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How Tax Reform Will Impact Restaurants

By Adam Berebitsky, Jeff Tubaugh, Lisa Haffer

On December 22, 2017, the conference version of the tax reform bill was signed into law, marking the largest change to U.S. tax policy in decades.

With most of the provisions set to go into effect in 2018, it's important that the restaurant industry review the changes that occurred during the conference process to understand the impact to their companies.

Tackling Tax Reform: Initial Steps Restaurateurs Can Take Now
Tax professionals are busy assessing changes caused by this bill, and are waiting for additional guidance on many key provisions to ensure the overall impact is fully understood. In the interim, here are two tips for restaurants to consider to begin tackling tax reform:

1. **Establish priorities.** When considering what to undertake in the coming months, focus on the areas that could have the greatest impact on your organization. Consider your expansion plans and remodels, factoring in the write-offs that are now available. It would also be wise to look at how your businesses tax liability will change: C corporations can measure expected tax payments, and S corporations and partnerships can look at tax distributions to see how that will change this year.

2. **Initiate tax reform conversations with your tax advisor.** Tax reform of this magnitude is the biggest change we've seen in a generation, and will require intense focus to understand not only how the changes apply at a federal level, but also to navigate the ripple effect this is likely to have on state taxation as well.

What Changes are Coming for Restaurants?
To help organizations navigate the key provisions affecting restaurants, we've summarized top considerations and implications on pages 2 and 3.

Provision	Summary of Changes	Implications for Restaurants
Reduce the Corporate Tax Rate	Reduces higher corporate rates (max 35%) to a flat rate of 21%. **Effective date:** Taxable years beginning after Dec. 31, 2017.	**Industry View**: Positive **What's at stake:** This will reduce the tax burden for restaurateurs structured as C corporations.
Pass-Through Tax Treatment / Section 199A	A new deduction of 20% of "qualified business income" from a partnership, S corporation or sole proprietorship. **Effective date:** Taxable years beginning after Dec. 31, 2017.	**Industry View:** Positive **What's at stake:** A 20% reduction from taxable income reduces the maximum individual tax rate on pass-through income from 37% to 29.6%.
Limitations on Interest Deductibility	Generally, caps deduction of interest expense to the sum of 1) business interest income; 2) 30% of adjusted taxable income (computed without regard to deductions allowable for depreciation, amortization, or depletion; and 3) the taxpayer's floorplan financing interest for the tax year. Disallowed interest is carried forward indefinitely. Contains a small business exception. **Effective date:** Taxable years beginning after Dec. 31, 2017	**Industry View:** Negative **What's at stake:** This would limit the interest deduction to 30% of EBITDA for four years, then 30% of EBIT thereafter. Taxpayers who are using debt to fund new restaurant openings and incurring significant start-up expenses for new locations within the same taxable entity could find themselves deferring the interest expense deduction as a result of lower taxable income
Repeal of Domestic Production Activities Deduction (DPAD or Section 199)	DPAD was a tax incentive for businesses that manufactured property at least partially within the United States. This could include restaurant commissaries. **Effective date:** Taxable years beginning after Dec. 31, 2017	**Industry View:** Negative **What's at stake:** This mainly impacts commissary kitchens. This rule allowed commissaries to sell prepared items to a restaurant for a profit, then deduct 9% of their qualified production activities income from the commissary
Eliminate Ability to Carryback Net Operating Losses and Limitation on Use of Net Operating Losses Against Future Income	An NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). The two-year carryback provision has been eliminated so restaurants can only carry losses forward. Losses can be carried forward indefinitely. **Effective date:** The elimination of carrybacks and reduction to 80% of taxable income use in future years are both effective in taxable years beginning after Dec. 31, 2017.	**Industry View:** Negative **What's at stake:** Costs incurred in one year will not be able to offset 100% of taxable income in the next year. In situations where restaurateurs earnings are volatile, the restrictions on the carryback and use of NOLs could present a significant cash flow obstacle.

Provision	Summary of Changes	Implications for Restaurants
Bonus Depreciation	Companies will be able to fully expense certain capital expenditures, including acquisitions of used property, starting with assets placed in service after Sept. 27, 2017. **Effective date:** 100% expensing of property is effective for assets placed in service after Sept. 27, 2017, through Dec. 31, 2022. The percentage of allowable expensing will be phased out at a rate of 20% per year from 2023 (80%) to 2026 (20%).	**Industry View:** Positive **What's at stake:** This is likely to encourage more capital spending, potentially driving up remodels. There is no limitation on the amount taken. The taxpayer may elect out of bonus depreciation.
Increased Section 179 Expensing	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 from $500,000. **Effective date:** Taxable years beginning after Dec. 31, 2017.	**Industry View:** Positive **What's at stake:** This expansion was intended to encourage improvements of property. It also implies larger depreciation deductions for companies able to use Section 179 (and bonus depreciation).
Work Opportunity Tax Credit	The House had a provision in their bill to eliminate the credit, but the final result is no change in this valuable credit for restaurants. The WOTC is a tax credit available for employers hiring individuals from one or more of ten targeted groups of employees. It's important to keep in mind that the WOTC remains slated to expire for employees that begin work on or after Jan. 1, 2020	**Industry View:** Positive
FICA Tip Credit	The House had a provision in their bill to increase the wage minimum for the calculation to go from $5.15 per hour to current federal minimum wage of $7.25 per hour, reducing the benefits of the credit for taxpayers operating in most states. The final result is no change in this valuable credit for restaurants.	**Industry View:** Positive

