OPEN YOUR EYES, NOT YOUR WALLETS TO RESTAURANTS' UNIQUE TAX CHALLENGES

MN Restaurant Owner 2017 Guide to Taxation

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Restaurants have the dubious honor of having unique tax law in three big areas of tax. Income, Payroll and Sales tax laws have specific rules that heavily affect how restaurants operate and set up their own internal processes. We will highlight a few topics from each of these areas and try to explain them in enough detail to arm restaurant owners with the knowledge to head into tax season with a few more weapons in their tax arsenal. Each tax area mentioned below has several caveats that are too specific to explore here, so please be sure to consult with a CPA that is well versed in restaurant-specific tax guidelines.

Income Tax

Capitalization Policies

Rarely does a new IRS rule make a restaurant owner's life easier. However, the new capitalization policies effective 1/1/2016 truly do that. In prior tax years, all items costing $500 or more had to be capitalized and depreciated over the assets' useful life which was generally five to seven years. This resulted in the need to track every piece of kitchen equipment and make sure to catalog all items that broke and were replaced during the year. This became far too cumbersome for any active restaurant owner.

The IRS listened and effective 1/1/2016, the IRS will allow you to immediately expense all items costing $2,500 or less. There is a higher threshold for certain taxpayers but most independent restaurants do not meet this criteria. We highly recommend adopting this as a written policy of your restaurant. While the written policy is not required by the IRS, it won't hurt and provides a bit of formality to your adoption of the rule.

There is an annual election that needs to be made with any tax return where this policy was followed. Best practice is to file this election with every return whenever this rule may apply.

Section 179

Section 179 has to be one of the most commonly known IRS tax code sections ever written. Rarely does a law change attach the actual IRS code section to the common name, but maybe a CPA came up with this - we aren't the most creative bunch. Section 179 has been around for many years but has had very little consistency from year to year.

In basic terms, Section 179 allows restaurant owners to immediately expense asset purchases instead of deducting the cost over 3, 5, 7 or even 15 years! Tying Section 179 to the $2,500 capitalization policy above would allow a restaurant owner to recognize an immediate tax savings after the purchase of nearly any new equipment. Section 179 will apply to new and used assets whether they are bought for cash, purchased with a loan or acquired with certain types of leases.

In 2016, Section 179 can be utilized on up to $500,000 in equipment as long as your restaurant does not buy over $2,000,000 worth of total equipment in 2016. The assets must be put into service by December 31, 2016. An item on order or a deposit on a new piece of equipment will not qualify for this deduction.

Minnesota has its own rules surrounding Section 179. Unfortunately, the State of MN has not complied with the federal law and only allows you to deduct $25,000 using Section 179 with a total purchase limit of $200,000. This can result in a restaurant having little to no tax obligation to the IRS and owing the State of MN more total tax than the IRS. Minnesota requires special tracking of these assets and spreads the deduction over the next 5 years.

There are many factors that go into claiming Section 179. Section 179 can be taken on one asset, all assets or none of a restaurant's newly acquired assets. The classic reaction is to take as much Section 179 as possible, but there are many different effects to consider. Having a good discussion with your CPA will save you a lot of headaches in the future.

Bonus Depreciation

A powerful "sibling" to Section 179 is Bonus Depreciation. I use sibling because the two can work harmoniously, but they also experience occasional conflict. Bonus Depreciation allows a restaurant to immediately take 50% of the cost of the new asset plus an additional amount of the residual value. The residual value is depreciated over the IRS-established useful life of the asset.

Bonus Depreciation is only allowed on new assets so it cannot be used as universally as Section 179, but it can be extremely powerful when used correctly. Bonus Depreciation is also only allowed to be utilized on specific groups of assets. The groups are combined by the IRS-defined useful life of the asset.

In order to make everything slightly more complicated than it needs to be, Minnesota once again does not follow the IRS rules related to Bonus Depreciation. Minnesota technically "allows" Bonus Depreciation but instead of allowing that deduction in one year, Minnesota allows 20% of the restaurant's Bonus Depreciation in year one and spreads the remaining 80% over the next five years.

