5 things every hospitality business owner should consider in the tax reform law

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The tax reform bill President Trump signed into law on December 22, 2017 contains many changes that will have a profound impact on both individual and corporate taxes. Though sweeping individual tax changes are not the subject of this article, some of them include:

- top to bottom reductions in tax rates
- doubling of the standard deduction for both married and single filers
- limits on deductions of state and local taxes
- the elimination of personal exemptions
- Increase in child tax credits

For hospitality business owners the changes are no less impactful. I say "business owners" rather than corporations on purpose because some of these changes will impact tax on business profits whether they are taxed through a corporation, pass-through entity (such as an S Corp or partnership), or on the owner's personal tax return using a Schedule C attachment. Hospitality businesses come in all shapes and sizes using all of these tax structures—the tax reform bill covers them all.

As with the individual changes, a detailed discussion of the differences in tax structures is not our topic here. I'll work on the premise that if you own a business, then you probably know what structure you're using or can find out. To the extent the changes affect tax structures differently, though, I will point out the variations.

So what are these 5 changes this article will cover, you ask? Well, in no particular order, they are:

1. Corporate Tax Rate Reduction
2. Pass-through entity deduction
3. Section 179 expensing & Bonus Depreciation
4. Interest Deduction Limitations
5. Expansion of the Cash Method of Accounting

With the exception of bonus depreciation, these changes all go into effect starting with the 2018 tax year. By no means is this an exhaustive list of the changes or even close to it. Rather, I've tried to pick some high profile changes that will likely impact nearly all hospitality businesses. So let's get started.

Corporate Tax Rate Reduction
Generally touted as the centerpiece of this legislation, the corporate tax rate reduction will have two major effects. First, it will drastically reduce the amount of tax paid by C Corporations. Under old law, C Corporations paid tax on a graduated rate schedule topping out at 35%. Under the new law, the corporate tax rate is reduced to a flat 21% for all C corporations, regardless of income. High profile companies such as Darden & Sonic have recently announced their estimates of tax savings under the new corporate rules. They both plan to invest the savings into their workforces and new technology.

Second, the corporate rate reduction will cause many pass-through entity owners to re-assess their decision to, in fact, be a pass-through entity any longer. One motivation, among several, for choosing pass-through status has generally been the high tax rate when you combine corporate level tax at 35% with the second layer of tax on dividends paid to owners—up to another 23.8% for the highest income earners. With the reduction in corporate tax rates, some pass-through entity owners might choose to convert to C Corporation status to take advantage of the lower rate. This might prove beneficial if owners plan to re-invest profits into the business rather than distributing most of them as dividends. For companies that generally pay most of their earnings to the owners, though, pass-through status might still be the way to go. Of course, other factors, both tax-related and non-tax, often play into the decision to be a C Corporation or pass-through entity so this is only one to consider. One of those other tax-related factors is the next topic—the brand new pass-through entity deduction.

Pass-through entity deduction
If you view the corporate tax rate reduction on its own, then it seems like C Corporation status has gained an edge over, or at least evened the playing field with, pass-through status. The significant reduction was seen by many as a benefit to mostly big companies. This viewpoint was likely a key driver pushing Congress to offer a new incentive for pass-through entities, generally perceived as the choice for small businesses. The new provision offered to "Main Street" businesses allows a deduction of up to 20% of pass-through entity income—income from S Corporations, partnerships, and sole proprietorships using Schedule C.

As with most taxpayer-friendly provisions, Congress has imposed many limitations and phase outs on this new 20% deduction, some of which will impact hospitality business owners. So here's how it works. If your overall taxable income is less than $157,500 if filing single or $315,000 if filing joint (you have to include your spouse's income too) then you generally have no restrictions on this deduction. Take 20% of your pass-through business income and that figure reduces your taxable income dollar for dollar. If you have more than one business, then add them all together (net profits and losses) to calculate your deduction. This deduction is taken after your standard/itemized deduction so you can take it whether you itemize or not.

It gets trickier if your income is above the $157,500/$315,000 limit. First, you will probably not be able to take the deduction if your pass-through income is from a professional service type of business such as law, consulting, medical, and, yes, accounting. This restriction shouldn't affect most companies in the business of actually providing hospitality. It could impact you if you have a management company providing only professional services to restaurants/hotels, even ones you own. Also, you could be limited if you run a side hustle providing hospitality consulting services. The rules are new and there is not a lot of guidance available yet, so be careful on this one!

Second, if you break through the income limits, you might face an alternate formula for calculating the allowable deduction. This alternate formula potentially limits the deduction based on your total W-2 wages and the cost of your real estate, furniture, fixtures, and equipment. Again, for most hospitality companies, this should not be a problem since labor and property costs are a significant portion of overall costs but this formula should be considered in your overall tax plan.

While the first two items come into play after you've calculated your taxable income for the year, the last three can have a major impact on how much of your income is considered taxable in the first place.

Section 179 expensing & Bonus Depreciation
As mentioned earlier, property and equipment costs play a major role in the operation of any hospitality business. Unfortunately, normal tax "capitalization" and "depreciation" rules don't allow you to deduct the entire cost of large equipment and property in the year of purchase. Businesses are required to deduct a portion of the cost each year for a defined number of years based on the type and use of the property. These rules can potentially put you in the position of spending cash in one year but not getting a tax deduction until future years—not the best financial result. Luckily, the existing tax law also has two immediate expensing options generally referred to as 1) Section 179 expensing and 2) bonus depreciation. These options potentially allow you to take the entire purchase price of property and equipment in one year. The new tax law expands these options tremendously.

