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Major shift in lease accounting could cause major headaches

Almost every manufacturer leases equipment or real estate. For decades, companies weren't required to report many lease-related assets and liabilities on their balance sheet. That's all about to change under a controversial new lease accounting standard that's scheduled to be published in early 2016.

Shifting the reporting paradigm

Under current U.S. Generally Accepted Accounting Principles (GAAP), companies are required to record lease obligations on their balance sheet if the lease is considered a financing arrangement, such as rent-to-own contracts for buildings or vehicles.

Currently, companies must consider various rules to determine if they have a capital lease. First, if the present value of lease rental payments amounts to more than 90% of the asset's value, the contract is generally considered a capital lease and the asset and liability are placed on the lessee's balance sheet. The other factors that force a balance sheet approach include a determination to see if the lease transfers ownership at the end of the lease term, if the lease agreement contains a bargain purchase option or if the lease term is equal to 75% or more of the estimated economic life of the asset.

> Manufacturers and distributors are especially concerned about the impact the new lease standard will have on their financial statements and the compliance burdens it will impose.

Under existing GAAP, if any of these conditions are present, the lessee must report the lease on the balance sheet as a capital lease. If these conditions aren't met, the lease is generally considered an operating lease and the lessee simply records the payments as expenses on the income statement.

The current accounting rules give companies significant leeway to structure deals to look like rentals. Investors and lenders often complain that this practice makes lessees appear more financially secure than companies that take out loans to buy the same assets. For some companies — such as trucking companies that lease their fleets of vehicles or manufacturers that rent all their warehouse space — lease payments represent significant financial obligations.

In 2013, the Financial Accounting Standards Board released Proposed Accounting Standards Update No. 2013-270, *Leases (Topic 842)*, to change the way these obligations are reported. It was largely converged with an international standard with the same name.

The standards boards have since disagreed on several aspects of the project — in particular, how leases should be reported on companies' income statements — and expect to publish separate final standards on leasing accounting in early 2016. However, both standards will focus on providing greater transparency in reporting future lease obligations.

Exempting operating leases

Manufacturers and distributors are especially concerned about the impact the new standard will have on their financial statements and the compliance burdens it will impose. They tend to rely heavily on fixed asset leases and, therefore, expect to suffer disproportionate adverse effects compared with companies in other industries. They're especially concerned that the new lease standard will upend loan covenants that require borrowers to maintain certain debt-to-equity ratios.

After fielding significant criticism, the FASB has decided to make its final guidance less far reaching than its 2013 proposal. It's expected to retain the requirement that companies record obligations to make payments on rentals of storefronts, equipment and vehicles as liabilities. But the FASB has decided that certain *operating* leases — those with terms of 12 months or less that are more akin to rentals as opposed to financing deals — will continue to be accounted for on the income statement as they are today.

Postponing the implementation date

As of this writing, the FASB is adding the finishing touches to its final standard on lease accounting. But the board has announced that the revised guidance won't go into effect for public companies until annual periods beginning after December 15, 2018. Private companies will have an extra year to comply.

Despite this delay, proactive manufacturers should talk to a financial advisor *today* about how the lease standard is likely to affect their financial statements and debt-to-equity ratios in the future. Doing so can help preempt negative consequences related to this major change. ■

Why lease?

When it's time to acquire new vehicles, equipment or warehouse space, manufacturers and distributors often wonder, "Should I lease it or buy it?" The revised accounting standard on leases makes leasing seem less advantageous, but there still may be sound financial reasons not to buy an asset outright.

An equipment lease is essentially a financing arrangement in which another company owns the equipment and leases it to you at a flat monthly rate for a specified term. At the end of that term, you can opt to buy the equipment, return it or lease new assets.

Depending on how the contract is written, a lease may eliminate the need for a large down payment, reduce maintenance costs and reserve capital for other purposes. Leases also offer more flexibility in case the company moves in a different strategic direction than expected — or the equipment becomes technologically obsolete.

Taxes also should factor into the decision. The classification of leases for tax purposes generally aligns with current accounting practice. Operating leases are typically deductible as an operating expense. Conversely, capital leases provide tax deductions for depreciation, insurance, interest and repair expenses on equipment. For advice on whether to lease or buy, contact your financial advisor.

Following the new PATH

Recent tax law extends depreciation expensing tax breaks — and more

Manufacturers and distributors tend to invest heavily in equipment, technology upgrades and leasehold improvements. Depreciation from these assets can be a major deduction for tax purposes.

