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Is it better for manufacturers to buy or lease equipment?

Manufacturing is an asset-intensive business, so deciding whether to buy or lease equipment or machinery is critical. This article reviews some of the factors you should consider as you make this decision.

Advantages of buying

One of the biggest advantages of buying over leasing is the ability to write off the full cost of eligible equipment purchases up front, using 100% bonus depreciation or Section 179 expensing. These write-offs are available whether you finance the purchase or pay cash.

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Usually, bonus depreciation is preferable because, unlike Sec. 179, it's not limited to your net taxable income (which means it can generate or increase an overall tax loss). Sec. 179 also imposes a limit on deductions (currently, $1.05 million) and is phased out once total fixed-asset investments exceed a certain threshold (currently, $2.62 million). Keep in mind, however, that 100% bonus depreciation is available only for assets placed in service through the end of 2022 (with certain exceptions), after which this tax incentive will gradually be reduced and then eliminated after 2026.

Writing off the cost of newly purchased equipment can be a valuable tax break. But sometimes it makes sense to forgo these immediate deductions and recover the cost over time through depreciation (typically over five, seven or 15 years). For example, if you believe that the government will increase tax rates or that you'll be in a higher tax bracket in future years, depreciation deductions may be worth more down the road than they are today. Also, if your company is structured as a pass-through entity — such as an S corporation, limited liability company or partnership — you and the other owners may be eligible to deduct up to 20% of your qualified business income (QBI) from the company.

The QBI deduction can't exceed 20% of your adjusted taxable income from the business, however. Taking bonus depreciation or Sec. 179 deductions reduces your taxable income, so it may reduce your QBI deduction as well. (Note: The QBI deduction is scheduled to expire after 2025.)

Advantages of leasing

Despite the tax breaks associated with buying equipment, leasing also has its advantages. Examples include:

- Lower down payments,
- Lower monthly payments, and
- Less risk of obsolescence.

Outdated equipment can be upgraded at the end of the lease term, but this advantage tends to diminish as the lease term increases. A long-term lease does little to reduce the risk of obsolescence

Consider alternative accounting methods

As noted in the main article, companies that adopt an accounting method that doesn't conform to U.S. Generally Accepted Accounting Principles (GAAP) can avoid reporting operating leases on their balance sheets. Common alternatives include the cash basis and income tax basis of accounting.

Another option that has been gaining acceptance among lenders is the AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs). This alternative (also known as "Little GAAP") is viewed by many lenders as more reliable than the cash and income tax bases of accounting, in part because it's derived from "legacy" GAAP. By combining traditional GAAP accounting principles with certain accrual-based income tax principles, FRF for SMEs produces financial statements that highlight the most relevant information without much of the complexity of GAAP-compliant reporting, which may be unnecessary for smaller businesses.

A significant difference between the two methods is that FRF for SMEs doesn't require operating leases to be reported on the balance sheet. Thus, manufacturers that switch from GAAP to FRF for SMEs can save substantial amounts of time and money while preserving an important advantage of equipment leasing.

and may even increase your risk, since your obligation to make lease payments continues even if you cease using the equipment. And, of course, for certain long-lived assets, buying allows you to keep the asset indefinitely, while leasing requires you to repeatedly renew a lease or negotiate a new one when it expires.

Review lease accounting rules

Traditionally, another advantage of leasing has been the ability to keep operating leases off the company's balance sheet. But new lease accounting rules that take effect soon will eliminate this advantage for companies that follow U.S. Generally Accepted Accounting Principles (GAAP). Under the new rules, companies will be required to report the assets and liabilities associated with all leases with terms of a year or longer on their balance sheets. By increasing the amount of debt on a company's balance sheet, this change can result in technical violations of loan covenants and cause lenders and investors to view the company's financials less favorably.

After a one-year deferral due to the COVID-19 pandemic, private companies are now required to adopt the new lease accounting rules for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. One option for companies that wish to preserve their ability to keep equipment leases off the balance sheet is to adopt a non-GAAP accounting method (see "Consider alternative accounting methods" above.)

