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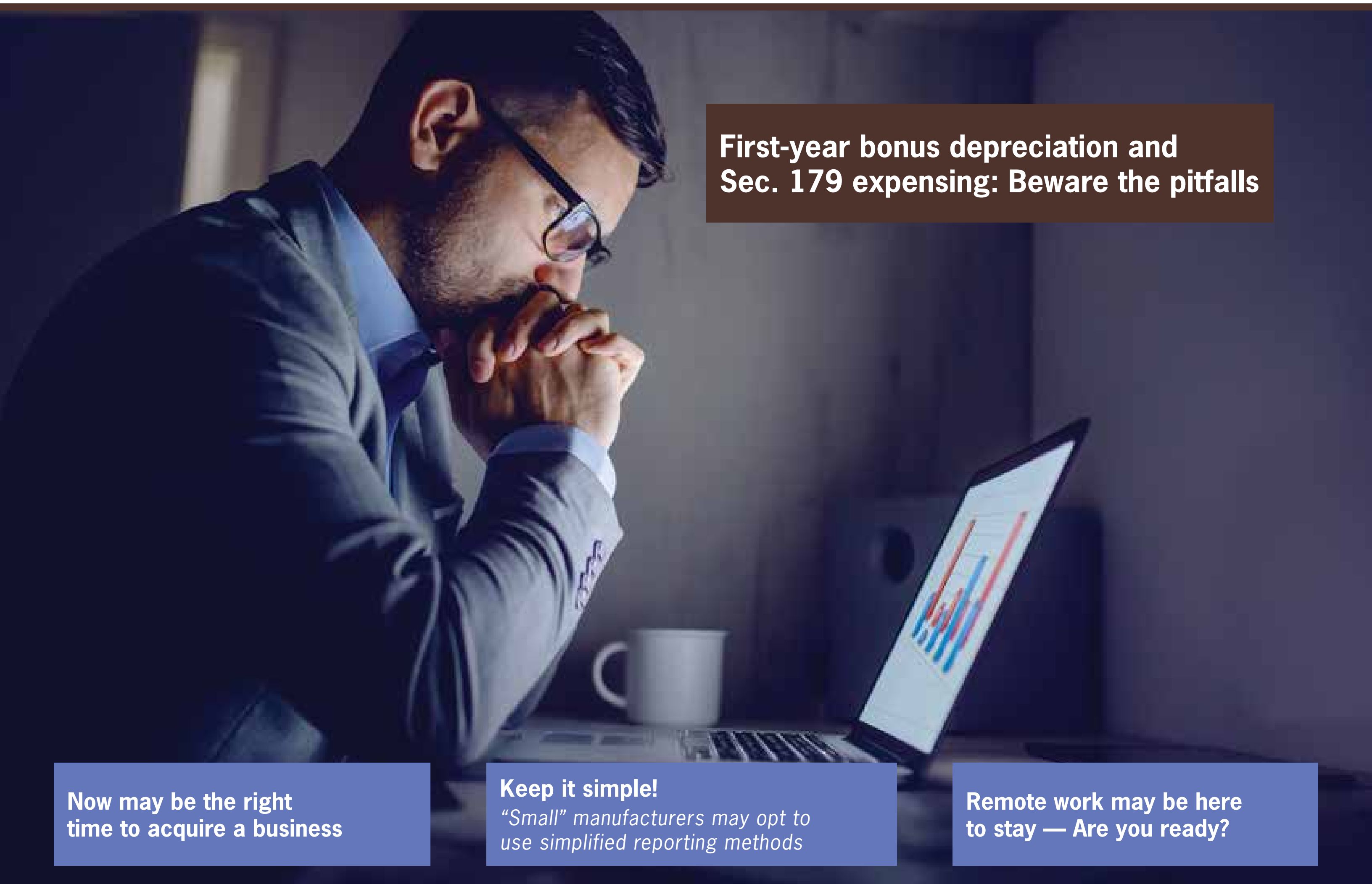

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Rick Virnig
President, Commercial Lender
Direct: 320-257-2835 | Fax: 320-257-2867
Cell: 320-493-4677 | rvirnig@anbmn.com
NMLS 1410584

3210 W Division St., St. Cloud, MN 56301 | 320-253-0142 | www.anbmn.com

First-year bonus depreciation and Sec. 179 expensing: Beware the pitfalls

Many manufacturers are eligible for tax write-offs for certain equipment purchases and building improvements. These write-offs can do wonders for a manufacturer's cash flow, but whether to claim them isn't always an easy decision. In some cases, there are advantages to the regular depreciation rules. So it's critical to look at the big picture and develop a strategy that aligns with your company's overall tax-planning objectives.

