all, most economists agree that there is an economic justification for subsidizing R&D spending, because studies show that not only does R&D spending benefit the private firm in terms of return from innovation, but it also seems to benefit society as a whole.[22] From the perspective of a private firm, there is no way to capture the entire return from innovation because such innovation will provide valuable information to others in the marketplace who will exploit it, regardless of patents and secrecy. The R&D Credit seems to compensate innovative taxpayers for the loss of that return. Even so, Congress' reindeer games with the R&D Credit and the uncertainty over whether the credit will be extended each year likely reduces its effectiveness.[23]

Stocking Stuffers

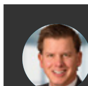
In addition to the top tax provisions on every M&D company's holiday wish list, there are a few smaller items that some M&D taxpayers are really hoping for:

- **Reduction in S-corporation recognition period for built-in gains** — Code section 1374(d)(7): When a small company switches from a C-corporation to an S-corporation (which is not a taxable event as a conversion to a partnership would be), there may be some untaxed retained earnings and profits that were never distributed to the shareholders as dividends when the company was a C-corporation, which are referred to as "built-in gains."[24] Normally, built-in gains are taxed at the top corporate rate and an individual income tax rate for the first 10 years the firm is structured as an S-corporation, but if extended, this tax provision reduces that period to five years.[25]

- **Domestic Production Activity Deduction (DPAD) applicable to Puerto Rico** — Code section 199(d)(8): When section 199 DPAD was first enacted in 2004, "domestic" meant the 50 U.S. states and D.C., but not U.S. possessions or territories. However, a temporary provision including Puerto Rico for purposes of DPAD has been in place since 2006 and is part of this year's tax extenders package.[26]

Now that the tax stockings are hung by the chimney with care, M&D companies will be eagerly awaiting their holiday haul. If these tax provisions get checked off their wishlists this year, manufacturers can expect to feel the holiday cheer all year long.

