BDO KNOWS: **TAX REFORM**

BENEFITS & HEADACHES FOR RESTAURANTS

January 25, 2018

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Agenda

- Flow-through income impacts (income reduction and loss limitations)
- Individual income tax rates
- State & local tax payments – impact on individual pass-through entity owners
- Corporation tax rates
- Net Operating Loss calculation
- Depreciation
- Interest expense deductibility limitations
- Like-Kind Exchanges
- Tax credits
- Gift card deferral

Section 199A

Deduction for Qualified Business Income

- Prior Law
  - Owner's share of flow-through income, loss, gains and credits generated by pass-through entities (S corporations and partnerships) are reported on Schedule K-1. Individual owners report these K-1 amounts on their personal tax returns, and the amounts are taxed at individual marginal rates.
  - Sole proprietors or individual owners of single member LLCs report all business activity on their personal tax return

Section 199A: Deduction for Qualified Business Income

- New Law for Tax Years Beginning After 12/31/2017 and Before 1/1/2026
  - A new deduction of 20% of “Qualified Business Income” from a partnership, S corporation or sole proprietorship
  - Qualified Business Income (QBI) includes the net domestic business taxable income, gain, deduction and loss with respect to any qualified trade or business (excludes investment income, partnership guaranteed payments and reasonable comp paid to the owner)
  - Does not include any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services and any trade or business where the principal asset of such trade or business is the reputation or skill of one of more of its employees (architects and engineers excluded)

Section 199A: Deduction for Qualified Business Income

- New Law *(continued)*
  - QBI - limitation based on wages and capital
    - Deduction of 20% of QBI cannot exceed the greater of:
      1) 50% of the owner's share of W-2 wages paid with respect to the QBI, **OR**
      2) the sum of 25% of the owner's share of W-2 wages plus 2.5% of the unadjusted basis of qualified property, determined immediately after its acquisition of the qualified property
  - Limitation does not apply to taxpayers with taxable income not exceeding $315,000 (married filing joint filers) and $157,500 (for all other filers)

Section 199A: Deduction for Qualified Business Income

- New Law *(continued)*
  - QBI
    - If losses are incurred, the losses will be carried forward as a loss from qualified trade or business in the succeeding taxable year (reducing the QBI in future years)
    - The deduction is to be applied at the partner or shareholder level for partnerships and S corporations
    - Reduces taxable income at the individual level and not Adjusted Gross Income

Section 199A: Deduction for Qualified Business Income

Example for operating entity

- S corporation with single owner
- Restaurant net income = $2,000,000 (assume this equals QBI)
- W-2 wages = $4,000,000
- Unadjusted basis of qualified property = $11,000,000

20% of QBI = $400,000 deduction

Limited to the greater of:

- 50% of W-2 wages = $2,000,000 **OR**
- 25% of W-2 wages ($1,000,000) + 2.5% of unadjusted basis of qualified property ($275,000) = $1,275,000

Deduction for owner = $400,000 (since limits are higher than 20% of QBI)

Section 199A: Deduction for Qualified Business Income

Example for active real estate entity

- Real estate net income = $350,000 (assume this equals QBI)
- W-2 wages = $0
- Unadjusted basis of qualified property = $5,000,000

20% of QBI = $70,000

Limited to the greater of:
- 50% of W-2 wages = $0 **OR**
- 25% of W-2 wages ($0) + 2.5% of unadjusted basis of qualified property ($125,000) = $125,000

Deduction for owner = $70,000 (since limits are higher than 20% of QBI)

Limitation on Losses for Taxpayers Other Than Corporations

- Prior Law
  - Owners of pass-through entities and sole-proprietorships are permitted to deduct their share of business losses as long as they pass the basis, at-risk and passive activity loss rules. Losses allowed are permitted to offset other items of income on their personal tax returns
- New Law for Taxable Years Beginning After 12/31/2017 and Before 1/1/2026
  - “Excess business losses” are not allowed for tax years beginning after 12/31/2017 and before 1/1/2026
  - Any excess business loss that is disallowed is treated as a net operating loss (NOL) carryover to the following year
  - Passive activity losses must be applied first before this limitation (so if losses are disallowed for passive activity reasons, then this limitation is not taken into account)

Limitation on Losses for Taxpayers Other Than Corporations

- New Law *(continued)*
  - Excess business loss defined as:
    - Taxpayer's aggregate deductions for the tax year from the taxpayer's trades or businesses, determined without regard to whether or not such deductions are disallowed for the tax year under this limitation; over
    - The sum of:
      - The taxpayer's aggregate gross income or gain from the tax year from such trades or businesses, plus
      - $250,000 (adjusted annually for inflation) or 200% of the $250,000 amount in the case of a married filing joint return ($500,000)
    - Partnerships and S corporations: the limit is applied at the partner and shareholder level and not at the entity level

