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# Manufacturing & Distribution

*Better Ways ▲ Better Results*

A NEWSLETTER FOR THE MANUFACTURING & DISTRIBUTION INDUSTRIES

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## AFTER THE ELECTIONS

### Is a Perfect Storm of Tax Increases Gathering?

Whether or not Joe the Plumber sees his taxes rise during the Obama administration, the owners of most manufacturing and distribution companies can probably expect a bigger tax bite in the coming years.

Among the most consistent planks of President Obama's campaign platform were pledges to lower taxes on middle-class incomes and increase taxes on higher incomes. Now he and the Democratic majorities in both houses of Congress also confront growing budget deficits.

If Congress cuts taxes anywhere, it must either reduce spending, incur a higher deficit or increase taxes elsewhere. Which of these is more likely under the new administration?

President Obama has proposed increased government spending on various social programs. The U.S. budget deficit, about \$450 billion in 2008, is expected to more than double in 2009 — before any tax cuts. And the Treasury's trillion-dollar-and-counting rescue plans must be funded as well. These all point ultimately to higher taxes for some taxpayers, although the recessionary climate may delay the increases somewhat.

#### Individual Income Taxes

During his campaign President Obama indicated he will push to continue the four lower tax rates established in 2001 (10, 15, 25 and 28 percent). He proposed



providing tax credits of up to \$500 for lower- and middle-income taxpayers and promised to eliminate taxes entirely on seniors earning less than \$50,000 a year.

Higher-income individuals, meanwhile, may be taxed more. President Obama called for increasing the two top rates — from 33 percent and 35 percent, respectively, to 36 percent and 39.6 percent. And he proposed to increase the effective rate even more — to more than 40 percent for some taxpayers — by restoring the personal exemption phase-out and the itemized deduction limitation, both of which shield some income from taxation.

It's also worth noting that leading Congressional Democrats, including House Speaker Nancy Pelosi, have shown interest in plans to "overhaul" the current 401(k) retirement savings system by reducing or even eliminating the tax protections that 401(k) contributions now enjoy, thus exposing a larger share of income to taxation.

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## International Accounting Standards are Coming



For the last six years, the Securities and Exchange Commission has promoted the convergence of U.S. Generally Accepted Accounting Principles (US-GAAP) into International Financial Reporting Standards (IFRS), which are currently used in more than 100 countries worldwide.

This past August, the SEC proposed a timetable by which all U.S. public companies will be required to adopt IFRS between 2014 and 2016. Private companies will likely face a similar transition sooner or later, since lenders and investors prize consistency of reporting across the globe. In fact, this is the primary reason for converging to a single set of accounting standards in the first place.

### Fundamental Change

This process will constitute a fundamental change because IFRS, though similar to US-GAAP in some ways, diverges in important aspects. Following are some of the most critical differences:

- **Principles Over Rules** – U.S. accounting standards are based on sharply defined rules – many more than are applied in the standards used in other countries. The method of accounting for a transaction is typically unambiguous and straightforward, once the appropriate rule is applied.

IFRS, by contrast, provides fewer detailed rules to account for transactions. Instead, it relies more on the judgment of accountants and auditors to reflect a transaction's substance and relationship to economic realities, and to treat it consistently with other transactions.

- **LIFO Off the Table** – The last in, first out (LIFO) inventory method permitted under U.S. accounting rules can deliver significant tax savings to manufacturers and distributors in times of inflation. But LIFO isn't recognized as an acceptable inventory method under IFRS.
- **Revaluation to Fair Value** – Under current US-GAAP rules, companies may not revalue their long-term fixed and intangible assets. However, IFRS permits a company to elect either a cost model or a revaluation model and apply it to an entire class of assets. Under the revaluation model, assets are revalued to fair value on a regular basis.
- **Impairment Losses** – When an asset's carrying value exceeds its fair value, US-GAAP recognizes an impairment loss. (Fair value is calculated as the sum of future undiscounted cash flows to be derived from the asset.) Under IFRS, a company recognizes an impairment loss if an asset's

carrying value exceeds the higher of: 1) its fair value minus the costs of selling it, or 2) its value in use (the discounted present value of future cash flows).

While US-GAAP prohibits reversal of an impairment loss, IFRS permits reversal, except for goodwill losses, up to the new recoverable amount not to exceed the original carrying amount.

- **Classification of Leases** – Where US-GAAP provides bright-line tests for determining whether a lease is an operating or capital lease, IFRS seeks the "essence of the transaction." This is determined by such factors as whether the lease term is a "major part" of the asset's economic life, and whether the present value of the minimum lease payments represent "substantially all" of the asset's fair value.
- **Classification of Debt Subject to Loan Covenant Violations** – US-GAAP allows such debt to be presented as a non-current liability if the lender provides a waiver prior to the issuance of financial statements. IFRS allows the debt to be presented as a non-current liability only if the lender provides a waiver prior to the balance sheet date. Otherwise, it must be presented as a current liability.

