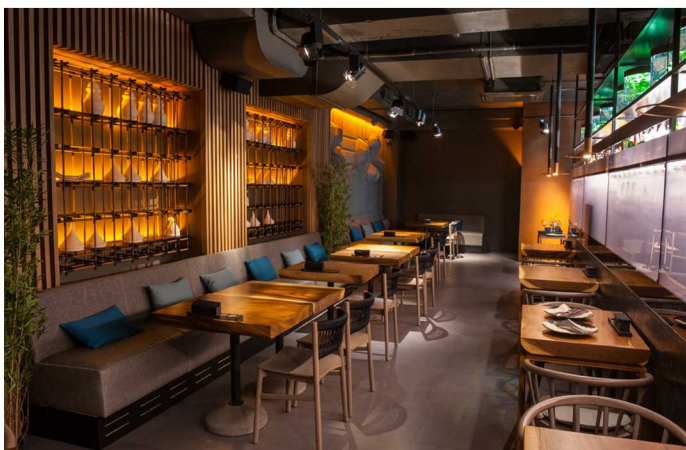


Tax Reform: Pass-Through Planning & Bonus Depreciation Pondering

By Lisa Haffer, JD, CPA



In a recent tax reform post, we discussed the expected implications of reform for the restaurant industry. Since then, we've had a chance to see the impact that some of the provisions will have on restaurant owners.

We've also received clarity regarding the 2017 bonus depreciation rules relevant to Qualified Restaurant Property (QRP). While we are still waiting for clarity on whether Qualified Improvement Property (QIP) will qualify for bonus depreciation in 2018 and future years, here are the latest updates:

STATE & LOCAL TAX DEDUCTION

SUMMARY OF CHANGES:

\$10,000 limit for combined personal income, real property and personal property tax (\$5,000 for taxpayers that file Married Filing Separate).

EFFECTIVE DATE:

Tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026

INDUSTRY VIEW:

Mixed

BDO'S TAKE:

- Restaurants that are taxed as LLCs or "S" Corporations and that operate in states that impose income tax on owners rather than on the entity itself, pass through their state income tax obligation to those owners. In the case of states

other than the state that the owner resides in, the entity's tax liability is often settled with composite or nonresident tax payments made by the entity. These payments are treated as if they were first distributed to owners, and then as if the owners turned around and paid the taxes to the nonresident states. As a result of this treatment, owners are eligible to deduct these taxes as itemized deductions for state and local tax on their personal tax returns. In addition to these nonresident taxes, owners can also deduct income tax payments made to their state of residence.

- In the case of a flow-through multi-state restaurant group with high taxable income, owner income taxes can be significant, and far greater than the \$10,000 cap.
- At first glance, the new state tax limitation might appear to have negative implications for pass-through owners. However, the benefits of the new Qualified Business Income (QBI) deduction (discussed below), coupled with reduced individual tax rates, may produce a lower overall federal tax liability for many pass-through owners.

PASS-THROUGH TAX TREATMENT/SECTION 199A

SUMMARY OF CHANGES:

A new deduction of up to 20 percent of Qualified Business Income from a partnership, S corporation or sole proprietorship.

EFFECTIVE DATE:

Taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026

INDUSTRY VIEW:

Positive

BDO'S TAKE:

- A 20 percent reduction from taxable income reduces the maximum individual tax rate on pass-through income from 37 percent to 29.6 percent.
- Planning idea: "S" corporation owners that pay themselves large salaries and whose "S" corporations also pay sizeable wages to non-owners may be able to reduce their federal tax liability by taking a lower salary. Benefits that could be reaped from this idea include employment tax savings, higher QBI deduction, and lower federal income tax

liability for the owner. Note that owners must still receive reasonable compensation for services performed.

- LLC owners can similarly reduce their federal tax liabilities by receiving preferred returns in lieu of guaranteed payments. Benefits to be reaped include employment tax savings, higher QBI deductions and lower federal tax liability for owners. Note that preferred returns may be re-categorized as guaranteed payments if they are paid regardless of profitability. Additionally, it is possible that regulations or other guidance issued may limit or eliminate this benefit in the future.

100 PERCENT BONUS DEPRECIATION

SUMMARY OF CHANGES:

- Companies can claim 100 percent bonus depreciation for the cost of certain capital expenditures, including acquisitions of **new or used** property, starting with assets acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023.
- The percentage of allowable bonus depreciation will be phased out at a rate of 20 percent per year from 2023 (80 percent) to 2026 (20 percent).