Among numerous other provisions, the Protecting Americans from Tax Hikes (PATH) Act of 2015 retroactively reinstated many depreciation-related tax breaks. Some breaks have been permanently carved into the IRS rules; others have been extended for several years. Here are some details on the depreciation tax breaks available for the 2015 tax year — and beyond.

Deduct purchases under Section 179

The PATH Act, which was signed into law in December 2015, allows small businesses to immediately expense up to $500,000 of qualified fixed-asset purchases in 2015 under the Section 179 deduction. It's subject to a total purchase limit of $2 million per taxpayer. Beyond that, the deduction is reduced dollar for dollar. But your company can't use Sec. 179 to reduce its taxable income below zero.

Just to clarify, these Sec. 179 amounts have been *permanently* extended. In future tax years, both the $500,000 and $2 million limits will be indexed for inflation. The special rules that allow Sec. 179 on computer software have been permanently extended, too.

The new legislation also permanently allows companies to use a 15-year straight-line cost recovery period for qualified leasehold improvements. Under the old rules, these improvements were generally subject to a 39-year straight-line cost recovery period.

Consider bonus depreciation

Companies that purchase more than $2 million in qualifying new fixed assets and those with insufficient taxable income can turn to bonus depreciation. The PATH Act allows 50% first-year bonus depreciation for assets placed in service in 2015 through 2017. In 2018 and 2019, companies can take 40% and 30% first-year bonus depreciation, respectively.

This special program isn't subject to a spending threshold and can even create a taxable loss. But it generally can't be applied to *used* assets. Under the PATH Act, special rules allow taxpayers to elect to accelerate the use of alternative minimum tax (AMT) credits instead of bonus depreciation for property placed in service in 2015. But starting in 2016, the amount of unused AMT credits that may be claimed in lieu of bonus depreciation increases.

Plan ahead

These changes are good news for companies that regularly invest in fixed assets. Before the PATH Act was passed, the Sec. 179 deduction would have been only $25,000 and the investment threshold was only $200,000 after December 31, 2014. What's more, no Sec. 179 would have been allowed for real

estate improvements and the bonus depreciation program had been discontinued prior to the new legislation.

In recent years, many manufacturers and distributors have postponed their fixed-asset purchases at year end, waiting to see if Congress would renew the "extender" tax provisions to make it worth their while. With year-end uncertainty eliminated, businesses are now free to plan their fixed asset purchases in 2016 and beyond.

Meet with your tax advisor

Before purchasing fixed assets, discuss these tax breaks with your tax advisor, because various restrictions apply. For example, qualified assets must be placed in service — not just ordered — by December 31 to be eligible for these programs in a given tax year. In addition, special rules apply to pass-through entities, including partnerships and S corporations.

Depreciation tax breaks are just the tip of the iceberg. Your tax advisor may offer other exciting tax planning strategies under the PATH Act. Examples include a temporarily expanded Work Opportunity credit, various energy tax breaks, and the research credit, which is now permanent. Set up your 2016 tax-planning meeting as soon as possible. ■

S corporation vs. C corporation

Is it time for you to make the switch?

The Protecting Americans from Tax Hikes (PATH) Act of 2015 accomplished more than just extending certain tax breaks. It also made some taxpayer-friendly provisions permanent — including the shortened recognition period for companies that convert from C corporation to S corporation status. This change is causing many manufacturers and distributors to re-evaluate their corporate status.

After weighing the pros and cons, many companies are electing Subchapter S status to gain enhanced flexibility in business decisions and to lower taxes. Here are some important issues to consider before you convert.

Tax considerations

C corporations pay taxes twice. First, they're charged corporate-level income taxes. Shareholders then pay tax personally on C corporation distributions and dividends. But S corporations are flow-through entities for tax purposes. This means that income, gains and losses flow through to the

owners' personal tax returns. S corporations generally aren't taxed at the corporate level.

However, double taxation of C corporations may become a major issue when the owners decide to sell assets or transfer equity. Historically, if a company elected Subchapter S status and sold assets or transferred equity any time within a 10-year "recognition period," it was charged corporate-level tax on any built-in gains that occurred while the company was a C corporation. Any gains that occurred after making the S election passed through the owners' personal tax returns.

Under the PATH Act, the recognition period has been permanently shortened to five years.

Under the PATH Act, the recognition period has been permanently shortened to five years. If a business sells assets or stock within the recognition period, only the appreciation in value from the date of the S corporation election will be exempt from corporate-level tax.