1. The Tax Increase Prevention Act of 2014 (P.L. 113-295) was signed into law on Dec. 19, 2014.
2. *See generally* Congressional Research Service (CRS) Report R43898, *Tax Provisions that Expired in 2014 ("Tax Extenders")*, by Molly F. Sherlock.
3. CRS Report R43510, *Selected Recently Expired Business Tax Provisions ("Tax Extenders")*, by Jane G. Gravelle, Donald J. Marples and Molly F. Sherlock; Table I., page 2.
4. IRC §51(d)(1)(A) through (I).
5. IRC §51(a) and IRC §51(i)(3)(A).
6. IRC §51(b)(3).
7. CRS Report R43510, *Selected Recently Expired Business Tax Provisions ("Tax Extenders")*, by Jane G. Gravelle, Donald J. Marples and Molly F. Sherlock; page 6.
8. IRC §168(k)(1)(A).
9. Authorized pursuant to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) and the Small Business Jobs Act of 2010 (P.L. 111-240), the 100% "super" bonus depreciation rate applies to property acquired after Sept. 8, 2010 and placed in service before Jan. 1, 2012. The IRS provides comprehensive guidance concerning the 100 percent "super" bonus deprecation in Revenue Procedure 2011-26.
10. In a Senate Finance Committee meeting on July 21, 2015, to consider the tax extenders for 2015, senators from opposite sides of the aisle held a lengthy debate on whether bonus depreciation is still necessary in the current economic environment. Roberts (R-Kan.) argued for making bonus depreciation permanent while Warner (D-Va.) felt that is should only be a temporary provision, if at all.
11. *See generally* Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2012 and 2013*, Washington, D.C., Nov. 15, 2011 (http://www.cbo.gov/publication/42717).
12. IRC §179(b)(1)(B).
13. IRC §179(b)(2)(B).
14. CRS Report R43510, *Selected Recently Expired Business Tax Provisions ("Tax Extenders")*, by Jane G. Gravelle, Donald J. Marples and Molly F. Sherlock; page 18.
15. IRC §41(a)(1).
16. The "fixed-base percentage method," which applies by default under IRC §41(a).
17. The "alternative simplified method" under IRC §41(c)(5).
18. Treasury Regulation §1.41-4(a).
19. IRC §41(b)(3).
20. IRC §41(d)(1).
21. IRC §41(d)(4)(F).
22. CRS Report R43510, *Selected Recently Expired Business Tax Provisions ("Tax Extenders")*, by Jane G. Gravelle, Donald J. Marples and Molly F. Sherlock; page 18.
23. *Id.*
24. IRC §1374(a).
25. IRC §1374(d)(7).
26. IRC §199(d)(8).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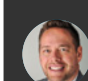
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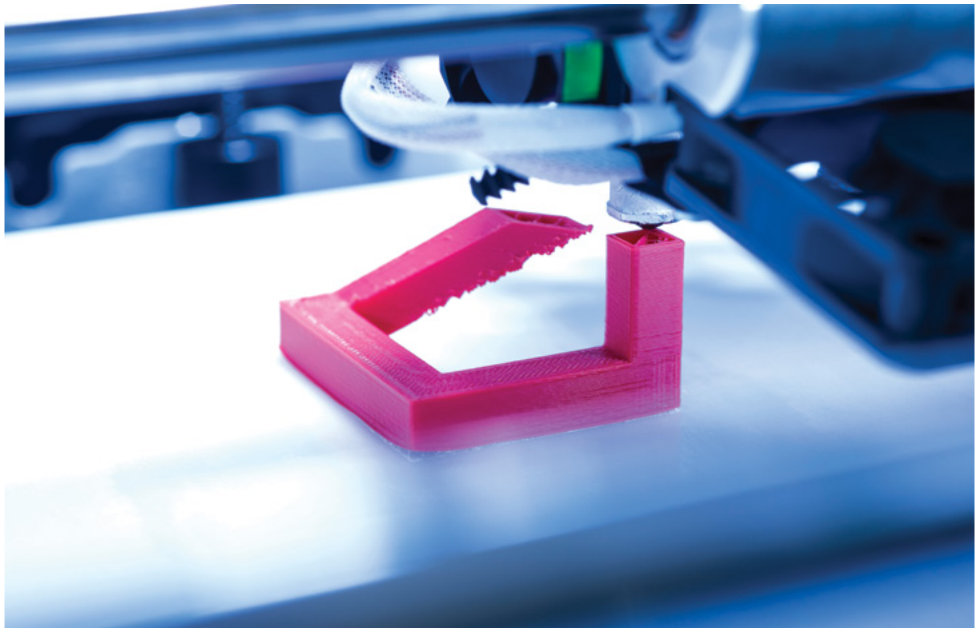
LOOKING AHEAD: TOP 2016 MANUFACTURING & DISTRIBUTION PREDICTIONS

By Larry Barger & Rick Schreiber

DATA SECURITY: EMBRACING THE INTERNET OF THINGS

As was the case this year, data security will be top-of-mind, particularly among senior management. Cyber attacks and data breaches are now an almost-daily occurrence and maintaining a strong threat protection system becomes even more challenging as products, like automobiles and wearable devices, as well as factories themselves, become Internet-enabled and more connected than ever. This year, we're expecting a significant increase in focus on and investment in the IoT as manufacturers and customers seek to take advantage of its capabilities. At the same time, manufacturers will have to increase their investment in security to keep up with an ever-expanding threat profile.



ELECTION YEAR BREEDS UNCERTAINTY

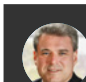
Typically, investment and deal-making slows down in advance of and during an election year. That could have significant implications for the manufacturing and distribution (M&D) industry, which has experienced strong deal flow over the past few years (for more information on mergers and acquisitions (M&A) activity in the industry, see our webinar recap on page 6). Companies and investors, including private equity investors, could wait on the sidelines to see what will happen in the political arena before they allocate their dollars or make any major financial or strategic investments. Specifically, as debates swirl around carried interest rates and the tax loophole which allows investors to pay lower taxes on certain types of income, deal flow could level off or slow down into 2016 while private equity funds weather that uncertainty.

