The Main Dish

Winter 2018

New tax law impact on restaurants/hospitality
By Bradley S. Dimond, CPA

Ho hum, not much to talk about...NOT! The press has been calling the new tax law "tax reform" but I like to think of it as "tax complification." In other words, for a great deal of taxpayers – mostly business employees – things will be much simpler. But for employers/small business owners, things will be more complicated. As with any tax legislation, there are winners and losers. While some readers might fall into the "loser" category, I believe that overall, you might be winners. If you want to skip the gory details, we still have generous rules to depreciate/expense capital items (new equipment, leasehold improvements, etc.), the industry-specific FICA Tip Credit as well as the Work Opportunity Tax Credit. In addition, for those that operate legally as "pass-throughs," there is a 20% deduction for "pass-through" income. For those that don't (i.e. C corporations) the income tax rate is lowered to 21% (down from 35%). About those gory details...

Individuals

Tax rates. They're going down for the most part, although for certain income levels, your rates might actually increase a bit (for higher earners not quite in the top bracket).

Standard deduction. This is basically getting doubled but see below, as many "itemized deductions" go away or are limited. This means that many workers (your employees mentioned above) might have simpler returns with larger standard deductions and will no longer be able to take itemized deductions.

Personal exemption + child tax credit. Personal and dependent exemptions go away, but the child credit is raised to $2,000 ($1,400 of which is refundable if you are not in a taxpaying position). In addition, the credit phases out at a much higher level ($400,000 for joint filers) than previously ($110,000).

Itemized deductions. State and local taxes have been one of the most discussed items and will be limited to $10,000, which covers both income taxes and real estate taxes...just be thankful you don't live in NY or CA. State and local taxes paid as business expenses (i.e. sales tax and property tax), however, remain deductible, for example, on Schedule C, E or elsewhere.

Medical expenses in excess of 7.5% of Adjusted Gross Income (AGI) are still deductible for 2017 and 2018; in 2019 the limit goes to 10% of AGI.

Mortgage interest is still deductible, but for new home purchases, you will be limited to $750,000 of mortgage debt. If you already purchased a home, you are grandfathered at the current limitation amount which, essentially, is $1.1 million. Home equity indebtedness (think cash out refinancing) will no longer be deductible.

Charitable deductions are still allowed but since less people will be itemizing, charitable organizations may stand to lose. Many advisers are suggesting that folks bunch charitable deductions into one year to get the benefit of itemizing every few years. Expect an increase in the use of donor-advised funds. The limit with respect to cash charitable deductions is increased from 50% to 60% of AGI.

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Most other itemized deductions go away…miscellaneous itemized deductions such as investment advisor fees, unreimbursed employee business expenses and tax preparation fees (Ouch!). Finally, the new law repeals the "Pease Limitation," whereby itemized deductions phased out over certain income levels (this is a good thing for people that itemize and make a lot of money).

Active loss limitation. This is not a highly publicized new item but potentially impactful for operators that are starting new stores/concepts or expanding. You will no longer be able to deduct losses on active businesses in excess of $500,000 against your other income. Any losses unused due to the limitation would become part of a net operating loss ("NOL") carryforward.

Businesses

A few general observations before specifics. The reduction in C corporation rates to 21%, the elimination of corporate AMT and the retention of other benefits (tip credit) has prompted many questions about converting from "pass-through" format to C corporations. Although in certain specific circumstances it might make sense, I would hesitate to jump to C corporation format for a few reasons. First, C corporations are still "double taxed." That is the C corporation pays tax on its income, albeit at a low 21% rate, but the shareholders pay tax on dividends from a C corporation at a 15% or 20% rate, most likely. Therefore, the combined rate on pulling money out of a C corporation is still higher than the individual rate on pass-through income (more on that in a minute). Don't forget, paying yourself a higher salary is not efficient because your salary is still taxed at the highest rates, albeit somewhat lower than under the prior law.

Pass-throughs. A new deduction for pass-through income is created under Code Section 199A (otherwise known as the "CPA Full Employment Act"). Assuming reasonable compensation is paid, a deduction is allowed for 20% of pass-through income. Since the highest rate is now 37%, the effective income tax rate on pass-through income is now 29.6% (37% top rate x 80% of pass-through income which is taxable). This being the tax code and all, it is not that simple. If your individual income is below $315,000, you will get the 20% pass-through deduction irrespective of the type of business conducted by the pass-through. If your individual income is over $415,000, you cannot take advantage of the deduction if the pass-through conducts a professional service business.

We assume you mostly conduct business in the hospitality industry; however, if income exceeds the hurdle amount, the deduction may be limited under two tests: the greater of (1) 50% of the entity's wages or (2) 25% of the entity's wages plus 2.5% of the entity's "unadjusted basis" in its assets. For example, assume entity has $1 million in taxable income, net of $300,000 of wages, equipment which originally cost $500,000 and two 50-50 owners. Each owner is entitled to a deduction, which is computed at the individual level, not the company level. The "potential" deduction is $100,000 for each owner (20% x $1 million x 50% ownership stake). The deduction allowed for each would be the greater of (1) $75,000 ($300,000 wages x 50% x 50% ownership stake) or (2) $87,500 ($300,000 wages x 25% plus 2.5% of $500,000 equipment cost x 50% ownership stake). So, each owner is allowed $87,500 out of a potential of $100,000 of deduction. (If anyone out there is still reading, my head hurts). We understand that this deduction is computed on an entity by entity basis. So, if you have five stores in five entities, well, you get the picture. Caveat: it is actually way more complicated than what I have described with other limitations, etc., and much guidance is needed from the IRS/Treasury. We have over a year before we have to start preparing tax returns with this deduction.

