Top 3 Tax Reform Tips for Franchise Businesses

Tony Perricelli, CPA

Scott + Company

Agenda

- Corporate Tax Rate Reduction
- Pass-through Entity Deduction
- Sec 179 expensing & Bonus Depreciation
- Bonus Tip! – Opportunity Zones

Corporate Tax Rate Reduction

Corporate Tax Rate Reduction

Highest rate drops from 35% to 21%

- *Old Law*
  - Corporate Tax Rates graduated up to a max of 35%, personal services taxed at max 35%
  - Subject to AMT
- *New Law*
  - Corporate Tax Rates lowered to flat 21%, no special rate for personal service corporations
  - AMT is repealed
  - Permanent change, no expiration

Pass-through Entity Deduction

SCOTT + COMPANY

Pass-through Entity Deduction

20% Pass-through deduction

- *Old Law* - No special deduction for pass-through entities
- *New Law* - New below the line 20% deduction for pass-through entities
  - S Corporations, Partnerships, Sole Proprietorships
  - Must have "qualified business income" (QBI) from a trade or business
    - *QBI does not include income earned as an employee*
    - *e.g. S Corp owners pays himself W-2 wages*

Pass-through Entity Deduction

20% Pass-through deduction (continued)

- *New Law - continued*
  - Subject to limits and exclusions unless your overall taxable income is less than $157,500 (single) or $315,000 (married filing joint)
  - If income is over the limits, then:
    - QBI cannot be from specified service businesses such as law, medicine, accounting, consulting, investment services, etc.
      - Architecture & engineering are not specified service businesses
    - Deduction allowed only if business has W-2 wages and/or tangible property in use by the business to produce income
    - Phaseout range is $50,000 for single and $100,000 for married filing joint

Pass-through Entity Deduction

20% Pass-through deduction (continued)

- *New Law - continued*
  - Treasury issued proposed regulations in August to clarify some of the details
    - *Doing business with a specified service business does not automatically disqualify your business e.g. rental of facility*
    - *Consulting services included with sale of goods*
    - *De minimis exception for hybrid business selling goods & services*
      - 10% of gross receipts for revenue < $25 million
      - 5% of gross receipts for revenue > $25 million
    - *Reputation or skill of one or more of its employees*
      - Generally only applies to celebrity endorsements
      - Does not disqualify other businesses owned by celebrities

Pass-through Entity Deduction

20% Pass-through deduction (continued)

- ***New Law - continued***
  - Example for operating entity
    - S corporation with single owner
    - Restaurant net income = $2,000,000 (assume this equals QBI)
    - W-2 wages = $4,000,000
    - Unadjusted basis of qualified property = $11,000,000

20% of QBI = $400,000 deduction

Limited to the greater of:

- 50% of W-2 wages = $2,000,000 **OR**
- 25% of W-2 wages ($1,000,000) + 2.5% of unadjusted basis of qualified property ($275,000) = $1,275,000

Deduction for owner =
$400,000 (since limits are higher than 20% of QBI)

Pass-through Entity Deduction

20% Pass-through deduction (continued)

- ***<u>New Law - continued</u>***
  - Example for active real estate entity

    - Real estate net income = $350,000 (assume this equals QBI)
    - W-2 wages = $0
    - Unadjusted basis of qualified property = $5,000,000

    20% of QBI = $70,000

    Limited to the greater of:
    - 50% of W-2 wages = $0 **OR**
    - 25% of W-2 wages ($0) + 2.5% of unadjusted basis of qualified property ($125,000) = $125,000

    Deduction for owner =
    $70,000 (since limits are higher than 20% of QBI)

Sec 179 Expensing & Bonus Depreciation

Sec 179 Expensing & Bonus Depreciation

Bonus Depreciation

- *Old Law* – *50% of basis of qualified property*
  - Only new purchases, no used items
  - Personal property and limited types of real estate improvements
  - Scheduled to be phased out by 2020
- *New Law* – *100% expensing from 9/27/17 through 2022,*
  - Allowed for new and used property
  - Personal property and a larger group of eligible real estate improvements including most interior improvements
  - Phased out from years 2023 – 2028