TALENT ISSUES COULD ESCALATE

A perennial issue for M&D companies in today's business landscape, as the baby boomer generation retires in droves, is that competition is fierce to bring in new talent to fill their shoes and bridge the skills gap. The manufacturing executive of tomorrow is going to be different than today's, and we expect to see an even greater push for education and talent development for a new generation of highly skilled workers who also possess not only the skills to operate sophisticated technology, but also the business acumen to address the challenges brought about by increasingly connected products and factories. Additionally, we tend to see stronger debates emerge around job creation during election years, which could help the industry spread a positive message and better sell itself to younger workers.

ADDITIVE MANUFACTURING

New additive manufacturing technologies, including 3-D printing, are expected to grow, particularly in regions built on steel production, like the Pittsburgh-Cleveland corridor. While 3-D printing has been in existence for a number of years, it's recently risen to prominence as various industries have begun to use it to create advanced designs and products that hadn't been made before. With more manufacturers taking advantage of the technology in their factories, we'll see strategic investments like America Makes—an initiative working to help strengthen the U.S. as a global competitor with respect to additive manufacturing—continue to take hold, creating innovation hubs that have been dubbed by some as a "new Silicon Valley."



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PErspective in MANUFACTURING

The global economic outlook remains sluggish, especially given the recent slowdown in China. Persistently low oil prices, while a boon to some manufacturers, are hurting companies that make machinery and equipment for the embattled energy sector. Reduced demand from China in particular has affected industrial output from Germany, and the strong dollar and pound have hurt exports for the U.S. and U.K.

With this backdrop, companies in all sectors of the global economy are looking to achieve growth by merger. Merger and acquisition (M&A) activity in general has been extremely strong this year, surpassing $4 trillion, according to Dealogic data. Half of that volume came from the U.S., which has seen volumes rise by 30 percent.

While it has not been as frenzied as some other sectors, the manufacturing space has seen its share of deal-making, making up a steady 15 percent of overall deal volume in the U.S., according to BDO Capital Advisors' analysis. There have been 453 M&A deals in the global manufacturing space so far this year, 106 of which were private equity-backed, according to data from *The Deal*. A total of 342 deals took place in North America, while Europe saw 83 deals. Six deals took place in South America and 15 deals were carried out in Asia.

This year has seen four manufacturing megadeals valued at over $10 billion, including Schlumberger's $12.7 billion acquisition of Cameron International; Danaher Corp's $13.8 billion tie-up with Pall Corp; Avago Technologies' $37 billion purchase of Broadcomm; and Berkshire Hathaway's record-setting $37.2 billion buyout of aerospace parts maker Precision Castparts, described by *Reuters* as the biggest bet of Warren Buffett's career.

Defense, aerospace and aeronautical engineering firms in particular have seen robust deal-making. In addition to Buffett's purchase of Precision Castparts, Blackstone recently agreed to buy Scottish engineering company and Boeing supplier MB Aerospace from Arlington Capital Partners for an undisclosed sum. Kidd & Company and Centerfield Capital Partners-backed Imaginetics bought Azmark Aerosystems. And, mid-market private equity firm Nautic Partners recently purchased Aerostar Aerospace Manufacturing, a maker of machined parts for commercial aircraft. According to a Nautic Partners press release, fragmentation in the supply chain for machined parts makes the industry ripe for consolidation.

There was an unexpected uptick in U.S. and U.K. manufacturing orders during the third quarter, despite the strength of the dollar and pound. U.S. manufacturing growth was driven by automobile output, business supplies and construction materials, and would have been stronger were it not for a drop in energy production, *Industry Week* reports. In the U.K., some economists expect the strength of the pound coupled with the global recession to dampen orders well into 2016, but one poll shows 26 percent of U.K. small and medium-sized manufacturers optimistically planning overseas expansion, *The Guardian* reports.

It remains to be seen whether this represents the beginnings of a recovery—analysis from *The Guardian* describes the increase in U.K. orders as "more blip than boom." Global growth is expected to remain weak well into 2016, and observers expect continued strong M&A activity as companies seek out cost synergies and increased scale—bringing continued deal-making opportunities for buyout firms.