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We have been using Henry+Horne as our trusted advisors for many years. They have helped us with our taxes including helping us with the IRS and saved us time and frustration. Our friends at Henry+Horne have been an asset to our business as they truly are knowledgeable and experts in their field.

What does all this mean? If you are doing business in multiple entities, and in some entities your deduction is not limited while in other entities it is, you need to huddle with your tax preparer because you may be able to move some things around or combine entities in a way that is beneficial but also serves a business purpose, as there are "anti-abuse" provisions. (See what I mean about the CPA Full Employment Act?)

A few other thoughts, there is no "active" versus "passive" test for this deduction, so passive investors are entitled to this as well. This also means that your tax preparer will need to report more information on K-1s such as your share of wages and your share of equipment costs. I would expect that tax preparation fees are going to rise.

Capital investments. Bonus depreciation is still alive and kicking, although scheduled to phase-out (what else is new). Whereas before, bonus depreciation only applied to new property, it now applies to both new and used property. For years ending after September 27, 2017 and property placed in service after that date, 100% bonus depreciation is allowed (you can elect to take only 50%). The amount phases out 20% a year beginning after 2022. In addition, for any commercial property, improvements to real estate interior are simplified and termed "qualified improvement property" and subject to a 10-year life? Why the question mark? The legislation does not provide for a life. The committee reports did that. See what happens when you rush through legislation in a matter of weeks?

Section 179 expensing is also expanded. The limit becomes $1 million as long as property placed in service during the year does not exceed $2.5 million. The new Section 179 rules also incorporate the changes with respect to "qualified improvement property." Why we need Section 179 expensing and 100% bonus depreciation for the next chunk of years is beyond me. All in all, the rules are more generous than before. Caveat: It is not clear to the author whether the property expensed under Section 179 will "count" as "unadjusted basis" property for purposes of determining the 20% pass-through deduction mentioned above.

Other business changes. There are many other changes I will not discuss in detail, such as increased ability to use the cash method of accounting (restaurants usually benefit from accrual method of accounting); increased limitations on the ability to deduct interest expenses (generally applicable if gross receipts exceed $25 million; most smaller operators might have difficulty obtaining financing to be highly leveraged anyway); and the repeal of Domestic Production Activities Deduction (not applicable to most restaurants unless producing for wholesale). Finally, there are limitations placed on the ability to deduct certain fringe benefits and entertainment costs.

Conclusion

Much has not been covered. I have tried to hit the salient points for the industry. Overall, operators/owners should benefit from the new law. Make sure you huddle with your CPA to ensure you firmly grasp the new rules and whether you might benefit from restructuring your legal form to take advantage of the new "pass-through" deduction. Finally, due to the political nature of the party line in the Senate, the new provisions mostly "sunset" in 2025. In other words, the new law reverts to the old law as it was prior to passage of the Act. Hopefully, we will get some certainty as we close in on that date. Of course, a change in the Administration or the party make-up of Congress might send us back to square one.

If you have any questions, Brad can be reached at (480) 483-1170 or BradD@hhcpa.com.

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We are proud to say Henry+Horne has been our CPA Firm for the last decade and they provide us with nothing but exceptional service. In our unique industry it is nice to have professionals who are up-to-date on all the tax laws and pay close attention to the news that affects the restaurant business.

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A look at life when you outsource your accounting
By Jessica Moulder, CPA, CFE

A new year is always a good time to evaluate the state of your restaurant... what's working, what isn't working and changes you can make to improve your business. Now is the perfect time to consider getting your accounting processes under control to make your business run smoother and you don't have to go it alone. Henry+Horne offers a full-service department available to outsource your daily accounting needs and using an outsourced accountant definitely makes your life easier.

Spend less time on your books

If you wanted to be an accountant, you would have gotten into the accounting business, right? Instead you opened a restaurant, so why not focus your energy there and leave the accounting to us? Sometimes restaurant owners are quite capable of doing the accounting work. They understand exactly what needs to be done and how to do it. Unfortunately, there just aren't enough hours in a day, and with all of the demands that come with running a restaurant, sometimes accounting work gets pushed to the bottom of the pile. The further behind you get, the more daunting the task becomes to catch up. And before you know it, you're faced with climbing Mt. Accounting to get things back on track. In the meantime, mistakes go unnoticed, bills may be paid late and you might be throwing money out the window without knowing it. An outsourced bookkeeper from Henry+Horne can keep your accounting up to date in real time (not to mention while using up-to-date technology to make the process as efficient as possible.)

Stop making mistakes (and save money)

Oftentimes, restaurant owners are used to being a jack of all trades and they approach new areas by trial and error. While that can actually be a great quality when it comes to running a business, you can't afford to chance certain things and anything tax-related falls into this category. Using Henry+Horne to handle your accounting work ensures things will be done in compliance with tax rules, including payroll tax, garnishments and PTO.

Get more timely information

Accounting work isn't just a necessary evil – it should be a resource to help you make important decisions about your restaurant. This includes operational and financial decisions that affect your bottom line when you analyze things in real time with Henry+Horne, which is so much more effective than looking at data that's months old.

Tap into higher level services

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If you have any questions, Jessica can be reached at (480) 839-4900 or JessicaM@hhcpa.com.

Henry+Horne has performed several audits of our annual financial statements, and each year they have submitted the reports on or before deadline. All members of the engagement team are very knowledgeable, extremely responsive and professional.