Limitation on Losses for Taxpayers Other Than Corporations

- New Law *(continued)*
  - Example
    - Taxpayer had $1,500,000 of gross income from his trades or businesses and $2,000,000 of deductions (not a passive activity and filing single)
    - Preliminary business loss = ($500,000)
    - His excess business loss is $2,000,000 – ($1,500,000 + $250,000) = $250,000
    - $250,000 disallowed and treated as a NOL to be carried to the next tax year
    - $250,000 is allowed as a reportable business loss

Food for Thought: Limitation on Losses for Taxpayers Other Than Corporations

- Impact
  - Limits the ability to deduct business losses against other income to the extent of the $250,000/$500,000 allowed maximum
  - Accelerated depreciation that creates losses will have less of a current year impact

Individual Income Tax Rates

- Prior Law
  - Maximum individual tax rate = **39.6%**
  - Net investment income tax rate on passive investment income = **3.8%**
- New Law for tax years 2018-2025
  - Maximum individual tax rate = **37%**
  - Net investment income tax rate on passive investment income = **3.8%**
  - Barring further legislation, pre-tax reform rates will go into effect again starting in tax year 2026

Food for Thought: Individual Income Tax Rates

- Impact
  - Reevaluate distribution policies for tax purposes to maximize cash flow (especially with tax credits maintained and QBI reductions!)
  - Maximize deductions in 2017 at higher rates

Individual Income Tax Rates

- Individual Alternative Minimum Tax (AMT) remains, but it is anticipated that less taxpayers will be subject to AMT due to the following factors:
  - Higher exemptions
  - Higher limits for when exemptions phase out
  - Lower itemized deduction for state and local income and property taxes (less of an add-back)

State & Local Tax Deduction

- Prior Law
  - Individuals are permitted a deduction for all state and local tax payments made during the year, including taxes paid on their behalf by an S corporation or partnership filing either composite taxes or non-resident withholding in non-resident states
  - Individuals are permitted to deduct payments made for personal real estate and property taxes
  - Both of these items listed are required addbacks for calculation of AMT

State & Local Tax Deduction

- New Law for Taxable Years Beginning After 12/31/2017 and Before 1/1/2026
  - Individuals are permitted a deduction for all state and local tax payments, real estate taxes and personal property taxes of $10,000 per tax year (married filing joint) or $5,000 per tax year (married filing separate)
- Impact
  - Pass-through entities doing business in multiple states where income taxes are assessed pass most of their multi-state income taxes through to the individual owners as deductions (some states still have entity level taxes that are fully deductible by the business). These state and local payments are now to be combined with the individual taxpayer's real estate and property taxes for a combined allowable deduction of $10,000

Corporate Tax Rates

- Prior Law
  - Corporations are taxed on their income at rates ranging from **15%-35%**
- New Law for 2018
  - Corporations are taxed at a flat rate of **21%**
  - Fiscal filers whose tax year straddles 12/31/17 will use a straddle computation based on both pre-tax reform graduated rates and 21%
- Impact
  - Decreased tax rate for corporations of up to **14%**

Corporate Alternative Minimum Tax

- Prior Law
  - Corporations are subject to AMT at a rate of 20%
- New Law for taxable years beginning after 12/31/2017:
  - Corporate AMT has been repealed
  - Corporations with Minimum Tax Credit carry-overs
    - Credit can offset regular tax liability
    - Credit becomes refundable in tax years 2018 – 2020 to the extent of 50% of the excess Minimum Tax Credit carryover claimed and becomes 100% refundable in 2021
  - Since corporate AMT is repealed, corporations with pre-2007 credit carryovers will be subject to a modified limitation on credit usage, with tentative minimum tax treated as “0” (same as post-2007 credits). As a result, corporate taxpayers with “old” credits may see an upswing in the amount of credits they can utilize in a given tax year.