Background

Taxpayers can elect to use the 100% bonus depreciation or the Section 179 expensing election to deduct the full cost of eligible property up front, in the year it's placed in service. Alternatively, they may spread depreciation deductions over several years or decades, depending on how the asset is classified under the tax code. Note that 100% bonus depreciation is available for property placed in service through 2022. Then, allowable bonus depreciation will be phased down to 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. After 2026, bonus depreciation will no longer be available.

In March 2020, a technical correction made by the CARES Act expanded the reach of bonus depreciation. Under the act, qualified improvement property (QIP), which includes many interior improvements to commercial buildings, is eligible for 100% bonus depreciation retroactively to 2018. So, taxpayers that placed QIP in service in 2018 and 2019 may have an opportunity to claim bonus depreciation by amending their returns for those years. If bonus depreciation isn't claimed, QIP is generally depreciable on a straight-line basis over 15 years.

Sec. 179 also allows taxpayers to fully deduct the cost of eligible property, but the maximum deduction in a given year is $1 million (adjusted for inflation), and the deduction is gradually phased out once a taxpayer's qualifying expenditures exceed $2.5 million (also adjusted for inflation).

Examples

While 100% first-year bonus depreciation or Sec. 179 expensing can significantly lower your company's taxable income, it's not always a smart move. Here are three examples of situations where it may be preferable to forgo bonus depreciation or Sec. 179 expensing:

1. You're planning to sell QIP. If you've invested heavily in building improvements that are eligible for bonus depreciation as QIP, you may be stepping into a tax trap by writing it off if you plan to sell the building in the near future. That's because your gain on the sale — up to the amount of bonus depreciation or Sec. 179 deductions you've claimed — will be treated as "recaptured" depreciation that's taxable at ordinary-income tax rates as high as 37%. On the other hand, if you deduct the cost of QIP under regular depreciation rules (generally, over 15 years), any long-term gain attributable to those

Can you deduct the cost of your website?

There was a time when websites were nothing more than “online brochures.” But today, they’re indispensable tools that many manufacturers use for critical business functions, including marketing and advertising, communications, supply chain management and e-commerce. Websites are especially important in the COVID-19 environment, as manufacturers rely more heavily on virtual rather than in-person interactions.

Developing an effective website can require a significant investment, but are those costs deductible for federal tax purposes? The IRS hasn’t published any website-specific guidance, but general guidance on the tax treatment of hardware and software is instructive.

Hardware. Servers and other hardware used to maintain a website are treated like other computer equipment, which is typically depreciable over five years. But it may be possible to deduct 100% of the cost in year one if you qualify for bonus depreciation or the Section 179 expensing election.

Software. Off-the-shelf software is generally amortizable over 36 months. Like hardware, however, it may also be eligible for bonus depreciation or Sec. 179 expensing. Internally developed software is typically amortized over 36 months, but, in some cases, it may be written off more quickly. For example, if your website is used primarily for advertising, it may be possible to deduct software development costs currently as “ordinary and necessary business expenses.” And certain development costs may qualify as deductible research expenses.

Other options. If you engage a vendor to set up and operate your website, the payments are likely deductible business expenses. And if your business is new, you’ll be eligible to deduct up to $5,000 in start-up expenses, including website costs, in year one.

The tax treatment of your website depends on your company’s circumstances, so be sure to consult your tax advisor.

deductions will be taxable at a top rate of 25% if the building is sold.

2. You’re eligible for the “pass-through” deduction. This deduction allows eligible business owners to deduct up to 20% of their qualified business income (QBI) from certain pass-through entities, such as partnerships, limited liability companies or sole proprietorships. The deduction, which is available through 2025, can’t exceed 20% of an owner’s taxable income, excluding net capital gains. (Several other restrictions apply.)

Claiming bonus depreciation or Sec. 179 deductions reduces your taxable income, which may deprive you of an opportunity to maximize QBI deductions. And since the QBI deduction is scheduled to expire in 2025, it makes sense to take advantage of it while you can.

3. Depreciation deductions will be more valuable in the future. The value of a deduction is based on its ability to reduce your tax bill. If you think your tax rate will go up in the coming years, either because you believe Congress will increase rates or you expect to be in a higher bracket, depreciation write-offs may be worth more in future years than they are now.