Happy Hour and Your Bottom Line

By Giselle El Biri

Happy hour has historically been a great way for restaurants to increase guest counts during slower time periods. But making happy hour profitable while giving guests a great experience can be tricky. To determine if happy hour will work for them, restaurateurs should consider multiple factors, including pricing, labor and the business's demographic and location.

Done right, businesses can look to happy hours as a consumer-friendly revenue raiser. Here are five tips for restaurateurs looking to implement a successful happy hour, according to clients:

Understand Your Restaurant's Demographics
The success of happy hour promotions are highly dependent on how accessible your location is for locals, and whether they might be interested in attending a happy hour. Because many restaurants count on the employees of surrounding businesses to be loyal happy hour attendees, ensuring your business' atmosphere is welcoming for patrons after a long day of work is crucial.

Be True to Your Concept
Your happy hour menu should be an extension of your current brand. Keep it simple and consistent by highlighting crowd favorites from your current menu. Another helpful tactic to keep guests coming back is to ensure promotions stay consistent over time, so guests know what to expect any day of the week.

Introduce New Items
Though it's important to offer crowd pleasers, happy hour can be a great time to introduce new offerings too. The benefit of

rolling out new items during happy hour is twofold: The discounted price may encourage guests to be adventurous with their choices, and the structured timeframe provides restaurants an opportunity to analyze the profitability of new items to determine their staying power on the regular menu.

Know your Happy Hour Menu Cost
When planning your happy hour menu, be aware of other intangible factors that could increase your pricing, such as commodity and labor costs. Consider how labor-intensive your proposed menu will be for your kitchen staff and how expensive ingredients are before finalizing choices.

Be Patient
If a restaurant stays true to its brand and is consistent with its pricing, foot traffic will follow.

Establishing new norms for the front and back of house, figuring out menus and deciding on appropriate discounting are not easy tasks. However, the chance to entice new regulars and try out innovative menu items, while also selling mainstays, could be worth the growing pains.

Getting Back to Business After a Natural Disaster

By Clark Schweers

When the threat of natural disaster looms, insurance is always top of mind. Liability, property and equipment insurance can help to protect against these events. Restaurateurs make large investments in kitchens in terms of specialized equipment for food preparation, refrigeration and sanitation. Whether it's a small flood or a Category 5 hurricane, property and equipment insurance can minimize the impact to your operations and help put your mind at ease.

The first several weeks following a natural disaster, businesses that are properly covered by insurance are likely beginning to check off steps on their emergency preparedness checklist. Those that haven't developed contingency plans, or are noticing gaps in their path forward, should consider incorporating the steps below for coping with disaster and picking up the pieces.

1. **Communicate with Employees and External Stakeholders.** Following the activation of an emergency preparedness program, it is critical to communicate with employees and business partners about their well-being, as everyone will be dealing with potentially significant, or even devastating, personal and professional issues.

2. **Review Your Insurance Policy.** Even if a business does not suffer physical damage, it may have coverage for business

interruption losses. For example, if a business's customers or suppliers have been flooded and cannot receive the business's goods or services, the insurance policy may include what is referred to as "contingent time element" coverage. Non-physical damage coverage for business interruption losses can also include lack of access to facilities (e.g., road closures), government declarations of emergency, cancellation of events or loss of utilities, among others.

3. **Maintain Contemporaneous Documentation.** To say that the hours and days after a disaster are hectic is an understatement. This is a trying time for businesses as they try to rebuild and recover. However, keeping careful records even during this time of disruption is critical. Email traffic around current market conditions and cancellations of sales or suppliers/customers being impacted is critical to preserve, as it is extremely valuable to a business interruption claim.

4. **Get the Right Team on Your Side.** A major property claim can take several months to resolve, and the complexity of the issues that may arise requires external experts to look out for a business's interests while management focuses on what is important—rebuilding and recovering.

5. **Establish Milestones for Claim Recovery.** Following a major catastrophe, resources are often stretched thin. It is important to create milestones and hold all members—from the adjusting team to internal stakeholders—accountable for achieving those goals.

Understanding Tax Profit and Loss Allocation Provisions that PE Investors Bring

By Jeff Tubaugh

When the owners of a restaurant company sell a portion of the equity in their operating partnership to a private equity firm, it signals a period of upcoming growth for their company.

While it is exciting for the restaurant owners to bring in this additional funding and expertise, it can also have a significant impact on the tax profit and loss allocations. Owners must pay close attention to the language often proposed in operating agreements for this type of investment.

Typically, a partnership that is family-owned or held by a small number of founding investors will have very straightforward tax profit and loss allocation provisions: owners share in the profits and losses of the entity based on the proportionate amount of units they each hold to the total units of ownership in the entity.