Sec 179 Expensing & Bonus Depreciation

Cost Recovery – Section 179

- *Old Law* – *Election to expense up to $510,000 of qualifying property in 2017 instead of depreciating it over time*
  - $510,000 cap is reduced dollar for dollar for all property in excess of $2,030,000 placed in service in 2017
  - Assets include tangible personal property & off-the-shelf software
  - Some real property improvements allowed if elected, but only if used in a business, no rental assets, qualified restaurant property was included
  - Deduction limited to taxable income each year

Sec 179 Expensing & Bonus Depreciation

Cost Recovery – Section 179 (continued)

- *<u>New Law</u> - Beginning after 2017*
  - Maximum expense amount increased to $1,000,000
  - Phase out threshold increased to $2,500,000
  - Includes qualified real property (if elected):
    - *Qualified improvement property (covers interior improvements to existing buildings)*
    - *Certain exterior improvements to existing buildings including roofs, HVAC, fire protection, alarm & security systems*
    - *No more qualified restaurant property*

- ***One advantage of Sec 179 over bonus depreciation - most states allow Sec 179 but not bonus depreciation***

Sec 179 Expensing & Bonus Depreciation

Cost Recovery – Section 179 (continued)

Tax Years	Max Deduction allowable	Deduction phaseout begins at
2017	$510,000	$2,030,000
2018	$1,000,000	$2,500,000
2019 & later	$1,000,000 + inflation adj.	$2,500,000 + inflation adj.

Sec 179 Expensing & Bonus Depreciation

Cost Recovery – Real property changes

- *Old Law* –
  - Non-residential real property depreciated over 15-39 years
  - Default life was 39 years, no bonus, no Sec 179, exceptions:
    - *Qualified restaurant or retail property – 15 years, eligible for Sec 179*
    - *Qualified leasehold improvement property - 15 years, eligible for Sec 179*
    - *Qualified improvement property – 15 or 39 years w/ bonus*

SCOTT + COMPANY

Sec 179 Expensing & Bonus Depreciation

Cost Recovery – Real property changes (continued)

- *New Law – Property placed in service after 2017*
  - Qualified restaurant/retail and qualified leasehold improvement property definitions have been eliminated
  - Qualified improvement property remains
    - *15 year life*
    - *Eligible for Sec 179 if elected and bonus depreciation*
    - *Technical correction needed and is expected*
  - Non-residential real property not meeting definition of qualified improvement property has a 39-year life (this includes new restaurant property)

Bonus Tip!
Opportunity Zones

Opportunity Zones - Background

- Passed as part of the Tax Cuts and Jobs Act - December 2017
- Intended to encourage new capital investment in low income communities
- Zones chosen by governors and mayors in each state/territory

Opportunity Zones – Tax Benefits

- Temporary Deferral of Capital Gains Tax
  - Sale of current investment at a gain
  - Must re-invest in Opportunity Fund within 180 days
  - Gain recognized – earlier of new investment sale or 12/31/2026

- Step-up in Basis on Deferred Gain (up to 15%)
  - 10% increase if Opportunity Zone investment held 5 years
  - Another 5% increase if held 7 years