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Net Operating Loss Deduction

- Prior Law
  - An NOL may be carried back two years and carried forward 20 years
  - An NOL can offset taxable income 100% for regular tax purposes and 90% of Alternative Minimum Taxable Income for AMT purposes (resulting in income under AMT even if NOL is larger than current year income)
- New Law for Losses Arising in Tax Years Beginning After 12/31/17
  - An NOL deduction is limited to 80% of taxable income (determined without regard to the deduction)
  - The two-year carryback provision has been eliminated so restaurants that operate as C corporations and their owners can only carry losses forward
  - Losses can be carried forward indefinitely

Cost Recovery - Bonus Depreciation

- Prior Law
  - Additional first-year depreciation deduction allowed of 50% in 2017, 40% in 2018 and 30% in 2019 on qualified property placed in service
  - Allowed for both regular and AMT
  - No limitations on the amount taken
  - Can cause a business to have a taxable loss
  - Taxpayer may elect out of bonus depreciation

- Qualification for Bonus Depreciation Under Prior Law
  - Property with a recovery period of 20 years or less (FF&E, Land Improvements, Qualified Leasehold Improvement Property)
  - Qualified Improvement Property
  - The original use of the property must commence with the taxpayer (cannot be “used”)

Cost Recovery - Bonus Depreciation

- New Law
  - Additional first-year depreciation deduction allowed of:
    - 50% for assets placed in service through 9/27/2017
    - 100% for assets acquired after 9/27/2017 and placed in service between 9/28/2017 and 12/31/2022
    - 80% in 2023; 60% in 2024; 40% in 2025; 20% in 2026
  - Allowed for both regular and AMT
  - No limitations on the amount taken
  - Can cause a business to have a taxable loss
  - Taxpayer may elect out of bonus depreciation

Cost Recovery - Bonus Depreciation

- Qualification for Bonus Depreciation Under New Law
  - Property with a recovery period of 20 years or less
  - Includes qualified improvement property (if technical correction issued)
  - Property can be new or used at the time of acquisition
- Impact
  - Large percentage of remodeling expenses can be 100% deductible in the year placed in service (exceptions would be exterior improvements) – larger if technical correction to qualified improvement property is issued
  - Acquisition of short-life assets from another restaurant/franchisee eligible for 100% (fight for more short-life assets in a purchase price allocation!)
  - Cost segregation more valuable than ever: 100% of assets moved to a 5-, 7- or 15-year life would be eligible for 100% bonus depreciation

Cost Recovery - Real Property

- Prior Law
  - Non-residential real property is depreciated over a 15- or 39-year life
  - 15-year life for qualified restaurant property and qualified leasehold improvement property
  - 15- or 39-year life (and bonus depreciation) for qualified improvement property
  - Qualified restaurant property and qualified leasehold improvement property were eligible for Section 179 depreciation (if election made on tax return)

Cost Recovery - Real Property

- New Law for Assets Acquired and Placed in Service After 12/31/2017
  - Qualified restaurant property and qualified leasehold improvement property definitions have been eliminated
  - Qualified improvement property remains and is given a 15-year life**
  - Qualified improvement property is eligible for Section 179 (if election made on tax return) and bonus depreciation**
  - Non-residential real property not meeting the definition of qualified improvement property is given a 39-year recovery period
- Impact
  - More restaurant buildings will be depreciated over a 39-year life instead of a 15-year life
  - Cost segregation becomes more valuable by moving 39-year assets to a 5-, 7- and 15-year life

**if technical correction made

Cost Recovery - Section 179

- Prior Law
  - Taxpayer can elect to expense the cost of qualifying property subject to limitations
  - Maximum $500,000 of qualifying property in service for the taxable year (indexed for inflation: $510,000 in 2017)
  - The $500,000 is reduced (but not below zero) dollar for dollar by the amount by which the cost of qualifying property placed in service during the year exceeds $2,000,000 (indexed for inflation: $2,030,000 in 2017)
  - Assets included are tangible personal property (FF&E) & off-the-shelf computer software

Cost Recovery - Section 179

- Prior Law
  - Certain real property can be included by filing an election with the tax return (real property is not included in the $510,000 or $2,030,000 limitations unless the election is filed). Real property eligible includes qualified leasehold improvements and qualified restaurant property
  - Limited to active trade or business assets (i.e., rental property assets are not eligible)
  - Deduction limited each year to taxable income limitations

Cost Recovery - Section 179

- New Law for Taxable Years Beginning After 2017
  - Increases the maximum amount a taxpayer may expense up to $1,000,000
  - Increases the phase-out threshold amount to $2,500,000
  - Includes qualified real property (if elected) to include:
    - Qualified improvement property (covers interior improvements to existing buildings)
    - Certain exterior improvements to existing buildings including roofs, HVAC, fire protection, alarm & security systems

Food for Thought: Cost Recovery – Section 179

- Impact
  - Larger depreciation deductions for companies able to use Section 179 (and bonus depreciation)
  - Restaurants previously could include qualified restaurant property as Section 179 property – now limited to qualified improvement property and limited exterior improvements only
  - Evaluating use of Section 179 vs bonus depreciation

