HIGHLIGHTS OF THE NEW TAX REFORM LEGISLATION FOR RESTAURANT OWNERS

Whether or not you believe the new tax legislation *Tax Cuts and Jobs Act* ("TCJA") signed by the President on December 22, 2017 will "Make America Great Again," it is now the law of the land. The TCJA has been touted as the most far-reaching piece of tax legislation enacted in over 30 years and there are volumes of provisions that impact U.S. individuals, trusts, estates, businesses, tax-exempt organizations and foreign investments. This includes reduced tax rates for individuals, corporations and private businesses, 100% CapEx expensing, limitations on business interest expense and the individual state income tax deduction, among many other enhancements and limitations. Despite a few downsides, the private restaurant owner may be well positioned to reap the benefits of the TCJA. This article highlights a few of the TCJA business provisions that have the broadest impact to the restaurant industry and private restaurant owners.

THE GOOD NEWS

INDIVIDUAL TAX RATES

The majority of private restaurant businesses are organized in passthrough tax structures thus allowing the restaurant's business income to be taxed at the owner level. Absent ownership through a trust or corporation, which is not a focus of this article, the relevant individual tax rates will apply. For calendar tax years 2018 through 2025, seven temporary tax rates apply for individuals: 10%, 12%, 22%, 24%, 32%, 35% and 37% as follows:

Ordinary Income Tax Rate Table for 2018[1]

Tax Bracket	Taxable Income Single		Taxable Income Married Filing Jointly	
10%	$ -	$ 9,525	$ -	$ 19,050
12%	$ 9,526	$ 38,700	$ 19,051	$ 77,400
22%	$ 38,701	$ 82,500	$ 77,401	$ 165,000
24%	$ 82,501	$ 157,500	$ 165,001	$ 315,000
32%	$ 157,501	$ 200,000	$ 315,001	$ 400,000
35%	$ 200,001	$ 500,000	$ 400,001	$ 600,000
37%	$ 500,001	+	$ 600,001	+

[1] Exclusive of 3.8% Net Investment Income Tax on investment income

The top tax rate of 37% was decreased from 39.6%. The tax treatment of capital gains and qualified dividends remains unchanged.

PAYROLL TAXES

As a result of the changes to individual tax rates coupled with an increased individual standard deduction through the year 2025, the federal income tax withholding tables and resulting calculations will change. This means your payroll system will need to be updated. The IRS issued Notice 1036 updating withholding tables but is encouraging employers and payroll services to utilize the 2017 withholding tables until the IRS systems can be updated. The IRS noted that the updated tables should be implemented no later than February 15, 2018. However, this may be delayed if there is another government "shutdown" come February 8th.

20% DEDUCTION OF PASSTHROUGH BUSINESS INCOME

Generally for tax years 2018 through 2025, the TCJA adds a new deduction under which a non-corporate taxpayer[1] will be allowed a 20% deduction for U.S. qualifying income from a partnership, S corporation, or sole proprietorship[2]. Foreign income and net capital gains will not count. The deduction is calculated as the lessor of:

(a) The "combined qualified business income amount" of the taxpayer, or
(b) 20% of the excess, if any, of the taxable income of the taxpayer over the net capital gains of the taxpayer.

Since the deduction is limited to 20% of taxable income, it cannot create a net operating loss for a taxpayer. With the new individual top tax rate of 37%, the 20% deduction on passthrough business income could result in an effective maximum income tax rate of 29.6% on such income.

Definitions

The "combined qualified business income amount" means, for any tax year, an amount equal to the deductible amount for each qualified trade or business of the taxpayer (defined as 20% of the taxpayer's Qualified Business Income ("QBI") subject to the W-2 wage limit; see below)[3].

QBI is generally defined as the net amount of "qualified items of income, gain, deduction and loss" relating to any qualified trade or business of the taxpayer. For this purpose, "qualified items of income, gain, deduction and loss" are items of income, gain, deduction and loss to the

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[1] Individual, Trust or Estate

[2] Qualified REIT income is not discussed here and is outside the scope of this article.

[3] If applicable, the combined qualified business income amount also includes 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

extent these items are effectively connected with the conduct of a trade or business within the U.S.[4] and included or allowed in determining taxable income for the year. If the net amount of "qualified income, gain, deduction and loss" relating to qualified trade or businesses of the taxpayer for any tax year is less than zero, the amount is treated as a loss from a qualified trade or business in the succeeding tax year.

QBI does not include: certain investment items; reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business; any guaranteed payment to a partner for services to the business; or a payment to a partner for services rendered with respect to the trade or business.

The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income.

Limitations

Except as provided below, the deduction cannot exceed the greater of:

(1) 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit"), or

(2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property." Qualified property generally means tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year.