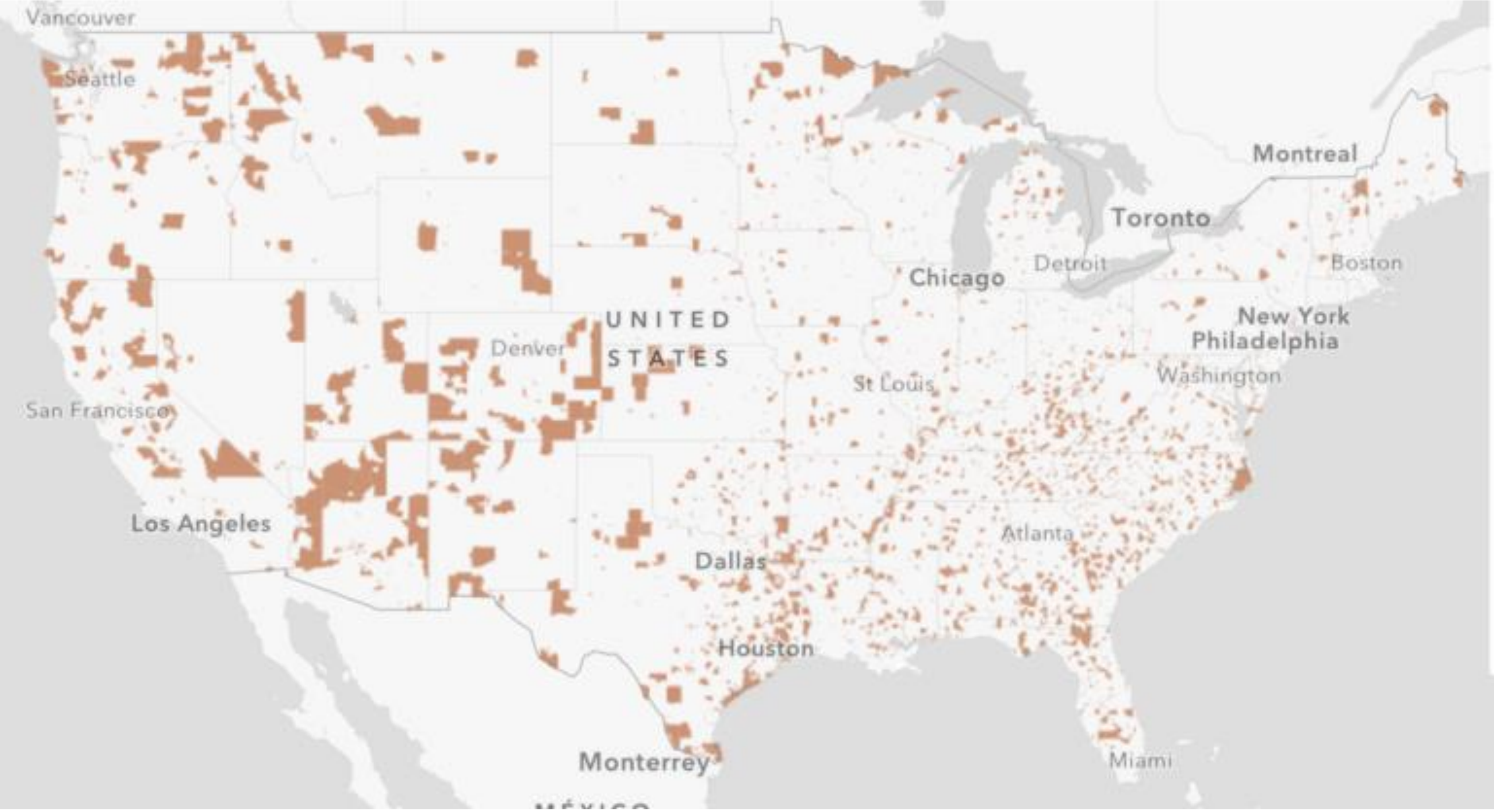
- Election to Permanently Exclude Capital Gain
  - Sale of Opportunity Fund investment if held for at least 10 years
  - Only gains earned after the initial investment in the Opportunity Fund

Opportunity Zones – Qualifications

- Formation/Annual Certification
  - Opportunity Zone Fund organized as a corporation, partnership, or LLC taxed as either a corporation or partnership
  - Funds must self-certify annually using IRS Form 8996

- Geographic
  - 70% or more of physical assets must be in a designated Opportunity Zone
  - Zones are designated in all 50 states and 5 territories – includes all of Puerto Rico
  - See US map, next slide

Opportunity Zones – Qualifications (cont.)



Source: eig.org

Opportunity Zones – Qualifications (cont.)

- Allowable Investments – “Qualified Opportunity Zone Property”
  - Qualified Opportunity Zone Business Property
    - Real estate or personal property acquired after 12/31/17
    - Original Use commences with Opportunity Fund
      - New construction, or
      - Fund “substantially improves” an existing property by investing at least as much as original purchase price of building portion in renovations/improvements
    - Rental or use in a business both qualify, but no personal residences
  - Qualified Opportunity Zone Stock/Partnership Interest
    - New Business – originally issued shares/ownership interest
    - Existing Business – moving into an Opportunity Zone, still need more clarification from Treasury

Opportunity Zones – Qualifications (cont.)

- Not Allowable Investments
  - Shell Companies or Financial Services/Banks
  - Private or Commercial Golf Course/Country Club
  - Massage Parlor/Hot Tub Facility/Suntan Facility
  - Racetrack or other gambling business
  - Liquor Store

Contact

Tony Perricelli

tperricelli@scottandco.com

Twitter @tonypcpa

Scott and Company
1441 Main Street, Suite 800
Columbia, SC 29201
803-361-2609