MANUFACTURER

Fall 2017

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NMLS 1410584

Tax issues to consider when investing in training and recruiting

A top concern for manufacturers is the shortage of skilled workers. There are various options to bridge the skills gap, but training and recruiting options often require a substantial investment. What's the most cost-effective way for you to tackle this challenge?

Deducting training costs

Before looking outside your organization for skilled job applicants, consider your *existing* employees. Could any promising employees qualify for an open position with the right training?

In addition to any continuing education requirements, employees may want to advance their skill set or simply keep their skills up to date. Depending on the number of employees who would like to participate, employers might decide to offer a class onsite or online — or send employees to an offsite location for training.

For federal tax purposes, companies can generally deduct the cost of courses that employees attend to maintain professional or job-related skills. The write-off covers items such as tuition, books, supplies and certain travel costs. (There are some limits for owners on deducting the cost of education that isn't job-related, however.)

Should you pay interns?

A modest salary certainly helps attract applicants to your recruitment programs. But many companies wonder whether they're legally *required* to pay interns for their services — or whether receiving on-the-job training or earning high school or college credit will suffice.

Under the Fair Labor Standards Act (FLSA), companies are generally required to pay at least minimum wage to employees. The FLSA applies to interns, too, unless they qualify for an exception.

Criteria the Department of Labor (DOL) uses to evaluate exceptions include the following:

- The internship is similar to training that would be given in an educational environment.
- The internship experience benefits the intern.
- The intern doesn't displace regular employees, but works under close supervision of existing staff.
- The employer receives no immediate advantage from the activities of the intern, and, on occasion, its operations may actually be impeded by participation in the internship.
- The intern isn't necessarily entitled to a job at the conclusion of the internship.
- The employer and the intern agree that the intern isn't entitled to wages for the time spent in the internship.

The more of these points that apply, the stronger the case will be for exemption from the FLSA. Also ask your attorney about state laws and other regulations that pertain to internships.

Additionally, some employers offer tuition reimbursement programs for work-related education expenses. Typically, these reimbursements are a tax-free fringe benefit to employees (no income or employment taxes), and the employer can deduct the costs as business expenses.

Alternatively, if a company maintains an educational assistance plan, employees may be able to receive up to $5,250 in annual tax-free education benefits. The courses don't have to improve or maintain job-related skills; they can lead to a new job, help the worker meet minimum requirements or just be educational. If you pay more than $5,250 in educational assistance benefits to an employee annually, he or she must generally pay tax on the excess amount.

Offering internships

If existing employees are unable (or unwilling) to fill a position, it's time to look *outside* your company. Some manufacturers partner with local high schools, tech schools, community colleges and universities. Internships can be an affordable way to vet candidates and infuse your teams with fresh, new ideas. But you may still be required to offer a modest salary under state and federal labor laws. (See "Should you pay interns?" at left.)

The bottom line is that interns who are paid and assigned meaningful work can be eager, productive team members. They're also more likely to return to work for you as full-time employees — and spread the word to their friends.

Relocating new hires

For hard-to-fill positions, you may need to expand the search beyond your company's geographic reach. And you might have to offer financial incentives to lure applicants.

In addition to paying signing bonuses and premium salaries, relocation packages can help attract talent, especially to less populated areas. Typically, employers provide an advance for moving expenses with an agreement that the new hire will return any excess funds within a reasonable time period.

Reimbursed moving expenses made in accordance with the IRS rules for "accountable plans" are deductible as normal business expenses. The reimbursements are generally tax-free to the employee, too.

> For federal tax purposes, companies can generally deduct the cost of courses that employees attend to maintain professional or job-related skills.

If a reimbursement arrangement doesn't meet the IRS requirements for accountable plans, the reimbursement will be treated as "nonaccountable." Payments made under nonaccountable plans are taxable compensation to the employee (subject to payroll and income taxes). However, the employee can offset the income on his or her personal tax return by deducting job-related moving expenses.

Bridging the skills gap

Looking for help attracting and retaining skilled workers? Contact your CPA advisors for creative, cost-effective solutions. ■

Family businesses: How to survive a "divorce"

Many successful small manufacturing businesses are run by families. Unfortunately, when business and personal lives are so intertwined, disagreements sometimes happen and family members decide to part ways. Here are valuation methods that apply when divvying up a marital estate that includes a family-owned business — or when buying out a dissenting shareholder.