Bonus Depreciation is another deduction that needs to be evaluated carefully and should involve plenty of discussion with your CPA.

Payroll Tax

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) is an employer credit tied to hiring individuals from certain targeted groups that have historically experienced barriers to employment. In 2016, the targeted groups include:

- Unemployed Veterans (including disabled veterans)
- Temporary Assistance for Needy Families (TANF) Recipients
- Food Stamp (SNAP) Recipients
- Designated Community Residents (living in Empowerment Zones or Rural Renewal Counties)
- Vocational Rehabilitation Referred Individuals
- Ex-Felons
- Supplemental Security Income Recipients
- Summer Youth Employees (living in Empowerment Zones)

The WOTC can be administratively intense to successfully claim, however it can result in a tax credit of $1,200 – $9,600 per employee depending on the group above. This means a dollar for dollar reduction in the amount owed to the IRS. The WOTC has strict timelines for application but the potential tax credit can be so lucrative it's important not to overlook it.

A great practice is to supply all new hires with a Form 8850 along with their new hire packets. This form is filled out by the new hire and simply tells the employer whether the employee falls into one of the above groups. If the new hire indicates they fall into one of the targeted groups, the employer has 28 days to submit this signed form electronically, via fax or by mail to the Minnesota Department of Employment and Economic Development.

Employer Tip Credit

The Employer Tip Credit is arguably the most beneficial restaurant-specific tax credit under current tax law. The credit can be complicated to calculate in states that allow employers to pay their tipped employees less than minimum wage, but for better or worse, Minnesota does not allow this. As employees report their tips on their payroll, the restaurant is required to match Social Security and Medicare on all of these wages. This boils down to the restaurant having to pay 7.65% extra in payroll tax on wages that went straight to the employee from the patron. There is, however, a silver lining to this. All of that extra payroll tax paid in by the restaurant can be claimed back as a tax credit on the owner's tax return. Much like the WOTC, this Tip Credit will reduce, dollar for dollar, any tax obligation to the IRS.

To put this in real terms, if the tipped employees of a restaurant collectively claim $50,000 worth of tips received during 2016, the restaurant has paid 7.65% in payroll taxes on those tips. When the company tax return and then the owner's tax return are filed, the owner will get $3,825 as a tax credit to offset their total IRS obligation. While it's technically a tax credit that has been paid for, it can be a nice surprise to offset a restaurant owner's personal tax obligation.

Sales Tax

Auto Gratuities

Auto Gratuities are a classic fight between a restaurant's necessity and a regulatory nightmare. Every restaurant owner knows a server that has been run ragged trying to keep up with a party of 10, only to get tipped 5%. Auto Gratuities should be a simple answer to this annoying problem. This transaction was unfortunately complicated by the IRS and the State of MN. To make it even worse, they complicated this transaction in different ways.

Let's tackle the IRS problem first. Auto Gratuities in the eyes of the IRS are cash wages to employees, NOT a tip. This means it needs to be included on the employee's payroll and it is NOT eligible for the employer tip credit discussed above. This can mean $7.65 in lost tax credits for every $100 of Auto Gratuities claimed instead of a regular tip.

Minnesota decided this was a sales taxable transaction. Not only is it sales taxable, it should be sales taxed at the appropriate percentage of liquor vs food tax as the overall bill breaks down to. Which means if the customer spent $75 on food and $25 on liquor, the auto-gratuity should be taxed 75% at the base food sales tax rate and 25% at the increased liquor sales tax rate. This sounds like a tracking nightmare, so it's time to say thank you to our point of sale providers.

Employee Meals

Employee meals are handled in two distinct ways. If the employee receives a discounted meal, simply charge sales tax on what the employee pays for the meal. If the original price of the meal is $15 but the employee receives $10 off per shift, tax the $5. Easy enough.

If the employee receives a free meal, however, it requires a little more tracking. The restaurant must pay Use tax (self-imposed sales tax) on the cost of the food and all the taxable items that went along with that meal. That cost includes disposable cups, napkins, straws and soft drinks.

Keeping up on the ever changing tax environment from various government agencies can be daunting. Hopefully after reading the items above, and with a great team around you, tax season can be a little less mysterious.

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