RESTAURANT FINANCE MONITOR®

Volume 29, Number 3 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

March 16, 2018

Real Estate and the New Tax Law: Great Opportunities Abound

By Dennis Monroe

One of the biggest winners under the new tax law is real estate, particularly restaurant real estate. Purchasing sites, making improvements, entering into sale-leasebacks, making renovations and remodels are all constant themes in our industry and stand to benefit under the new tax law.

Let's look at some opportunities in restaurant real estate sites. I'm grateful to Pat Weller and Jeff Shea from our firm's commercial real estate practice for their insights:

Leasing Real Estate—If you are a tenant, rather than having a leasehold allowance and having the landlord do the work, consider doing the leasehold improvements yourself and at your expense. Although this may seem counterintuitive, such an arrangement will allow your operating entity to write off almost all the cost of interior leasehold improvements as bonus depreciation, but beware of this caveat: the tax authorities may soon change this. Additionally, under Section 179, you will likely be able to expense the cost of most exterior improvements. Both provisions make it attractive to actually complete and pay for improvements yourself.

Obviously there are other considerations, including the issues of financing and cash flow, however, given the change to the tax laws, if you pay for the leasehold improvements yourself and at your cost, your rent should be lower, and your operating company should be able to expense these costs immediately.

Owning Real Estate—Operators should take full advantage of the increases in available depreciation under Section 179, as well as additional areas for bonus depreciation. Because of the advantageous depreciation of eligible improvements, an owner/operator will want to allocate as many of the elements of their building as qualify for bonus depreciation under Section 179. To ensure maximum benefits, a quality cost segregation analysis of the real estate is more important than ever. In addition, it is important to structure ownership of restaurant real estate as a trade or a business in order to take advantage of these favorable tax treatments and avoid passive real estate loss rules.

Like-Kind Exchanges—Like-kind exchanges are still allowed for real property, but no longer available for personal property such as furniture, fixtures, equipment or intellectual property such as trademarks or goodwill. This will have a large impact on sellers of restaurant property. Consider a typical sale of a restaurant:

In addition to the land and building, most operators will sell fixtures, furniture and equipment, franchise rights and possibly goodwill. Because these non-real property assets no longer qualify for like-kind exchange treatment, any gain on the sale will be taxed. Therefore, when you are selling a business and want to maximize like-kind treatment, keep as much allocated to the sale of land and building as possible. A sale involving multiple asset types requires a clear allocation to each separate asset type.

Sale/Leasebacks—Nothing has changed regarding sale/leasebacks under the new tax law. Still, there is a strategy to consider if you are planning to use a sale/leaseback as a financing vehicle, and there are more proceeds from the sale/leaseback than your depreciated basis or, in the case of an acquisition, your cost.

It may be advantageous to try and escrow the overage with the sale/leaseback buyer rather than taking the same as cash. If you escrow the overage and use it for improvements in the future, such as remodels and renovations, the funds will not be taxed as a gain. Rather, they can be invested in updates and other high performing assets at your restaurant facility. By setting up an escrow structure as discussed above, you will create an effective financing vehicle with favorable tax treatment.

For example, let's look at a transaction where a buyer purchases a business for $1.5 million, and the seller and buyer allocate $1 million to the real estate and $500,000 to the business assets. If the buyer can do a sale/leaseback for $1.2 million on the real estate, the buyer has a theoretical gain of $200,000. The key here, particularly if the buyer knows that improvements will need to be made to the real estate in the future, is to put that money into escrow under the control of the buyer of the real estate to avoid that gain.

Remodels and Franchisors—A number of franchisors have indicated the new tax law will create an incentive for their franchisees to invest in technology upgades, perform remodels and buy new equipment. This may be so, however, with corporate tax rates lower and the current 20% deduction/credit for flow-through income, franchisees may not be able to achieve the tax advantages their franchisors envision. The true value of the changes in the tax law to a franchisee must be carefully considered on a case-by-case basis.

In addition, franchisees will not receive these benefits until they file their tax returns, and then they will only see the benefits if they paid a substantial amount of tax. As such, the favorable depreciation benefits may have limited value to the franchisee. So while franchisors are touting the idea of doing improvements, franchisees need to approach the subject carefully.

Real estate is still—and will always be—a critical part of the restaurant industry. It also presents all kinds of interesting opportunities under the new tax law. Make sure you take this into account as you structure your operations going forward.