Timing is everything

Keep in mind that forgoing bonus depreciation or Sec. 179 deductions only affects the timing of those deductions. You’ll still have an opportunity to write off the full cost of eligible assets over a longer time period. Your tax advisors can analyze how these write-offs interact with other tax benefits and determine the optimal strategy for your company’s situation. ■

Now may be the right time to acquire a business

The COVID-19 pandemic has resulted in financial losses for many businesses, including manufacturers. As a result, some owners may be looking for an exit strategy. In this uncertain market, some investors see opportunity. For those who are able, now can be a good time to acquire a distressed business with an eye to turning a profit. Here's some guidance on this strategy to help you avoid potential pitfalls.

Looking at the long term

While turnaround acquisitions can yield significant long-term rewards, acquiring a troubled target can also pose greater risks than buying a financially sound business. The keys are choosing a company with fixable problems and having a detailed plan to address them.

Look for a company with hidden value, such as untapped market opportunities, poor leadership, and excessive costs. Also consider cost-saving or revenue-building synergies with other businesses that the buyer owns. Be sure to assess whether these opportunities exceed acquisition risks and potentially provide ample financial benefits.

Doing your homework

Successful turnaround acquisitions start by understanding the target company's core business — specifically, its profit drivers and roadblocks. Without a clear understanding, you may misread the company's financial statements, misjudge its financial condition and, ultimately, devise an ineffective course of rehabilitative action. This is why many successful turnarounds are conducted by corporate buyers in the same industry as the sellers or by investors (such as private equity funds) that specialize in a particular sector.

During the due diligence phase, pinpoint the source of your target's distress, such as excessive fixed costs, decreased demand for products and services, or overwhelming debt. Then determine what, if any, corrective measures can be taken. Don't be surprised to find hidden liabilities — such as pending legal actions or deferred tax liabilities — beyond those you already know about.

You also may find potential sources of value, such as tax breaks or proprietary technologies. Benchmarking the company's performance with its industry peers' can help reveal where the potential for profit lies.

Managing cash flow

Before completing a transaction, determine what products drive revenue growth and which costs hinder profitability. Does it make sense to divest the business of unprofitable products, services, subsidiaries, divisions or real estate? Should you cut staff?

Implementing a longer-term cash-management plan and developing a forecast based on receipts and disbursements is also critical. Cost-saving and revenue-generating opportunities, such as excessive overtime pay, high utility bills and unbilled services, can be achieved with a strong cash-management plan and a thorough evaluation of accounting controls and procedures.

Reliable due diligence hinges on whether the target company's accounting and reporting systems can produce the appropriate data. If these systems don't accurately capture all transactions and list all assets and liabilities, a potential buyer won't be able to track progress and fully pursue growth opportunities or respond to potential problems.

Structuring the deal

When buying a business, the parties can structure the deal as a sale of either assets or stock. *Buyers* generally prefer *asset* deals, which allow them to select the most desirable items from the company's balance sheet. In addition, the buyer receives a step-up in basis on the acquired assets, which lowers future tax obligations. And the buyer negotiates new contracts, licenses, titles and permits.

On the other hand, *sellers* typically prefer to sell *stock*, not assets. Selling stock simplifies the deal, and tax obligations are usually lower for the seller.

However, stock sales may be riskier for buyers because the business continues to operate, uninterrupted, and the buyer takes on all debts and legal obligations. In a stock sale, the buyer also inherits the seller's existing depreciation schedules and tax basis in the company's assets.

Developing a plan

Current market conditions make business acquisitions both tempting and tricky. Consult your CPA to help develop a strategic plan that minimizes potential risks and maximizes your long-term value. ■

Keep it simple!

"Small" manufacturers may opt to use simplified reporting methods

The Tax Cuts and Jobs Act (TCJA) expanded the tax code's definition of "small business" to include those with average annual gross receipts of $25 million or less (adjusted for inflation) for the three preceding tax years. Both the 2020 and 2021 inflation-adjusted threshold is $26 million. Manufacturers that qualify as small businesses may be eligible for simpler reporting methods that could also defer federal income taxes. Let's take a closer look.

Accounting methods

Under the cash method of accounting, income is recognized when it's received, and expenses are deducted when they're paid. Under the accrual method, income is recognized when it's earned, and expenses are deducted when they're incurred, regardless of the timing of cash receipts or payments.