No one right answer

Unfortunately, in the buy vs. lease debate, there isn't a universal right answer. It depends on your particular circumstances and an analysis of the relative advantages and disadvantages of each option. Your CPA can help you weigh the pros and cons. ■

Now's the time to review your estate and succession plans

Every business owner needs an exit plan. In light of potential tax changes on the horizon, you might want to review your plan this fall. Perhaps most significant, the federal gift and estate tax exemption will be cut drastically at the end of 2025 — or much sooner if recent proposals become law. So, if you plan to leave your manufacturing business to your family or transfer it to an unrelated third party, consider taking proactive measures today to help achieve your long-term estate and succession planning goals.

Give business interests to family

If you plan to transfer your manufacturing business to your children or other family members, consider gifting business interests to them as soon as possible. For 2021, the federal gift and estate tax exemption allows you to transfer up to $11.7 million tax-free ($23.4 million for gifts you split with your spouse). But this generous exemption is set to expire at the end of 2025 and return to its previous level of $5 million (adjusted for inflation).

It may be reduced even more, and sooner, under certain proposals being considered by Congress. One proposal, for example, would lower the estate tax exemption to $3.5 million and the gift tax exemption to $1 million. It would also replace the current 40% estate and gift tax rate with graduated rates reaching 65% for the wealthiest Americans. Plus, there's a proposal to eliminate valuation discounts for lack of marketability and control for transfers of business interests between members of a family that control the business.

It's likely that these changes will apply prospectively, so there may still be time to transfer substantial amounts of wealth on a tax-advantaged basis under current rules. IRS regulations issued in 2019 confirmed that the Service wouldn't attempt to "claw back" a portion of gifts made before January 1, 2026, and subject those amounts to estate taxes after the current exemption amount sunsets. It's generally believed that a similar rule would apply in the event the exemption is reduced earlier.

Consider capital gains issues

Another reason to act quickly is that recent proposals would eliminate an income tax incentive to hold onto business interests for life. Under current rules, a person who inherits appreciated property receives a "stepped-up" basis equal to the property's fair market value on the date of death, allowing all appreciation to that point to escape capital gains tax.

In contrast, assets transferred by gift retain the donor's basis. There are proposals to eliminate the stepped-up basis for assets transferred at death and, for both gifts and bequests, to provide for immediate taxation of the unrealized gain (subject to a $1 million lifetime exclusion and an exception for certain family owned and operated businesses).

Look outside the family

There are many ways to exit a business. In addition to transferring your interest to family members (either by sale or by gift or bequest), other methods include:

- Selling the business to a third party,
- Selling the business to your management team,
- Selling your interest to your co-owners, or
- Conducting an initial public offering.

If you're not interested in selling the business or transferring it to your family, another option to consider is an employee stock ownership plan (ESOP). ESOPs are qualified retirement plans that invest in the company's stock.

Although ESOPs can be somewhat complex to set up and administer, they offer substantial benefits. They allow business owners to create liquidity by selling some or all of their stock to the plan, while retaining control and sharing equity with employees. They also generate various income tax benefits for the company, the owners and the employees.

Each of these options presents different tax and nontax implications. Identify your preferred approach as early as possible so you can begin to formulate a strategy.

Have a comprehensive plan

While this article focuses on ownership succession, it's also important to address management succession in your exit plan. Contact your CPA to learn more about both. ■

Labor shortage

How manufacturers can attract and retain qualified workers

The CFO Survey, a collaboration of Duke University's Fuqua School of Business and the Federal Reserve Banks of Richmond and Atlanta, tracks CFO optimism and top concerns. According to the survey, labor quality and availability was the most pressing concern in the second quarter of 2021. The labor shortage has been a major concern among CFOs for years, and the COVID-19 pandemic has only exacerbated the problem.

The struggle to find qualified workers has been especially pervasive among manufacturers. In most U.S. cities, job openings — for positions such as assemblers, machinists, technicians and engineers — exceed qualified applicants by a wide margin.

Here are a few creative ideas to help manufacturers bridge the gap.