With restaurant labor costs commonly encompassing a significant percentage of sales, it is projected many restauranteurs will observe their deduction is not limited by the 50% of W-2 wages. Notwithstanding a labor intensive restaurant enterprise, businesses with large real estate holdings but few actual employees, will benefit from the latter limitation test using 2.5% of tangible depreciable property.

The above limit does not apply for taxpayers with taxable income below the "threshold amount" ($315,000 for married individuals filing jointly, $157,500 for other individuals, indexed for inflation after 2018). The application of the limit is phased in for individuals with taxable income

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[4] Pursuant to IRC Sec. 864(c)

exceeding the threshold amount, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals). Thus, for 2018, the limit fully applies to married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

For a partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year. A partner's or shareholder's allocable share of W-2 wages is determined in the same way as the partner's or shareholder's allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro-rata share of an item.

Limitations for service businesses

Except as provided below, the deduction does not apply to specified service businesses (i.e., trades or businesses involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill of one or more of its owners or employees (excluding engineering and architecture), or any business that involves the performance of services that consist investment and investment managing trading or dealing in securities, partnership interest or commodities). However, the disallowance of the deduction for specified service trades or businesses of the taxpayer does not apply for taxpayers with income below the threshold amount described above. And, the benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). Thus, for 2018, the limit fully applies to married taxpayers with taxable income over $415,000 and other individuals with taxable income over $207,500.

The deduction does not apply to the trade or business of being an employee.

The application of the 20% QBI deduction is complex and will be unique to each business owner. Many questions about the new provision and its application are still unanswered. To avoid an unexpected 2018 tax outcome from over-enthusiastically applying this new provision, it is advised that restaurant business owners perform income tax projections and plan to “stress test” any limitation that may be imposed on this deduction and its impact to your effective tax rate.

<u>100% EXPENSING OF CAPEX</u>

Increased Code Sec. 179 expensing

For property placed in service after Dec. 31, 2017, the Sec. 179 expensing limitation is increased to $1 million, and the property investment threshold/phase-out amount is increased to $2.5 million. For tax years after 2018, these amounts (as well as the $25,000 sport utility vehicle limitation) are indexed for inflation.

Additionally, the TCJA expands the definition of Sec. 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging and also, improvements to nonresidential real property[5]: roofs; heating, ventilation and air-conditioning property; fire protection and alarm systems; and security systems.

Temporary 100% cost recovery of qualifying business assets.

A 100% "bonus" first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The additional first-year depreciation deduction is allowed for new and used property. Thus, the "original use" requirement of the prior law "bonus" depreciation is eliminated. Instead, property qualifies under this provision as long as the property was not used by the taxpayer prior to the time of acquisition.

The term "qualified property" is generally defined as property which has a tax recovery period of 20 years or less. This easily encompasses personal property equipment, machinery and furniture items. However, it also is expected to include Qualified Improvement Property[6], which is any improvement to an interior portion of a building, if such improvement is placed in service after the date such building was first placed in service. It does not include any improvement related to the enlargement of the building, any elevator or escalator or the internal structural framework of the building.

The TCJA eliminates the separate definitions (and special 15-year recovery periods) for "qualified leasehold improvement property," "qualified restaurant property" and "qualified retail improvement property." Under prior law, qualified restaurant property was not eligible for 50% bonus depreciation but was provided a 15-year recovery period and included the entire restaurant building and real estate improvements. Since the TCJA tentatively limits the 15-year recovery period only to restaurant property that meets the definition of qualified improvement property, a large portion of a restaurant building and building improvements will be required to be depreciated as non-residential real property over a 39-year recovery period.

[5] After the date such property was first placed in service

[6] The Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466) sets a 15-year recovery period for qualified improvement property. However, the text of the final bill omits the provision which would have given a 15-year recovery period for qualified improvement property. A technical correction will be needed to create a 15-year recovery period for qualified improvement property.

Under pre-TCJA bonus depreciation law, a taxpayer if desired, may elect 50% in lieu of 100% expensing for qualified property placed in service during the first tax year ending after Sept. 27, 2017. That would be December 31, 2017 for calendar year taxpayers. Also, an election out of the application of 50% and/or 100% bonus depreciation is available.

The 100% expensing tax break should not be confused with expensing under Sec. 179, which is subject to separate rules.

After the tax year 2022, the first-year 100% bonus depreciation deduction phases down, as follows:

- 80% deduction for property placed in service after Dec. 31, 2022 and before Jan. 1, 2024.
- 60% deduction for property placed in service after Dec. 31, 2023 and before Jan. 1, 2025.
- 40% deduction for property placed in service after Dec. 31, 2024 and before Jan. 1, 2026.
- 20% deduction for property placed in service after Dec. 31, 2025 and before Jan. 1, 2027.

First-year bonus depreciation sunsets after 2026.