PErspective in Manufacturing is a feature examining private equity investment in the manufacturing sector.

WEBINAR RECAP: "IS THERE A CREST IN SIGHT FOR MANUFACTURING & DISTRIBUTION M&A ACTIVITY?"

Last month, BDO hosted its first Manufacturing & Distribution (M&D) Merger & Acquisition (M&A) Outlook webinar, "Is There a Crest in Sight for Manufacturing & Distribution M&A Activity?"

Rick Schreiber, Partner and National Leader of the M&D practice, co-presented alongside Dan Shea, Managing Director and Head of Private Equity Coverage for BDO Capital Advisors, LLC, and Jerry Dentinger, Partner and Leader of the firm's Central Region Transaction Advisory Services Practice. During the webinar, the thought leaders took attendees on a journey along the path of M&D deal flow in 2015 and shared thoughtful insights on current and future activity in the space. Key takeaways included:

Industry Conditions Favor Investment

Before the Great Recession, investors weren't batting an eye at deals in the manufacturing space. Today, however, the industry is attracting their attention. In fact, manufacturing stocks are tracking alongside the S&P 500's overall performance. Why are investors favoring the industry? For many reasons, including its sustainable energy cost advantage, shrinking labor cost disparity, influx in niche manufacturers and competitive edge in innovation. Of equal importance is the space's cyclicality, which has typically allowed for reasonable purchase valuations which has ultimately led to attractive investment returns.

Private Equity is Well Positioned to Benefit

This year, the market has been incredibly active with no shortage of deal closings. More private equity investors are taking spots at the table, providing stiff competition against

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JANUARY

Jan. 8 & 11
BDO KNOWLEDGE Quarterly Technical Update – Q4 2015*
Online Webinar

Jan. 13-15
NAM 2016 Winter Leadership Conference
The Salamander Resort
Middleburg, Va.

Jan. 25-26
IMTS Exhibitor Workshop
Renaissance Schaumburg Hotel
Schaumburg, Ill.

FEBRUARY

Feb. 8-10
AeroDef Manufacturing 2016
Long Beach Convention Center
Long Beach, Calif.

Feb. 29-March 1
American Manufacturing Summit 2016
Renaissance Schaumburg Hotel
Chicago

MARCH

March 2-5
The MFG Meeting – Manufacturing for Growth
JW Marriott Desert Springs Resort & Spa
Palm Desert, Calif.

March 23-24
Manufacturing in America Symposium
Ford Field
Detroit

** indicates that BDO is hosting or attending this event*

For more information on these and other service offerings for the manufacturing and distribution industry, please contact one of the service leaders below:

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WEBINAR RECAP

strategic buyers. In many deal negotiations, private equity investors are willing to offer prices comparable to or greater than those offered by strategic buyers. This is partly because private equity investors possess a large pool of un-invested capital totaling approximately $500 billion. The available equity as well as debt capital, coupled with a limited universe of sellers, has bolstered intense competition. Both premium as well as average assets have been trading hands as private equity firms aggressively put money into deals where they believe they can build value.

Changes on the Horizon in 2016?

The headline as we look toward 2016 is that while economic indicators could slow the pace of activity, investors are still interested in the sector, though they may be more selective and exhibit more restraint.

While the market may remain active, the rate of deals could change, with lenders pulling back should the economy slow. If this is the case, valuations could decline and deal volume could level off. However, the U.S. holds a number of advantages today, including relatively low energy costs, a narrowing labor gap and high levels of innovation, and its economic high ground will continue to attract onshore investment in manufacturing, even despite the strong U.S. dollar. Finally, buyers will most likely display more discipline, which is particularly healthy in light of the advanced age of the current economic upcycle.

Between the arrival of a new—and election—year and the persistence of economic changes, it will be interesting to see how deal flow dynamics in the M&D industry shift in 2016.

BDO MANUFACTURING & DISTRIBUTION PRACTICE

BDO's Manufacturing & Distribution practice consists of multi-disciplined professionals, well versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

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