Valuing a private business interest

The question on everyone's mind in shareholder divorces and buyouts is: How much is the business worth? There are three ways to value a privately held manufacturing business. First, the cost (or asset-based) approach starts with the company's balance sheet. Then adjustments are made to various balance sheet accounts — such as inventory or equipment — to reflect fair market value (rather than historic cost).

For example, raw materials inventory may be undervalued if your company uses the LIFO (last in, first out) method. Similarly, equipment may be undervalued, because manufacturers typically use accelerated tax depreciation methods.

The cost approach may overlook "goodwill" and other intangible assets. The value of intangible assets is better captured by the market and income approaches, however.

The market approach derives value from sales of similar businesses. Here, the value of the company is derived from a pricing multiple, such as price-to-earnings or price-to-EBITDA (earnings before interest, taxes, depreciation and amortization expense).

Under the income approach, a future earnings stream (typically cash flow) is discounted to its present value. When future cash flow is expected to be stable, it may be divided by a capitalization rate, which can be thought of as the mathematical inverse of a pricing multiple under the market approach.

Measuring goodwill

Goodwill is the excess of a business's value (under the income or market approach) over its net tangible book value (the cost approach). In a few states, the entire value of the business — including goodwill — is part of the marital estate. Alternatively, some states exclude all goodwill from the marital estate.

About half the states separate goodwill into two pieces: personal goodwill and entity goodwill. The former can't be separated from the business owner. The latter is a function of the business's location, employees, name recognition, contracts and customer lists. These states include entity goodwill in the marital estate, but exclude personal goodwill if maintenance awards are based on the owner's future earnings.

Personal goodwill is most frequently associated with professional practices, such as medical practices or law firms. But some courts recognize that manufacturers can possess personal goodwill — for example, if the business's success is tied to key relationships with the owner or if the owner has unique knowledge that can't be (or hasn't been) transferred to others.

When evaluating personal goodwill in a dissenting shareholder context, it's important to consider whether personal goodwill could be transferred to a third party. If a shareholder would need to work closely with a hypothetical buyer to transition the business after a deal closed, a portion of personal goodwill might belong to the individual shareholder, rather than the business.

Adjusting the financials

Family businesses aren't always run like publicly traded companies that strive to maximize profits and shareholder value. So, adjustments may be needed to reflect how unrelated parties would operate the business.

Common financial statement adjustments include:

- Owner and family member compensation and perks (including company vehicles and season tickets to sporting events),
- Non-market-value rent paid to related parties,
- Inventory accounting anomalies, and
- Unrecorded liabilities (such as pending lawsuits and warranty claims).

When valuing a minority owner's interest, courts in divorce and dissenting shareholder lawsuits generally consider whether a buyout price is fair.

So, they may sometimes be reluctant to apply discounts for lack of marketability and control if the discounts would provide a windfall to the controlling shareholder.

Finding your expert

Do-it-yourself valuations are unlikely to withstand scrutiny in court. If your business needs to be valued for a shareholder divorce or buyout, contact a business valuation specialist. Choose someone who understands manufacturing industry trends, accounting practices and key value drivers. ■

Loan or lease

What's the smartest way to finance new asset purchases?

If your company needs to expand its facilities or update equipment, you may be weighing the pros and cons of financing vs. leasing. Here's some guidance to help you make an informed decision.

Traditional financing

Few companies have enough cash on hand to purchase fixed assets — such as warehouses, office space, furniture and machinery — outright. Instead, the buyer may apply for a bank loan to acquire hard assets.

The loan term is usually tied to the item's useful life (say, 30 years for a plant mortgage and five years for an equipment loan). The loan's interest rate may be fixed or vary based on a market index. And most loans require a down payment of at least 10% of the asset's price and personal guarantees from the company's owners.

Borrowers can deduct interest expense and depreciation on their income tax returns. You can also elect to accelerate depreciation deductions under

Section 179 and the bonus depreciation program. (These deductions could be impacted by tax reform legislation, however.) At the end of the loan term, the company owns the asset.

Leasing

Alternatively, a lease is a contract between a company (the lessee) and a landlord or financing company (the lessor). The approval process for leases is generally quicker and easier than for bank loans.

Although lessees lose out on interest and depreciation deductions, they're allowed to deduct monthly lease payments for tax purposes.

A lease typically commits the lessee to make monthly payments over a period of time for the use of the equipment. Lease payments include imputed interest charges, which are typically higher than the interest rates for traditional bank loans. A lease also may include an option for the company to buy the equipment, for some stated price, at the end of the lease.