First, Section 179 expensing allows a business to immediately deduct up to $510,000 of the cost of personal property put in service each year. It's a no-questions-asked, simplified method to match your deductions with your cash outlay. To qualify, you must have taxable income (it can't bring your income below zero in a given year) and have purchased less than $2,000,000 worth of new property during the year. The new tax law increases the limits, allows more types of property to qualify for the deduction, and indexes the limits for inflation starting in 2019.

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As seen in the chart below, the Section 179 deduction limit nearly doubles from 2017 to 2018, the phaseout amount increases significantly, and they're both indexed for inflation in future years. Also, old Section 179 law did not allow the special deduction for most types of real estate components unless they were part of a narrowly-defined group of leasehold improvements. The new law, though, greatly expands the type of real property improvements that qualify for the Section 179 deduction. It now includes all interior leasehold improvements made after the property has been placed in service as well as the following costs incurred to improve a structure:

- roofs
- heating, ventilation, and air-conditioning property
- fire protection and alarm systems
- security systems

Tax years	Max deduction allowable	Deduction phaseout begins at
2017 (old)	$510,000	$2,030,000
2018 (new)	$1,000,000	$2,500,000
2019 & later	$1,000,000 + inflation adj.	$2,500,000 + inflation adj.

To be clear, these costs cannot be expensed under Section 179 if they are incurred as part of new construction or an upfit of a property that has not yet been placed in service. To qualify, the improvements must be made in a later year.

Second, the new law expands an expensing provision called "bonus depreciation." Bonus depreciation is similar to Section 179 expensing in that it allows items to be deducted much more quickly than normal tax depreciation rules. Bonus depreciation differs from Section 179, though, in that it is neither subject to dollar limits for the deduction, nor is it subject to phaseouts based on the dollar value of property placed in service during the year. These factors allow it to be used by larger companies that put more than $2.5 million of property in service each year. Also, most state tax systems do not allow bonus depreciation so you will need to make an adjustment when calculating your state income tax. By contrast, Section 179 is allowed by most states and usually does not require an adjustment.

Under old law, bonus depreciation was 50% of the cost of new property and was being phased out over several years ending in 2020. The new law expands the deduction to 100% of the property cost from the years 2018-2022. It also allows businesses to elect either the new 100% rate or the old 50% rate for any property placed into service between September 27, 2017 and December 31, 2017. Starting in 2023, it begins to phase down every 2 years in 20% chunks and is eliminated by the year 2028.

Interest Deduction Limitations

Many businesses rely on some type of debt to finance their operations and growth. Whether it is a startup loan to get things up and running, equipment financing, or an acquisition loan for a new building, bank and private loans provide important financing to allow companies to build and expand. Until now, the interest paid on these loans was almost always fully deductible against taxable income.

Under the new law the deduction for business interest is limited to 30% of the company's taxable income beginning in 2018. Any excess interest that is not deductible in a given year can be carried forward to the next year and potentially taken then, subject to the same 30% limitation. Like any good rule, of course, this one comes with exceptions. For the years 2018-2021 taxable income is computed for purposes of this limitation before considering any depreciation and amortization that could normally be taken. This will ease the transition a little by increasing the limits for a few years. Also, the limit does not apply to the following businesses:

- any business with average gross receipts of less than $25 million over the latest 3-year period
- any real estate or farming business provided they use a slower depreciation method than is normally allowed
- public utilities and cooperatives
- vehicle, boat and machinery dealerships that use floor plan financing

Expansion of the Cash Method of Accounting

For most large hospitality companies, using the cash method of accounting doesn't make much sense from a management standpoint. Owners and financial executives want to see financial results that include accounts payable, accounts receivable, and various accrual items since they represent future revenue and expenses to be used in planning. For smaller companies without full accounting departments, though, using the cash method of accounting can help simplify bookkeeping and smooth out cash flow, particularly when inventory or large accounts receivable balances are present. No small business owner wants to pay tax on income he or she has not yet collected and not be allowed to deduct the cost of inventory for which cold hard cash has been paid out.

The old law required use of the accrual method of accounting for tax purposes for any company that either has more than $1 million of average gross receipts with inventory, or has over $5 million of average gross receipts without inventory. Starting in 2018, the new law raises this cash method exemption limit to $25 million of average gross receipts for the last 3 years for any type of company, with or without inventory. The higher exemption amount will allow many more companies to either simplify their bookkeeping or strategically plan their tax payments based on actual cash flow rather than accrual calculations.

The new tax law is quite extensive and has many more changes that will have a long-term effect on business owners in the hospitality industry. These highlights will give you plenty to think about over the next year. As your work with your accountant to prepare your 2017 tax returns, make sure to consider these and the numerous other changes and how they will affect your personal and business tax situation.

About the author:

Tony Perricelli, CPA, serves as a member of Scott and Company LLC's tax and advisory practice. He has been providing tax compliance and planning services for closely-held businesses and individuals since he joined the firm in 1998. Tony serves clients in a variety of industries including hospitality, retail, real estate, and professional services. He currently serves on the Board of Directors for the South Carolina Restaurant & Lodging Association and is an active member of the South Carolina Association of Certified Public Accountants and the American Institute of Certified Public Accountants. Follow him at twitter.com/tonypcpa for insights on improving cash flow through tax savings. Reach Tony at tperricelli@scottandco.com or at (803) 753-5244.