So it's important to establish the company's fair market value at the conversion date and to allocate it to the company's assets. This enables taxpayers to quantify which portion of the gain should be taxed as C corporation gain and which portion should be taxed as a flow-through gain to shareholders.

Subchapter S qualifications

For businesses contemplating a Subchapter S election, there's no time like the present to start the clock on the five-year recognition period. But not every business qualifies for this election. It's available to only domestic corporations that use a calendar fiscal year and offer just one class of stock (though differences in voting rights are permitted). Qualifying businesses also must have no more than 100 shareholders — including individuals, certain trusts and estates but excluding partnerships, corporations, foreign individuals and entities, and ineligible corporations.

Beware, too, that Subchapter S status restricts how the company distributes cash and liquidates assets. All payouts must be made to shareholders on a pro rata basis. If these rules aren't followed or if the company merges with another entity that doesn't qualify, the company will lose its Subchapter S status.

Potential pitfall

Although S corporations are required to make pro rata distributions to shareholders, they aren't required to distribute income to shareholders. So shareholders who lack control over making distributions may find themselves required to pay personal-level taxes on S corporation income, regardless of whether the company distributed any cash to cover those tax liabilities.

The annual tax burden can be substantial for highly profitable S corporations — and even more substantial for high-income taxpayers. As a courtesy, most S corporations pay enough distributions to cover shareholders' tax obligations. But there's no guarantee of distributions for shareholders who lack control over the business.

A tough choice

Before electing S status, your business must obtain the approval of all shareholders. Although there are many benefits to making the switch — especially now that the recognition period to avoid corporate-level capital gains tax has been permanently shortened — it's not a prudent option for every business. Your legal and tax advisors can help determine the right choice for your circumstances. ■

Social media tips for manufacturers

Social media can be an inexpensive, but effective, way to market products and brands. But does it work for manufacturers, especially those that don't sell directly to the public?

Some trendsetting manufacturers have successfully integrated social media into their marketing campaigns to drive traffic to their websites, build brand loyalty and attract new talent. Here's how.

Stand out

The first questions to ask before jumping on the social media bandwagon are:

- What differentiates your company?
- What will customers and prospective employees react to?
- What do you hope to accomplish?

The answers will guide your company's social media strategy. Posts should focus on what makes your company special, be relevant on a personal level and encourage people to act in a way that accomplishes your goals.

For example, a small consumer products manufacturer uses social media to boast about its "Made-in-America" competitive edge. It creates compelling posts about making quality products that are "safe for families to use." So far, the manufacturer has more than 10,000 Facebook friends, including many employees who were recently hired. Its posts also include hyperlinks that drive traffic to the company's website.

Another manufacturer wants to position itself as a leader in technology. It uses videos and Twittercasts to demonstrate its latest product innovations, research efforts and equipment upgrades. It encourages customers to chat with service reps through links on LinkedIn and Twitter.

Examples of other issues that manufacturers promote through social media include green manufacturing practices, involvement in Project Lead the Way programs, safe and flexible work environments, and employee participation in charitable events.

Keep it simple

Creating social media content isn't that hard to do. Most business-to-business social media posts consist of just a picture and a couple of sentences — possibly less if your company connects directly with consumers. A clever infographic or a short video may take more time to create than text, but it can be very effective at grabbing people's attention.

There's no rule for how often companies should post new content. But anyone who's active on social media knows that there's a limit to how many times you can post without becoming a nuisance. You want customers to remember your company, but sometimes, less is more.

Remain active

Social media requires ongoing attention. In addition to creating new posts, you'll need to continuously watch for inappropriate comments and block social media "trolls" looking to cause mischief. You can also contact your financial advisors about how to measure click-through rates and evaluate the return on investment from your social media activities, so you can adjust your strategy as needed. ■

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Hertzbach & Company, P.A. has more than 65 years of experience in helping manufacturing and distribution firms achieve their financial goals. We can guide you in analyzing and managing the unique risks in this cyclical industry. Our clients tell us that our consulting services help them improve the efficiency, profitability and longevity of their businesses. Manufacturers have unique needs in the business world. Today's volatile economic conditions make operating a manufacturing company especially challenging, requiring management's constant attention to every aspect of the business. As a manufacturer or distributor of goods, your profitability is subject to the ups and downs of the economy.

Government regulations, collective bargaining and liability issues seem to be the only sure things in your industry. To have any chance of success you need excellent management, marketing, planning, analysis and internal controls. More than ever, managers in the manufacturing industry must keep a watchful eye on areas such as profit centers, tax considerations, and state and local regulations.

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