Typically, businesses that use the cash method can defer more taxable income than they would under the accrual method. And businesses that switch from the accrual method to the cash method often enjoy significant tax savings in the year they make the change.

In addition, manufacturers that qualify as small businesses may elect to use the completed-contract method to account for long-term contracts expected to be completed within two years. Compared to the more complicated percentage-of-completion

method that's required for larger companies, the completed-contract method allows a small business to defer tax until the contract has been substantially completed.

Inventory relief

The TCJA exempts small businesses from complex inventory accounting requirements and permits them to account for inventories by either:

1. Treating them as nonincidental materials and supplies, or

2. Conforming to the inventory method used in the business's financial statements or books and records.

Treating inventories as nonincidental materials or supplies means deducting their cost in the year they're consumed and used by the business. Many manufacturers interpreted "used or consumed" to mean "used in the production process." However, proposed IRS regulations provide that an item is used or consumed when it's provided to the customer.

Manufacturers who take advantage of this provision should watch for the final regulations. If the proposal is finalized in its current form, manufacturers may not be able to deduct inventory costs as early as they had hoped.

More TCJA exemptions

The TCJA provides two more exemptions for small businesses:

1. Exemption from uniform capitalization rules. Manufacturers that qualify as small businesses are exempt from the uniform capitalization rules. Those rules require a business to capitalize to inventory, rather than expense, direct production costs and certain indirect costs. Not only does this process complicate tax reporting, but it can also increase a company's tax liability.

2. Exemption from business interest deduction limit. The TCJA limits deductions for net business interest expense to 30% of adjusted taxable income (temporarily increased by the CARES Act to 50% for 2019 and 2020). The limit doesn't apply to small businesses, so they're allowed to deduct 100% of their business interest in the current tax year.

> Typically, businesses that use the cash method can defer more taxable income than they would under the accrual method.

Size matters

Does your company qualify as a small business for federal tax purposes? If so, you may now be eligible for simplified reporting options that you didn't qualify for in the past. Your tax advisors can help you evaluate the potential benefits of small business status and determine whether it would be advantageous to change your accounting methods. ■

Remote work may be here to stay — Are you ready?

The COVID-19 pandemic has forced many companies to shift gears and focus on ways to conduct business remotely. And many experts believe that the trend toward remote work will continue even after the pandemic is over. Unlike other businesses, manufacturers must continue to rely on workers on the shop floor, such as machinists, assemblers and repair persons. Here are some possible ways manufacturers can adapt their operations to the new normal.

Allow executives and office staff to work remotely. Providing remote work opportunities helps you recruit and retain talent. And by minimizing the number of people at the workplace, it facilitates social distancing when necessary.

Look into automation. You can reduce the number of people needed on your shop floor through automation. Even before the pandemic, many manufacturers were beginning to embrace Internet-connected devices that can be monitored and operated remotely.

Reconfigure office space. With more employees working remotely, manufacturers can lower their costs by reducing office space. This also provides an opportunity to reconfigure spaces to help boost productivity, efficiency and employee satisfaction.

Invest in remote workers. It isn't enough to simply send workers home to work. To make it work, it's critical to provide employees with the resources they need to be productive at home. Assist employees with the expenses necessary to create an efficient work environment, such as office furniture, computer equipment and high-speed Internet service.

Pay attention to cybersecurity. Make sure remote employees' home Wi-Fi networks are password-protected or encrypted. Alternatively, consider making them use a virtual private network (VPN) to connect to the company's systems. Provide employees with company computers with the latest security patches and appropriate malware protection or, if they use their own devices, ensure that they follow security protocols.

It's uncertain what the new normal will look like or when today's volatile conditions will subside. But it's likely that remote work will continue to play a prominent role. Now is the time to adapt without missing a beat. ■

American National Bank of Minnesota
3210 W. Division St.
St. Cloud, MN 56301

Rick Virnig
President, Commercial Lender
Direct: 320-257-2835 | Fax: 320-257-2867
Cell: 320-493-4677 | rvirnig@anbmn.com
NMLS 1410584

Margie Otten
Commercial Real Estate Lender
Direct: 320-257-2842 | Fax: 320-253-9045 | motten@anbmn.com
Cell: 612-390-1553
NMLS 1489092

Tammy Reis
Vice President, Mortgage Specialist
Direct: 320-257-2840| Fax: 320-257-2867 | treis@anbmn.com
NMLS 709753

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