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Tax Reform and Tax Planning for Restaurant Operators

The tax reform legislation is teeming with new rules, but I'd like to focus on how the new law affects the restaurant industry and how operators should respond to the changes. Along the way, I try to suggest some issues to consider as you go about your tax plans. I am grateful to Jeff Tubaugh from BDO USA and to my colleague Brian Tunis from Monroe Moxness Berg for their invaluable insights in assembling these recommendations.

Cost recovery—bonus depreciation

Bonus depreciation has been enhanced to allow for depreciation of 100% of the cost of certain eligible assets in the first tax year they are placed into service. This change is for a limited time, starting September 27, 2017 through December 31, 2022.

Bonus depreciation now is also available for used assets. So, if you're buying an existing restaurant, as long as the assets have a useful life of 20 years or less, they will qualify for bonus depreciation. If you're doing any remodeling during the years when the 100% bonus is in place, a large percentage of your costs will qualify for bonus depreciation—a huge benefit to restaurants making improvements or buying new equipment. Also remember we still have the Section 179 deduction which applies specifically to outside improvements.

Limitations on losses

Until now, owners of pass-through entities and sole-proprietorships were permitted to deduct their share of business losses as long as they passed certain loss tests. Losses allowed were permitted to offset other items of income on their personal tax returns. This has been especially helpful to owners of early stage restaurant businesses.

Under the new act, "excess business losses" (determined through specific calculations) are not allowed for tax years beginning after 12/31/2017 and before 1/1/2026, and any excess business loss that is disallowed is treated as a net operating loss carrying over to the following year.

If you are in the growth mode, you have a lot of opportunities to create depreciation deductions which may result in losses. Make sure these losses are fully utilizable and also, as we discuss in the next section, you may want to think differently about losses in light of the pass-through deduction.

Twenty percent pass-through deduction

Starting in 2018, all taxpayers earning less than $157,000 (or $315,000 for married taxpayers) can deduct 20% (the maximum deduction) of income from pass-through businesses. Taxpayers above these thresholds must meet certain tests to determine how much of the deduction they can take. Their deduction for each business is limited by the qualified business income ("QBI") of the business, the W-2 wages paid with respect to the business, and/or the basis of property purchased for use in business.

Using the pass-through deduction makes a lot of sense for taxpayers under the income threshold. Those above have more planning to do to get the maximum possible deduction. For example, operators who hold separate restaurants in different pass-through entities may consider consolidation of such entities in order to increase the amount of W-2 wages paid. They may also consider shifting more of their income away from wages towards 1099 income or distributions in order to increase QBI and thereby the deduction (which may however carry risk of IRS scrutiny).

Incidentally, another benefit of consolidating entities is if you open a new store and set it up as a subsidiary entity within a holding company structure, you can usually expense your start-up costs versus capitalizing and amortizing.

Interest expense limitation

Restaurants are known for their high leverage and significant interest expense. Make sure you don't run afoul of the new interest expense limitations which, simply stated, is 30% of EBITDA.

Using management companies

Using a C-corporation as a management company and thus shifting income from operating companies could help you take advantage of the significantly lowered corporate tax. Another technique for shifting income and playing in this rate-sensitive environment, particularly in the case of proprietary restaurant chains, is to place your intellectual property in a separate entity, allowing for a reasonable charge for royalty payments.

Estate and gift tax: gifting now or later?

The estate and gift tax exemption amount was raised to $11.2 million ($22.4 million for married taxpayers) for 2018. In the past, operators who were affected would try and remove appreciation from their estates by using techniques like gifts, favorable sales and value-freezing techniques. Now, depending on state law, they may want to rethink making these kinds of transfers.

How can franchisors use cash basis?

Corporations (or partnerships with corporate partners) are now allowed to use the cash method of accounting if their gross receipts do not exceed $25 million (increased from $5 million). In most cases this won't make much of a difference to restaurant owners, who already operate in a cash-basis environment. However, for a smaller franchisor whose gross receipts do not exceed the new limit, we think that a switch to cash basis might be beneficial. In that scenario, some of the royalties that have been accrued but not paid may get a tax advantage—assuming there are no issues with deferred revenue.

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