Interest Expense

- Prior Law
  - Interest paid or accrued by a business generally is deductible in calculating taxable income (limitations and adjustments for original issue discount (OID) and investment interest will not be addressed)

- New Law for Taxable Years Beginning After 12/31/2017
  - Deduction for business interest expense is limited to the sum of (1) business interest income; (2) 30% of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year
  - Disallowed interest expense during the tax year is carried forward indefinitely
  - Floor plan financing is defined as indebtedness used to finance the acquisition or lease of motor vehicles and boats held for sale to retail customers and secured by the inventory acquired

Interest Expense

- New Law for Taxable Years Beginning After 12/31/2017
  - Deduction for business interest expense is limited to the sum of (1) business interest income; (2) 30% of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year
  - Business interest expense is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include Investment Interest
  - Adjusted taxable income is defined as taxable income computed without regard to:
    - Any item of income, gain, deduction or loss which is not properly allocable to a trade or business
    - Any business interest expense or business interest income
    - Net operating losses
    - Deductions for depreciation, amortization or depletion (this line is only applicable for tax years beginning after 12/31/2017 and before 1/1/2022)

Interest Expense

- New Law for Taxable Years Beginning After 12/31/2017
  - Limitation on deductibility not applicable to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million
  - Does not apply to rental property activity if not considered a trade or business. If rental is a trade or business, then the taxpayer can elect out of the interest rules which then subject the rental activity to different methods of depreciation.

Food for Thought: Interest Expense

- Impact
  - Taxpayers who are using debt to fund new restaurant openings and incurring significant start-up expenses could find themselves deferring the interest expense deduction as a result of lower taxable income
  - Many taxpayers taking advantage of bonus depreciation in 2022 and forward will most likely be limited on their ability to deduct interest expense in years of large depreciation deductions
  - Existing capital/debt structures are not grandfathered into the new rules so highly leveraged companies without substantial depreciation deductions are likely to have higher tax obligations

Like-Kind Exchanges

- Prior Law
  - No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" which is to be held for productive use in a trade or business or for investment
  - Used for tangible personal property (autos or restaurant equipment, for example) and real property
- New Law for Exchanges Completed After 12/31/17
  - Non-recognition of gain for a like-kind exchange is limited to real property only

Work Opportunity Tax Credit

- Prior Law
  - Tax credit available for employers hiring individuals from one or more of 10 targeted groups of employees
  - Credit is based on the amount of qualified wages earned by employees in their first two years of employment
  - Credit is available for employees hired prior to 1/1/20
- New Law
  - NO CHANGE!

FICA Tip Credit

- Prior Law
  - Tax credit available for employers to reimburse them for the social security and Medicare taxes paid on employee reported tips over $5.15 per hour
- New Law
  - NO CHANGE!

Advance Payments, Including Gift Cards

- Prior Law
  - Under GAAP, restaurants can defer recognizing the revenue from gift card sales until the year the card is redeemed. This can lead to an indefinite deferral for GAAP
  - In contrast, tax is limited to a 1-year deferral under Revenue Procedure 2004-34 or a 2-year deferral under Regulation 1.451-5
    - 1-year deferral under Revenue Procedure 2004-34 applies to situations where the taxpayer selling the gift cards is not necessarily the same taxpayer that redeems the cards (i.e., gift cards for franchise groups, where the card can be bought and redeemed at any store within the brand).
    - 2-year deferral under Regulation 1.451-5 applies to situations where the taxpayer selling the gift cards satisfies the meal with goods it has on hand (i.e., the same taxpayer that sells the card redeems the card).

Advance Payments, Including Gift Cards

- New Law
  - The Tax Act codifies the 1-year deferral provided by Revenue Procedure 2004-34, and it is intended that this codification overrides the opportunity to use the 2-year deferral found in Regulation 1.451-5
  - IRS guidance is needed to further refine and clarify what is meant by the override of the 2-year deferral, including the effective date of such an override

Example

Assume a franchisee operates 5 stores which each generate $100,000 in taxable income. At a high level, how would the pass-through entity deduction and the change in the income tax rates impact the tax due?

	2017	_	2018
Taxable Income Per Store	$100,000		$100,000
Number of Stores	5		5
Total Taxable Income	$500,000		$500,000
Less: New 199A Deduction	-		$100,000
Adjusted Taxable Income	$500,000		$400,000
Highest Individual Tax Rate	39.6%		37.0%
Tax	$198,000		$148,000

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