As a result of this new law and the potentially significant time value benefits of 100% bonus depreciation, buyers acquiring restaurants will have an incentive to allocate as much purchase price as possible to tangible, depreciable property eligible for 100% bonus depreciation. Additionally, owners constructing new restaurants or leasehold buildouts may now give cost segregation studies more attention to identify personal property and interior non-structural improvement items.

SIMPLIFIED ACCOUNTING

For tax years beginning after 2017, restaurant businesses with less than $25 million in annual sales are generally no longer required to capitalize and include certain kitchen labor and similar expenses in inventory costs. Prior law mandated producers or re-sellers to capitalize direct and indirect costs incurred with respect to the production activity. Restaurants are considered producers, the activity of processing and combining ingredients for sale to customers is generally considered a production activity. Adoption of the TCJA provision is a change in the taxpayer's accounting method and will likely require the taxpayer request and apply for an accounting method change.

TIP CREDIT AND WOTC

For the avoidance of doubt, the Federal “FICA Tip Credit”, for employer’s social security tax paid on employee tips, and the Work Opportunity Tax Credit (“WOTC”) for wages paid to persons in certain targeted/eligible groups, were spared by lawmakers and remain intact. Originally proposed to be repealed, they were not included in the final bill. Note that the WOTC is scheduled to terminate with respect to persons who begin work for the employer after December 31, 2019.

CORPORATE TAX RATES

One item certainly receiving a lot of attention, but that perhaps arguably may have the least impact to the private restaurant owner, is the TCJA’s permanent replacement and reduction of the corporate tax rates to a flat 21%. Corporate alternative minimum tax is also repealed. This is certainly a win for the corporate taxpayer and may provide other tax planning and structuring opportunities for private equity investors in the restaurant industry. However, most restaurant businesses organized in passthrough structures will continue to have an overall income tax rate advantage over their C corporation counterparts.

SOME BAD NEWS

INTEREST EXPENSE LIMITATION

Limitation

For tax years beginning after Dec. 31, 2017, every business that is not exempt is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance is determined at the tax filer level. However, for sole proprietorships, S corporations and partnerships/LLCs, the disallowance is required to be determined at the entity level. This could mean a large highly leveraged restaurant business that perhaps lacks healthy unit economics and/or incurs disproportionate overhead expenses, may face a haircut on its interest expense deduction.

For tax years 2018 through 2021, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization or depletion. For passthrough businesses, this is essentially EBITDA until 2022. After 2021, adjusted taxable income will include deductions for depreciation, amortization and depletion, further decreasing taxable income from which to apply the 30% limitation.

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions outside the scope of this article.

Exemption for Small Businesses

An exemption from these rules applies for certain taxpayers with average annual gross receipts for the prior three tax years that do not exceed $25 million. So, small highly leveraged restaurant business need not concern about the interest expense deduction limitation.

80% LIMITATION ON NET OPERATING LOSSES; CARRYBACKS ELIMINATED

For tax years beginning after 2017, The TCJA limits the Net Operating Loss ("NOL") deduction to 80% of taxable income. This is effective only for losses arising in taxable years beginning after December 31, 2017. Unused NOL carryovers to future years can be carried forward indefinitely. NOL Carryback claims are eliminated for losses arising in taxable years beginning after December 31, 2017. Note that a restaurant business owner with a large CapEx budget or with new location openings could potentially face a net taxable business loss from the 100% first year bonus depreciation deduction. Prior to claiming the full deduction, tax planning for business losses and the 80% limitation on the carryforward should be considered.

NEW LIMITS ON MEALS AND ENTERTAINMENT

Entertainment

The TCJA repeals deductions for entertainment, amusement and recreation expenses that are directly related to the conduct of a taxpayer's trade or business. Specifically, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Under prior law, 50% of expenses associated with, or directly related to, entertaining a person(s) directly related to a taxpayer's trade or business were deductible.

Meals

Taxpayers will still generally deduct 50% of the food and beverage expenses associated with operating their trade or business. However, for amounts incurred and paid after December 31, 2017, and until December 31, 2025, the 50% limitation is expanded to apply to expenses of the employer associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through

an employer-operated facility that meets certain requirements. Such amounts paid or incurred after December 31, 2025 then become non-deductible.

SEEK PROFESSIONAL ADVICE

At this point in time, certain provisions of the TCJA beg more questions than answers. Technical corrections to the law and guidance in the form of Regulations are expected to address some of these matters. Seek professional advice from your tax advisor. Be patient but deliberate with your tax planning. Each restaurant business and the tax posture of its owner(s) is unique. The tax impact under the TCJA depends on a myriad of factors including the business entity type, ownership and capitalization structure, as well as the operating business economics.

For more information regarding the TCJA's impact on restaurant owners and franchisees, please contact Bennett Thrasher Partner Cory Bennett or Tim Watt by calling 770.396.2200.