Financial incentives

In today's competitive labor market, one way to attract and retain workers is through financial incentives. This may include signing bonuses, stay-bonuses (awarded to employees who stick around for a prescribed period), and above-market wages.

While employee compensation packages can be costly, employees value traditional benefits, such as health plans and 401(k) plan matching contributions. Negotiate with providers to see if you can reduce the costs while still offering them to employees.

You also might consider offering "voluntary" benefits, including consumer goods purchasing services, life insurance and disability insurance. Employees usually pay for these benefits, although they might be payroll-deducted. Employers may be able to provide these programs to employees on a more economical basis than via traditional sales channels.

Intangible benefits

Remember, the goal is to make your company's compensation package as attractive as possible — without breaking the bank. Therefore, before increasing your compensation budget, check your employment value proposition (EVP). EVP refers to everything that employees appreciate about working for your company. It may surprise you but pay, while important, isn't always at the top of an employee's list.

Survey workers to help determine which monetary, intangible and noncash components they value the most and identify gaps in your offerings.

When evaluating your EVP, talk to your employees to find out what they value most about working for you. Intangible "benefits" such as respect and concern for employees' well-being, an upbeat corporate culture, learning and training options, and professional growth opportunities are what many employees look for.

Employees also look for flexible work arrangements. This can include flextime (altering starting and ending times of the workday) or compressed workweeks (working the traditional number of hours in less than five days). Some manufacturers may be able to attract seasonal employees.

Manufacturers may be able to mitigate a labor supply shortage by making better use of the workers they already have on staff through cross-training. Also consider whether an apprenticeship program is right for your manufacturing business.

Finding the right fit

Survey workers to help determine which monetary, intangible and noncash components they value the most and identify gaps in your offerings. When employees believe you'll do your best to provide jobs with more responsibility and pay whenever possible, they'll do more to help your company grow and provide additional opportunities for advancement. Though your company might not have much of a career ladder to climb, few employees get excited about positions they perceive as "dead-end" jobs. Finding cost-effective benefits that your employees value will help you assemble a skilled, motivated and productive workforce to thrive as the economy moves forward. ■

The future of the supply chain is digital

As the supply chain for the manufacturing industry becomes increasingly global, it's also becoming increasingly complex. Even before the COVID-19 pandemic, many manufacturers and distributors were adopting digital solutions — particularly blockchain — to improve the visibility and traceability of raw materials and goods through the supply chain. These upgrades helped enhance transparency, security, quality and safety, and reduced the risk of fraud. Disruption of the global supply chain during the pandemic highlighted the need to gain greater control over the process.

What is blockchain?

Simply put, blockchain — the technology behind Bitcoin and other decentralized cryptocurrencies — is a distributed, shared database (or ledger). It's highly secure because it's continuously copied and synchronized among thousands of computers (called nodes) maintained by third parties.

The lack of centralized storage and control — combined with a rigorous third-party verification process — makes the ledger extremely resistant to mistakes, tampering or fraud. Transactions can't be added to the ledger until they're verified through established consensus protocols, which means that someone who wants to falsify information would have to tamper with all of the copies simultaneously.

What are the benefits?

Combined with bar codes, sensors or digital tags affixed to physical items, blockchain can be used to document and track each step in the supply chain in real time. This provides protection against fraud and counterfeiting by accurately and transparently tracking the movement of all materials and products from one party to the next throughout the process. It also gives companies the ability to identify and respond to supply chain risks and disruptions in real time.

Other potential benefits include:

Improved traceability of products and materials throughout their journey. For example, blockchain enables food manufacturers and distributors to quickly trace tainted produce back to the farm where it originated, allowing them to handle product recalls much more effectively and efficiently.

Enhanced quality control. For instance, some hospitals are using blockchain to track the temperature of COVID-19 vaccines that are required to be stored in ultra-cold conditions. Sensors monitor the temperature where vaccines are being stored or transported and transmit this data via the cloud to a blockchain network.

Looking ahead

Blockchain may not be quite ready for prime time, especially among smaller manufacturing and distribution businesses. But given the many significant benefits of this technology, it's likely to provide users with a big competitive advantage in the near future. ■

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