RESTAURANT FINANCE MONITOR®

Volume 29, Number 10 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

October 19, 2018

What We Have Learned About The New Tax Law That We Can Use In A Creative Structure

The tax law, passed almost a year ago, isn't so new anymore. Let's take what we've learned over that time and apply it to ideas for structuring your restaurant business.

1. The Lower Tax Rate for C Corporations. We don't want to get overly enamored with the lower C corporation tax rates, but they are very beneficial for accumulating money, particularly if you have large debt service. However, C corporations still present the issue of double taxation when money is taken out of the corporation. By using a C corporation, you also may not be utilizing the new depreciation rule to its fullest extent. Therefore, consider using multiple different forms of entities. For example, use a C corporation for an operating company that's highly leveraged and has significant debt service. The payment of principal, which will be in the form of after-tax dollars, will then be at the lower 21% rate (note: state taxes will still apply but will be deductible). In conjunction with the C corporation, use related non C corporation flow through entities to hold real estate and maybe even some fixed assets (with depreciation and flow-through tax advantages) as leasing entities to the operating entity. This may be a way to get money out of the C corporation in the form of rent, in lieu of dividends, to take full advantage of depreciation at individual income tax rates, and, in the long run, to minimize double taxation. You might also consider making the C corporation a fiscal year so that there is some ability to shift income between different forms of entities that have different taxable year-ends.

Another structure that is very common involves use of a management company for both non-tax and tax reasons. While this structure may complicate the calculation of the 20% flow through deduction, it offers the opportunity to employ your store management team in a separate entity and the ability to draw management fee payments from the C corporation. The management company, as a flow-through entity, will need to pay reasonable salaries, but the owners can get the benefit of avoiding double taxation on dividends, and may be able to get the benefit of the flow-through deduction, which is equal to 20% of the flow-through income (subject to the required calculations and limitations).

Another technique in using multiple entities is what I'll call an "intellectual property entity", again, for both non-tax and tax reasons. The intellectual property entity is used to hold certain intellectual property – or even franchise rights, if your franchisor will allow it, and then charges a license fee to the operating entity. In most cases, you'll want to use a flow-through entity for this intellectual property entity. In the end, it may still be the best option to not worry about shifting income to other entities, and leave the money in the C corporation to accumulate at the new lower tax rate. You can pay your principal payments at a lower rate and then make investments at that level, always keeping in mind that there may be potential for accumulated earnings tax. Make sure to plan to structure any eventual sale in a manner to avoid double taxation.

2. The Income Deduction For Flow-through Entities. Setting aside the advantages of the C corporation and using just a flow-through entity means you have to be very mindful of the new rules. Since there are various limitations on the calculation of the flow-through deduction, which may impact factors such as payroll and maximizing depreciation in that entity, it may also make sense to use separate entities, even outside of the C corporation structure. As with any flow through entity, the tax rules governing passive and active activities may still apply. There is a significant amount of planning to be done for flow-through entities, particularly if there are multiple entities.

3. The Favorable Depreciation Rules. The new depreciation rules introduce a need for some new planning and analysis, including the potential for being less aggressive with your depreciation rates. This, in conjunction with the lower C corporation tax rate may create a better long-term strategy. In almost all cases, cost segregation on real estate should still be done to provide the option of the faster depreciation on furniture, fixture and equipment. Whichever option you choose on depreciation, keep in mind the 20% deduction for income from flow-through entities. That is something that's very valuable because it does, in effect, lower your tax rate. Depreciation is often money in the bank that can be used in the future. Finally, don't forget that there are significant differences between federal and state depreciation rates, so pay attention to the latter as you plan.

4. Like-kind Exchange. Under the new rules, like-kind exchanges only apply to real estate and no longer are available for equipment. In the past, like-kind exchange could be instrumental in the trading in old equipment for new equipment, or if franchise rights were sold in order to invest in new franchise rights. That's not the case, which may make equipment leasing more favorable, since there is no gain on the disposition. If it's a true lease, it's simply terminated, and when you acquire a new piece of equipment, you enter into a new lease with a deduction for the rentals.

Summary. Use of multiple entities have been common in the restaurant industry and under the new tax law will continue to be a key tool. The use of different entities, in addition to potentially placing stores in separate entities, will involve tax planning to uncover the advantages that may lie in setting apart operations, intellectual property, management, real estate, and other assets. In addition, don't get enamored with depreciation: the lower tax rates may mitigate some of the advantage of the accelerated depreciation. Since individual situations differ, depreciation planning will require case-by-case analysis.

Thanks for the help from Rick Gibson of Monroe Moxness Berg and Jeff Eischeid and Tim Watt of Bennett Thrasher LLP.

—Dennis Monroe