### Relevance Today

IFRS will require a raft of new choices, procedures and technology. While the SEC's goal of implementation between 2014-2016 seems a long way off, U.S. manufacturers and distributors should begin to get a big-picture understanding of IFRS and its implications today. In particular, companies that do business abroad will find themselves encountering the "convergence" movement long before an actual shift to IFRS in the U.S. ■

*For more information, please call Keith Friedlein at 630-545-4505.*

## Other Payroll Taxes

High-income earners are also likely to see an increase in the FICA (Federal Insurance Contributions Act) taxes deducted from their paychecks, also commonly known as Social Security taxes. One part of FICA is the OASDI tax, which stands for Old Age, Survivors, and Disability Insurance. The cap on wages subject to the OASDI tax has already increased in 2009, subjecting an additional \$4,800 to the tax. (The other portion of FICA taxes, collected for Medicare, applies to all income with no cap at all.) President Obama has also mentioned the possibility of a new “payroll surtax” of four percent on earnings greater than \$250,000.

## Capital Gains and Dividends

The maximum tax rate on capital gains and dividends has declined considerably since the 1980s, when it stood at 28 percent. By 2003 it had dropped to 20 percent, and in that year Congress reduced it to 15 percent. Low-income taxpayers currently pay no taxes on capital gains. But those provisions are scheduled to expire at the end of 2010, and President Obama, as a candidate, proposed returning the maximum rate to 20 percent.

## Estate Taxes

Under the current and somewhat complex law, estate taxes are scheduled to fall, disappear and rise again. The estate tax exclusion was \$2 million for 2008 and is \$3.5 million for 2009, with a top tax rate of 45 percent. The tax is set for repeal entirely in 2010, but then will be reinstated in 2011 with a much lower exclusion (\$1 million) and a higher top tax rate of 55 percent. President Obama has proposed returning the exclusion to \$3.5 million and the top tax rate to 45 percent in 2011.

## Businesses

During the campaign Obama seemed to advocate

lowering the U.S. corporate tax rate, which is the second-highest in the industrialized world. He also mentioned new credits for creating jobs, an extension of higher expensing limits and a permanent place for research and experimentation credits. But what one hand gives, the other can take away. President Obama has called for a sharp closing of business tax “loopholes,” among which he has specifically singled out executive compensation.

The Treasury’s rescue plans already aim to curtail executive compensation by limiting deductibility. That may also foreshadow less favorable tax treatment for deferred compensation.

Companies that hire outside the U.S. may find themselves ineligible for either new or current tax benefits. For example, the new administration is considering new limits on the use of foreign tax credits as part of a planned “crackdown” on foreign tax havens. Also, since employers pay half of the OASDI tax, a higher cap on employee incomes subject to that tax will increase employer taxes as well. All in all, according to the Tax Policy Center, President Obama’s proposals could increase business-related taxes by \$770 billion over a ten-year period.

## Uncertainty, and Time for Review

Coming into office in a full-fledged recession, President Obama indicated he is reconsidering the timing of some of his campaign tax-increase proposals. It’s not yet certain how

much, or how quickly, taxes on higher incomes will rise. But whenever these increases are enacted, some could be made retroactive. According to Philip Czajkowski, tax partner and member of the *Manufacturing & Distribution Group* at Wolf & Company LLP, “These impending changes, especially in the larger context of the financial-credit crisis and economic downturn, make it important to review tax and investment positions now.”

For some taxpayers, it may be beneficial to accelerate some income and defer some deductions. Deferred compensation plans should also be reassessed, since they may be vulnerable to higher tax rates. And choices about retirement savings need analysis, too: Should contributions be maximized in tax-deferred accounts, or placed in regular accounts taxed at capital-gains rates that are still lower than regular income tax rates? ■

*Our firm can help your company understand the new tax climate and make decisions that keep hard-earned money in your hands. For more information contact Phil Czajkowski at 630-545-4580.*



## Learning from Recent History

The first year after a presidential election often brings a major tax overhaul. In the first year of Bill Clinton’s second term, Congress enacted the Taxpayer Relief Act of 1997. Then, after George W. Bush’s election in 2000, lawmakers passed the Economic Growth and Tax Relief Reconciliation Act of 2001.

Further, major tax legislation is typically completed by midsummer and made retroactive to January 1.

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Wolf Financial Group



## Trim Payroll Costs for Tight Times

However the financial crisis unwinds, many manufacturing and distribution

companies are facing at least a few quarters of difficulty in growing their sales. And when sales growth isn't attainable, conserving cash becomes critical.

For many employers, their greatest single expenditure is payroll costs — not just wages, but also payroll taxes, medical benefits, 401(k) contributions, workers compensation insurance, and so on. One dollar of wages can easily translate to a total employer cost of \$1.30 or more, and payroll processing costs add even more. Here are some ways to find savings:

**Outsource payroll.** A payroll service leverages economies of scale that reduce overall costs. Outsourcing virtually eliminates employee time spent on processing, producing, calculating and distributing paychecks, as well as correcting errors — including tax errors, which carry penalties. It also reduces employers' liability.

**Consider direct deposit.** You may not see the costs of paper checks — paper stock, handling, storage — but you're paying for them. Electronic transactions are more convenient for employees, and they cut down on lunchtime trips to the bank, which often erode productive time.

**Look closely at workers compensation.** Workers rates vary according to employee classification;

a thorough review of classifications can save money.

**Review health insurance.** Employee contributions toward medical coverage let you establish a Section 125 plan, by which such contributions are taken from pretax compensation. This approach saves the employer FICA and other employment-related taxes. A yearly review of insurance plans can ensure that rates are the lowest available. Active involvement in wellness education and incentives to promote healthy lifestyles also can reduce insurance claims and costs.

**Examine overtime.** Look back over a few months, and evaluate every overtime hour to see which were necessary and which weren't. Then make changes going forward. ■