Lease terms can be flexible. Some leases require an initial down payment on the lease to help reduce monthly costs. Sometimes, the lessor covers all maintenance and insurance costs; other leases call for the lessee to pay these expenses over the lease term.

Although lessees lose out on interest and depreciation deductions, they're allowed to deduct monthly lease payments for tax purposes. Additionally, during the lease term, a lessee may be allowed to upgrade to a new piece of equipment if technology improves. Or, if the business unexpectedly loses a major account, the lessee may be able to cancel the lease or downgrade to a smaller piece of equipment.

New reporting requirements

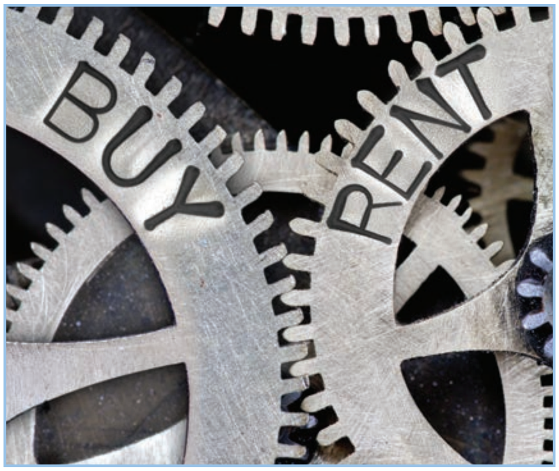
Current accounting rules require lessees to report capital (or finance) leases, but not operating leases, on their balance sheets. Capital leases transfer ownership of the underlying asset to the lessee by the end of the lease term. Leases that don't meet the criteria established for capital leases are classified as operating leases.

Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, requires companies to report *all* leases with terms of at least 12 months on their balance sheets. The new guidance takes effect in fiscal years starting after December 15, 2018, for public companies, and for fiscal years beginning after December 15, 2019, for private ones.

The updated standard is expected to make lessees appear more leveraged than in previous years — which may cause loan covenant violations and hamper access to capital. So, it's important to consider how the financial reporting changes will be perceived by stakeholders.

Need help?

Manufacturers need to consider various tax, financial and practical issues before deciding whether to buy or lease fixed assets. Contact a tax advisor to help you understand the pros and cons of leasing.



Understanding and reducing cyberrisks

"Manufacturers must strike a balance between progress and security," said National Association of Manufacturers board member Rick Schreiber in a recent statement. "Data analytics and the Internet of Things may spur the next industrial revolution, but with that comes increased exposure to cyberrisk. Manufacturers still have some catching up to do to adequately protect their data, customers, products and factory floors."

Costs of data breach

Data breaches can cause safety issues, negative publicity, lost productivity, and compromised personal and corporate data. The average cost of a data breach in the United States has risen to a record high of $7.35 million, according to a 2017 study published by independent research group Ponemon Institute. That's an increase of 5% from the 2016 study.

The findings indicate that data breaches cost companies an average of $225 for each lost or stolen record. That includes $79 for direct costs incurred to investigate and resolve the breach, as well as $146 for indirect costs, including abnormal turnover of customers.

Preventive measures

Here are five proactive ways to minimize the risk of a breach:

1. Identify weaknesses. Many manufacturers own intellectual property — such as patents, designs and formulas — that may be targeted by thieves, including a dishonest person *inside* your organization. The use of automated equipment, cloud computing software, mobile devices and data-sharing arrangements also may provide other "ins" to hackers who want to exploit your company or its supply chain partners.

2. Turbocharge asset controls. Once you've identified at-risk assets, take steps to protect them. This includes encrypting electronic data; securing computers, smart devices and other IT equipment (including those used off-site); formalizing protocols for cloud storage and interfaced equipment (including secure disposal); and negotiating assistance from cloud storage providers in case of a breach.

3. Consider breach insurance. Most commercial liability policies don't cover losses for data breach or the cost of breach response. For this type of coverage, you'll need to purchase separate policies or addendums to your existing coverage. The amount of coverage needed depends on which assets are most at risk.

4. Train employees. The Ponemon study found that 24% of breaches were caused by negligent employees. So, train them about the latest scams and encourage the immediate reporting of suspicious incidents.

5. Establish a response team. Planning *before* a breach takes place can decrease the average cost of a data breach by about 12%, according to Ponemon. The response team can monitor for potential weaknesses, develop a response plan and conduct drills.

Audit must-have

Cyberthreats are a major risk manufacturers and distributors face today. Internal and external auditing procedures can help you evaluate and minimize the risks of data breach.

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