APPLYING 100 PERCENT BONUS DEPRECIATION: Sept. 27, 2017 – Dec. 31, 2017

BDO'S TAKE:

- Restaurant assets eligible for 100 percent bonus for the period **Sept. 27, 2017 – Dec. 31, 2017** include:
 - Tangible property depreciated under MACRS with a recovery period of 20 years or less, including the following categories of assets, if acquired after Sept. 27, 2017, and placed in service before Jan. 1, 2018:
 - Restaurant equipment and furniture
 - Land improvements
 - Qualified leasehold improvement property (QLHI)
 - Qualified restaurant property (QRP) that also is qualified improvement property (see below)
 - Qualified retail improvement property (QRIP)
 - Qualified improvement property (QIP) **defined in Internal Revenue Code Section 168(k)(3)** [emphasis added] that is depreciated under MACRS and acquired after Sept. 27, 2017 and placed in service before Jan. 1, 2018.
- QLHI, QRIP and QRP placed in service during 2017 are all eligible to be depreciated over 15 years. These classes of property have differing rules, however, with respect to

eligibility for bonus depreciation:

- QLHI and QRIP acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2018, are eligible for 100 percent bonus depreciation.
- QRP acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2018, is also eligible for 100 percent bonus depreciation, but only if it also meets the definition of QIP. As discussed later in this post, questions still exist regarding the eligibility of QIP for 100 percent bonus depreciation for property placed in service after Dec. 31, 2017. However, in good news for restaurants and their owners, the definition of QIP, as provided in Internal Revenue Code Section 168(k)(3), remained intact through the end of 2017. As a result, QRP that also meets the definition of QIP is eligible for 100 percent bonus depreciation so long the assets are acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2018.

APPLYING 100 PERCENT BONUS DEPRECIATION: Jan. 1, 2018 – Dec. 31, 2022

BDO'S TAKE:

- Restaurant assets eligible for 100 percent bonus for periods **between Jan. 1, 2018, and Dec. 31, 2022**, include:
 - Tangible property depreciated under MACRS with a recovery period of 20 years or less, including the following categories of assets, if acquired and placed in service after Dec. 31, 2017, and before Jan. 1, 2023:
 - Restaurant equipment and furniture
 - Land improvements
 - **Potentially** Qualified Improvement Property (see sidebar).
- Under pre-tax reform law, restaurants and retailers have historically relied on three favorable classes of assets [Qualified Leasehold Improvement Property, Qualified Restaurant Property, and Qualified Retail Improvement Property] to maximize depreciation deductions. Under prior law, QLHI and QRIP were defined as having a 15-year life, making them eligible for bonus depreciation under the enumerated bonus category of "tangible property depreciated under MACRS with a recovery period of 20 years or less." QRP also was defined with a 15-year life but was only eligible for bonus depreciation if it also met the definition of QIP. Under prior law, QIP was also one of the enumerated classes of assets eligible for bonus depreciation, and it could be either 15-year property or 39-year property.
- The new law eliminates the 15-year classes of qualified

real property, namely QLHI, QRP and QRIP, and it replaces them with the definition of QIP. As noted, this category of asset existed before tax reform, with one distinct and important difference: Under prior law, QIP was one of the enumerated categories of assets that was eligible for bonus depreciation. In framing the new law, the intent was that QIP would be assigned a 15-year life, and thus eligible for bonus under the category of tangible property depreciated under MACRS with a recovery period of 20 years or less. In what was likely an inadvertent omission, the new law fails to assign a 15-year life to QIP. This omission wouldn't necessarily prevent QIP from being eligible for bonus depreciation if QIP had been included in the enumerated list of categories of assets that are eligible for bonus as it had been under prior law. However, in a cruel twist of fate for restaurants and retailers (and their owners), QIP was not included in the enumerated list of bonus-eligible assets, nor was the definition of QIP amended under the new law to contain a defined 15-year recovery period.

- IRS guidance is needed (and needed soon!) to clarify the tax depreciation treatment of QIP. We are cautiously optimistic that Congress's intent with respect to QIP was to make it eligible for bonus depreciation, either by giving it a recovery period of 15 years or designating it as one of the enumerated classes of property that qualifies for bonus depreciation. However, until guidance is issued, a conservative approach is to depreciate QIP property over a 39-year life without bonus depreciation.

- Property eligible for Section 179 includes:
 - Qualified Improvement Property
 - Any of the following improvements to an existing building that is nonresidential real property:
 - Roofs
 - Certain HVAC property
 - Certain fire protection and alarm systems
 - Certain security systems

BDO'S TAKE:

- Expect to see an uptick in the use of Section 179. Smaller taxpayers may benefit from a combination of both Section 179 and bonus depreciation.

This article originally appeared in BDO USA, LLP's "Selections" blog (April 2018). Copyright © 2018 BDO USA, LLP. All rights reserved.
www.bdo.com

INCREASED SECTION 179 EXPENSING

INDUSTRY VIEW:

Positive

SUMMARY OF CHANGES FOR 2017:

- **For property placed in service during tax years beginning in 2017**, the maximum amount a taxpayer may expense under Code Sec. 179 is \$510,000. Property eligible for Section 179 includes qualified leasehold improvement property, qualified restaurant property and qualified retail property. See sidebar on next page.

SUMMARY OF CHANGES FOR 2018 AND BEYOND:

- **For property placed in service in tax years beginning after Dec. 31, 2017**, the maximum amount a taxpayer may expense under Code Sec. 179 is increased to \$1 million.