Private equity investors typically hold preferred units that pay a percentage yield on their capital investment annually until all of their capital is repaid—any unpaid yield accrues over time. When the company is liquidated, private equity investors receive their unpaid yield first. This is often followed by a repayment of any unpaid portion of their preferred equity contribution; only then will common unit holders receive a payout.

Understanding the Tax Impact

Tax profit and loss provisions grow more complicated once private equity firms get involved, often looking something like this:

"For each fiscal year (or portion thereof), except as otherwise provided in this agreement, Net Income or Net Loss (and, to the extent necessary, individual items of income, gain, loss or deduction) of the Company shall be allocated among the Members in a manner such that the Capital Account balance of each Member, immediately after making such allocations, is, as nearly as possible, equal to the Distributions that would be made to such Member pursuant to Section* if the Company were dissolved, its affairs wound up and its assets sold for cash equal to their Book Value, all liabilities paid off and net assets of the Company distributed."

(* refers to the liquidation section of an agreement)

These types of tax allocation provisions are commonly known as "targeted capital account allocation provisions." Instead of allocating income based on straight ownership percentages, each partner's ending capital account must hit a "target" that is equal to the amount the partner would receive upon the company's liquidation. Essentially, this mirrors what would happen if the company sold its assets at book value, paid off all liabilities and distributed final cash. The amount of profit or loss allocated to each owner equals whatever amount is needed to get from the ending target from the previous year to the ending target in the current year.

For companies that show tax profits, income is allocated first to the preferred owners in order to account for their increased right to receive liquidating distributions due to any unpaid accrued yield on their preferred equity. The common owners will typically share whatever income remains.

For companies that show tax losses, often due to large amounts of depreciation in the restaurant industry, the allocations get more challenging. Because the accrued yield owed to preferred owners increases every year that it goes unpaid, their ending "target" capital account also increases because that additional yield is due to them at a liquidation event. In other words, they cannot be allocated a loss because their target has gone up, not down.

While the IRS has not specifically addressed this situation in published guidance, many advisors believe that the preferred unit holders must receive an allocation of gross income in a year of tax loss; this results in allocating losses to common unit holders in excess of the partnership's net loss for the year. It presents a challenging situation: most operating agreements require that tax distributions are paid out to cover tax obligations. In this example, a tax distribution would need to be made because of taxable income reported by preferred owners, even though the company is in a loss position. It is difficult for owners to wrap their heads around the fact that they effectively have to pay the new investors to help those same investors pay tax on gross income allocations, at a time when the company has a net tax loss and potentially negative cash flow due to investment in new stores.

Scenario Planning

Before diving head-first into a revised operating agreement with a private equity investor, make sure that the new preferred owners and the existing common owners all understand the tax allocation provisions to avoid surprises. Discuss the potential outcomes with a tax advisor to make sure the allocations are in line with the expectations of all parties involved.

Tax Considerations for Restaurants Entering New Markets

By Adam Berebitsky

Today the average family's schedule is faster-paced than before. As traditions around the dinner table reflect that change, the restaurant industry is growing at staggering rates. In fact, according to the **National Restaurant Association State of the Industry report**, 2017 restaurant industry sales are expected to top $800 billion. For new restaurant concepts entering the market, it is critical that state and local tax aspects be considered prior to opening the restaurant's doors.

State and Local Business License Registrations

The first step for restaurant concepts entering new markets is to determine whether there are any state or local, including county or city, business registration applications that are required to be filed. A business license requirement is based on the specific restaurant location and an annual license fee for the benefit of operating in that jurisdiction may apply. Each jurisdiction is different with respect to its registration process. Most states have simplified the process and allow taxpayers to file the registration electronically, allowing the state to process registration applications quicker. In addition to an initial registration, an annual license renewal may be required.

Income, Sales and Use Tax, Employment and Personal Property Tax Registrations

Depending on state rules, a restaurant may be required to register for income, sales and use, employment and personal property tax. Some states, such as Florida, Maryland and Virginia, allow a taxpayer to register for all of these taxes using one form. Other states may require separate registrations for each type of tax. Once registered, the restaurant will be required to file tax returns on a periodic basis depending on the type of tax.

Establishing solid procedures at the onset of opening the restaurant will be important to avoid the pitfalls of delinquent tax return filings and unanticipated tax liabilities.

Miscellaneous Tax and License Registrations

Depending on the type of restaurant concept that a company is operating, there are various licenses that need to be considered. Although not an all-inclusive list, several examples of taxes and licenses include a food service facility license, liquor license, restaurant license, convention and tourist taxes, litter tax and alcohol/beverage permits. Each tax or license may be administered by a different state agency, which adds complexity to the registration process.

Because tax and license registrations vary by state, it is important that an investigation is performed to identify and understand the requirements in each operating jurisdiction. Careful planning is critical to make sure the appropriate licenses and registrations are in place prior to opening a restaurant location so that the company can focus on operating the business and servicing customers—two very important components of success in the ever-changing restaurant landscape.